

HBOS plc

Half-Year Management Report

For the half-year to 30 June 2012

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

This announcement contains forward looking statements with respect to the business, strategy and plans of HBOS plc, its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the HBOS Group or the HBOS Group's management's beliefs and expectations, are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will or may occur in the future. The HBOS Group's actual future business, strategy, plans and/or results may differ materially from those expressed or implied in these forward looking statements as a result of a variety of risks, uncertainties and other factors, including UK domestic and global economic and business conditions; the ability to derive cost savings and other benefits, including as a result of the Lloyds Banking Group's Simplification programme; the ability to access sufficient funding to meet the HBOS Group's liquidity needs; changes to HBOS plc's, Lloyds TSB Bank plc's or Lloyds Banking Group plc's credit ratings; risks concerning borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability; changing demographic and market related trends; changes in customer preferences; changes to laws, regulation, accounting standards or taxation, including changes to regulatory capital or liquidity requirements; the policies and actions of governmental or regulatory authorities in the UK, the European Union, or jurisdictions outside the UK, including other European countries and the US; the implementation of the draft EU crisis management framework directive and banking reform following the recommendations made by the Independent Commission on Banking; the ability to attract and retain senior management and other employees; requirements or limitations imposed on Lloyds Banking Group plc, Lloyds TSB Bank plc and the HBOS Group as a result of HM Treasury's investment in Lloyds Banking Group plc; the ability to complete satisfactorily the disposal of certain assets as part of the Lloyds Banking Group's EC state aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations, market disruptions and illiquid markets; the effects of competition and the actions of competitors, including non-bank financial services and lending companies; exposure to regulatory scrutiny, legal proceedings, regulatory investigations or complaints, and other factors. Please refer to Lloyds Banking Group plc's latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements. The forward looking statements contained in this announcement are made as at the date of this announcement, and the HBOS Group undertakes no obligation to update any of its forward looking statements.

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FINANCIAL REVIEW

Principal activities

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

During 2011, the Group earned revenue 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; general insurance; and private banking and asset management.

However, following the restructuring of the Lloyds Banking Group's insurance entities described below, with effect from July 2011 the Group no longer has any general insurance activities and its life, pensions and investments activities are greatly reduced.

Review of results

In July 2011, the Lloyds Banking Group completed a restructuring of the legal ownership of its insurance businesses, as a result of which the Group's subsidiary, HBOS Insurance & Investment Group Limited, sold its wholly owned life, pensions and general insurance subsidiaries to Lloyds TSB General Insurance Holdings Limited and Scottish Widows Financial Services Holdings Limited, which are also wholly owned by Lloyds TSB Bank plc.

The Group recorded a profit before tax of £64 million for the six months to 30 June 2012 compared to a loss before tax of £1,977 million for the six months to 30 June 2011. The loss in 2011 was partly due to a £1,155 million charge in respect of payment protection insurance (see note 14), and there was a similar charge of £240 million in the six months to 30 June 2012 but this has been offset by a past service credit of £258 million relating to the Group's defined benefit pension schemes (see note 3).

Total income net of insurance claims decreased by £1,535 million to £4,125 million for the six months to 30 June 2012 from £5,660 million in the six months to 30 June 2011.

Net interest income decreased by £577 million to £3,584 million in the six months to 30 June 2012 compared to £4,161 million in the same period in 2011. Net interest margins fell, reflecting increased funding costs, the impact of the sale of assets which are outside of the Lloyds Banking Group's risk appetite and strong deposit growth in an increasingly competitive market.

Other income decreased by £2,381 million to £1,594 million in the six months to 30 June 2012, compared to £3,975 million in the same period in 2011, largely due to a £1,618 million reduction in insurance premium income following the disposal of the Group's wholly owned life, pensions and general insurance subsidiaries together with losses on the sale of assets which are outside of the Lloyds Banking Group's risk appetite

Net trading income decreased by £290 million to £1,235 million in the six months to 30 June 2012, comprising a decrease of £382 million in the income from insurance businesses partly offset by a £92 million increase in banking income. The decrease of £382 million in insurance income reflects £929 million reduction in income following the sale of the Group's wholly owned insurance businesses partly offset by a £548 million increase in income within the Group's retained insurance business; largely matched by an increase in insurance claims expense. Net trading income within the Group's banking business was £140 million for the six months to 30 June 2012 compared with £48 million for the six months to 30 June 2011.

There was a reduction of £1,423 million in the insurance claims expense to £1,053 million in the six months to 30 June 2012 compared to £2,476 million in the six months to 30 June 2011; £1,894 million was as a result of the sale of the Group's wholly owned insurance businesses, but this was partly offset by an increase of £471 million which largely matched the improvement in net trading income driven by the impact of market conditions on the policyholder assets within the Group's retained insurance business, relative to the six months to 30 June 2011.

FINANCIAL REVIEW (continued)

Total operating expenses decreased by £1,755 million to £1,779 million in the six months to 30 June 2012 compared to £3,534 million in the six months to 30 June 2011; this decrease largely reflects the fact that there was a £1,155 million charge in respect of payment protection insurance in the six months to 30 June 2011, compared to £240 million in the six months to 30 June 2012. Excluding these charges, operating expenses decreased by £840 million to £1,539 million in the six months to 30 June 2012, compared to £2,379 million in the six months to 30 June 2011, reflecting a past service credit in relation to the Group's defined benefit pension schemes of £258 million (six months to 30 June 2011: nil) and the impact of the sale of the Group's wholly owned insurance subsidiaries together with continuing cost synergies arising from the combination of the Lloyds TSB and HBOS businesses.

Impairment losses decreased by £1,821 million to £2,282 million in the six months to 30 June 2012 compared to £4,103 million in the six months to 30 June 2011. The reduced charge was a result of the continued application of the Group's prudent risk appetite and strong risk management controls resulting in improved portfolio and business quality, from continued low interest rates, partly offset by subdued UK economic growth and a weak commercial real estate market; together with significantly lower charges from the Group's wholesale Irish and Australasian portfolios.

On the balance sheet, total assets were £8,240 million higher at £576,239 million at 30 June 2012, compared to £567,999 million at 31 December 2011, reflecting the continuing disposal of assets which are outside of the Group's risk appetite, customer deleveraging and de-risking and subdued demand in lending markets offset by the placing of funds with other Lloyds Banking Group entities. Loans and advances to customers decreased by £26,775 million, or 7 per cent, from £357,110 million at 31 December 2011 to £330,335 million at 30 June 2012; debt securities held as loans and receivables decreased by £6,104 million, or 54 per cent, from £11,276 million at 31 December 2011 to £5,172 million at 30 June 2012, again reflecting disposals of assets outside of the Lloyds Banking Group's risk appetite. Trading and other financial assets at fair value through profit or loss were £10,836 million higher at £56,183 million at 30 June 2012 compared to £45,347 million at 31 December 2011. Shareholders' equity increased by £774 million, from £23,771 million at 31 December 2011 to £24,545 million at 30 June 2012.

At 30 June 2012, the Group's core tier 1 capital ratio increased to 11.5 per cent compared to 10.8 per cent at 31 December 2011, principally driven by a reduction in risk-weighted assets of £15,198 million. The total capital ratio improved to 16.9 per cent (compared to 16.0 per cent at 31 December 2011). Risk-weighted assets reduced by 8 per cent to £184,126 million at 30 June 2012 compared to £199,324 million at 31 December 2011 due to the asset disposals and subdued demand for new lending noted above, together with continued improvements to the overall quality of the Group's portfolios, partially offset by the application of revised regulatory rules relating to the Group's private equity (including venture capital) investments which are now risk-weighted rather than being deducted from total capital. The removal of this deduction from total capital contributed to the improvement in the total capital ratio.

PRINCIPAL RISKS AND UNCERTAINTIES

The principal risks and uncertainties facing the Group in the second half of 2012 are:

Economy

Global economic growth deteriorated in the first half of 2012. Emerging markets, having been the mainstay of global growth since the financial crisis broke, slowed as last year's monetary policy tightening designed to tackle rising inflation took effect. In the Eurozone, some countries with particularly high government debt or deficit levels have struggled to achieve the necessary fiscal tightening to bring their public finances onto a sustainable trajectory, and their growth prospects weakened significantly as more tightening was planned and their costs of sovereign borrowing rose. In the US, public finance concerns are less immediate, but the unsustainable long-term trajectory of debt on current policies has led to political stalemate, raising the risk of sudden fiscal tightening at the start of 2013 as previous loosening measures expire.

Whilst initial GDP estimates are unreliable, current data suggests the UK economy entered a 'double-dip' recession in the first quarter of 2012, on the technical definition of two consecutive quarters of falling GDP. The declines in GDP across the two quarters are small, however, and generally consistent with a broadly stagnant economy rather than one falling into a deepening contraction.

The Irish economy appears to have grown in 2011 for the first time since 2007. Strict austerity measures in recent years targeted at improving international competitiveness are beginning to pay off – weak domestic demand is now being more than offset by increasing net exports.

Future economic developments in the UK and Ireland are highly contingent on how successful political leaders are at stemming the Eurozone crisis, to what extent the private sector can offset shrinking of the public sector, and how the implementation of new regulation on banks impacts their ability to supply credit whilst meeting tighter capital and liquidity criteria. The recent weakening in the Eurozone economy and the balance of risks make recession there through 2012 the most likely scenario.

Liquidity and funding risk

Liquidity and funding is managed at a Lloyds Banking Group level and continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on maintaining confidence in the short and long-term wholesale funding markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.

During the first half of 2012 there has been good investor demand across a range of term products, notwithstanding fears over the Eurozone and the threat of credit rating downgrades. Lloyds Banking Group took advantage of this demand and completed its full year 2012 term funding requirement in the first half. The stock of primary liquid assets increased during the half and the Group continued to meet its regulatory liquidity ratios at all times.

Lloyds Banking Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group's funding plan. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

The combination of right-sizing the balance sheet and continued development of the retail deposit base has seen the Group's wholesale funding requirement reduced materially in the past three years. The progress the Group has made to date in diversifying its funding sources has further strengthened its funding base with further significant progress during the first half of 2012.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)**Credit risk**

Lloyds Banking Group achieved a significant reduction in its impairment charge, due primarily to lower impairments in the non-core Irish and Australasian portfolios, together with strong Retail performance and lower charges on leveraged acquisition finance exposures within Wholesale. Prudent credit policies and procedures are in place throughout the Group, focusing on development of enduring client relationships through the cycle. As a result of this approach, the credit quality of new lending remains strong.

These lower charges were supported by the continued application of our conservative risk appetite and strong risk management controls resulting in an improved portfolio overall and good new business quality, continued low interest rates, and broadly stable UK retail property prices, partly offset by subdued UK economic growth, high unemployment and a weak commercial real estate market. The Group's exposure to Ireland is being closely managed, with a dedicated UK-based business support team in place to manage the winding down of the book.

Lloyds Banking Group continues to proactively manage down sovereign as well as banking and trading book exposure to selected Eurozone countries.

Regulatory

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which Lloyds Banking Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group. This is particularly the case in the current market environment, which continues to witness high levels of government and regulatory intervention in the banking sector. Lloyds Banking Group faces increased political and regulatory scrutiny as a result of its size and systemic importance.

Independent Commission on Banking and White Paper on banking reform

The Government appointed an Independent Commission on Banking (ICB) to review possible measures to reform the banking system and promote stability and competition. The ICB published its final report on the 12 September 2011 putting forward recommendations to require ring-fencing of the retail activities of banks from their investment banking activities and additional capital requirements beyond those required under current drafts of the Capital Requirements Directive IV. The report also makes recommendations in relation to the competitiveness of the UK banking market, including enhancing the competition remit of the new Financial Conduct Authority (FCA), implementing a new industry-wide switching solution by September 2013, and improving transparency. The ICB, which following the final report completed its mandate, had the authority only to make recommendations, which the Government could choose to accept or reject.

The ICB specifically recommended in relation to the Group's European Commission mandated branch disposal (Project Verde), that to create a strong challenger in the UK banking market, the entity which results from the divestment should have, or have the capability to achieve, a share of the personal current account (PCA) market of at least 6 per cent (although this does not need to arise solely from the current accounts acquired from the Group) and a funding position at least as strong as its peers.

The Government supported the recommendation that an entity with a larger share of the PCA market than the 4.6 per cent originally proposed might produce a more effective competitor. In relation to the Group's announcement that it was to pursue exclusive negotiations with The Co-operative Group, the Government commented that such a transaction would deliver a significant enhancement of the PCA market share, with the share divested by the Group combining with The Co-operative Group's existing share to create a competitor with approximately 7-8 per cent share of the PCA market. The Government also stated that the execution of the divestment is a commercial matter, and that it has no intention of using its shareholding to deliver an enhancement.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

The Government published its response to the ICB recommendations on 19 December 2011 and a White Paper in June 2012. The Government has endorsed the ICB's proposals to ring-fence retail banking operations as part of a wider regulatory framework including capital and liquidity and effective macro- and micro-prudential supervision, which aims to remove any implicit tax-payers' guarantee for the ring-fenced entities. The White Paper suggests that a broader range of customers, products and geographies could be allowed inside the ring-fenced bank and recommends 2019 as an implementation deadline. The Government no longer considers it necessary to give authorities the power to impose a separate resolution buffer to ensure that banks have adequate loss-absorbing capacity. Given that the Group is predominantly a retail and commercial bank, it would expect to be less affected by the implementation of a retail ring-fence, but believes it will be important for any transition period to be flexible in order to minimise any impact on economic growth, and for banks to implement the required structural changes.

The ICB also recommended that ring-fenced banks should hold a common equity capital base of at least 10 per cent and primary loss-absorbing capacity of at least 17 per cent to absorb the impact of potential losses or financial crises.

New regulatory regime

On 27 January 2012, the Government published the Financial Services Bill. The proposed new UK regulatory architecture will see the transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). The PRA will be responsible for supervising banks, building societies and other large firms. The FCA will focus on consumer protection and market regulation. The Bill is also proposing new responsibilities and powers for the FCA. The most noteworthy are the proposed greater powers for the FCA in relation to competition and the proposal to widen its scope to include consumer credit. The Bill is expected to take effect in early 2013.

On 2 April 2012 the FSA introduced a new 'twin peaks' model and the intention is to move the FSA as close as possible to the new style of regulation outlined in the Bill. There will be two independent groups of supervisors for banks, insurers and major investment firms covering prudential and conduct. (All other firms (ie those not dual regulated) will be solely supervised by the conduct supervisors).

In addition, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory matters across the EU.

Capital and liquidity

Evolving capital and liquidity requirements continue to be a priority for the Group. The Basel Committee on Banking Supervision has put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of 'capital', introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2013 and 2021.

Solvency II

The Solvency II Directive will introduce enhanced capital adequacy and risk management requirements for insurers, with the ultimate aim of increasing policyholder protection. It is now expected to be implemented in January 2014. It sets out a harmonised, risk-based framework for managing insurance business and calculating capital requirements and also introduces improved disclosure and reporting requirements. It will give the regulators enhanced powers and responsibilities.

Anti bribery

The Bribery Act 2010 came fully into force on 1 July 2011. It enhances previous laws on bribery and is supported by some detailed guidance issued by the Ministry of Justice on the steps a business needs to take to embed 'adequate procedures' to prevent bribery. A company convicted of failing to have 'adequate procedures' to prevent bribery could receive an unlimited fine.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)***US regulation***

Significant regulatory initiatives from the US impacting the Group include the Dodd-Frank Act (which imposes specific requirements for systemic risk oversight, securities market conduct and oversight, bank capital standards, arrangements for the liquidation of failing systemically significant financial institutions and restrictions to the ability of banks to engage in proprietary trading activities known as the 'Volcker Rule'). Furthermore, under the so-called swap 'push-out' provisions of the Dodd-Frank Act, the derivatives activities of US banks and US branch offices of foreign banks will be restricted, which may necessitate a restructuring of how the Group conducts its derivatives activities. Entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants will be required to register with the SEC or the US Commodity Futures Trading Commission, or both, and will become subject to the requirements as to capital, margin, business conduct, recordkeeping and other requirements applicable to such entities.

The Dodd-Frank Act also grants the SEC discretionary rule-making authority to impose a new fiduciary standard on brokers, dealers and investment advisers, and expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the United States with respect to violations of the antifraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. The details of these regulations will depend on the final regulations ultimately adopted by various US regulatory authorities. In addition the Foreign Account Tax Compliance Act (FATCA) requires non-US financial institutions to enter into disclosure agreements with the US Treasury and all non-financial non-US entities to report and/or certify their ownership of US assets in foreign accounts or be subject to 30 per cent withholding tax.

European regulation

At a European level, the pace of regulatory reform has increased with a number of new directives or changes to existing directives planned in the next 12 months including a revised Markets in Financial Instruments Directive, Transparency Directive, European Markets Infrastructure Regulations, Insurance Mediation Directive and a Fifth Undertakings in Collective Investments in Transferable Securities Directive as well as a proposed Directive regulating Packaged Retail Investment Products. Despite opposition from the UK Government, a proposed Financial Transaction Tax is a possibility for EU-wide implementation.

Market risk

There is a risk to the Group's banking income arising from the level of interest rates and the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Equity market movements and changes in credit spreads impact the Group's results.

- The main equity market risks arise in the life assurance companies and staff pension schemes.
- Credit spread risk arises in the life assurance companies, pension schemes and banking businesses.

Continuing concerns about the fiscal position in Eurozone countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the euro and widened spreads between central bank and interbank rates.

Customer treatment

Customer treatment and how the Group manages its customer relationships affect all aspects of the Group's operations and are closely aligned with achievement of the Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products across different brands and numerous distribution channels to an extremely broad and varied customer base, we face significant conduct risks, such as: products or services not meeting the needs of our customers; sales processes which could result in selling products to customers which do not meet their needs; and failure to deal with a customer's complaint effectively where we have got it wrong and not met customer expectations.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

There remains a high level of scrutiny regarding the treatment of customers by financial institutions from regulatory bodies, the press, and politicians. The FSA in particular continues to drive focus on conduct of business activities through its supervision activity.

There is a risk that certain aspects of the Group's business may be determined by regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

People risk

The quality and effectiveness of the Group's people are fundamental to its success. Consequently, the Group's management of material people risks is critical to its capacity to deliver against its long-term strategic objectives. Over the next six months the Group's ability to manage people risks successfully may continue to be affected by the following key drivers:

- the Group's continuing structural consolidation and the sale of part of our branch network under Project Verde may result in disruption to our ability to lead and manage our people effectively;
- the continually changing, more rigorous regulatory environment, may impact our people strategy, remuneration practices and retention; and
- macroeconomic conditions and negative media attention on the banking sector may impact retention, colleague sentiment and engagement.

Insurance risk

The major sources of insurance risk are within the insurance businesses and the Group's defined benefit staff pension schemes (pension schemes). Insurance risk is inherent in the insurance business and can be affected by customer behaviour. Insurance risks accepted relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The primary insurance risk carried by the Group's pension schemes is related to longevity.

Insurance risk within the insurance businesses has the potential to significantly impact the earnings and capital position of the Insurance Division of the Group. For the Group's pension schemes, insurance risk could significantly increase the cost of pension provision and impact the balance sheet of the Group.

State funding and state aid

HM Treasury currently holds 39.2 per cent of Lloyds Banking Group's ordinary share capital. United Kingdom Financial Investments Limited (UKFI) as manager of HM Treasury's shareholding continues to operate in line with the framework document between UKFI and HM Treasury managing the investment in Lloyds Banking Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group, although there have been no indications that the Government intends to change the existing operating arrangements.

Lloyds Banking Group made a number of undertakings to HM Treasury arising from the capital and funding support, including the provision of additional lending to certain mortgage and business sectors for the two years to 28 February 2011, and other matters relating to corporate governance and colleague remuneration. The lending commitments were subject to prudent commercial lending and pricing criteria, the availability of sufficient funding and sufficient demand from creditworthy customers. These lending commitments were delivered in full in the second year.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

The subsequent agreement (known as Merlin) between five major UK banks (including Lloyds Banking Group) and the Government in relation to gross business lending capacity in the 2011 calendar year was subject to a similar set of criteria. Lloyds Banking Group delivered in full its share of the commitments by the five banks, both in respect of lending to SMEs and in respect of overall gross business lending. The Group has made a unilateral lending pledge for 2012 as part of its publicly announced SME charter.

In addition, Lloyds Banking Group is subject to European state aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of Lloyds Banking Group and remedy any distortion of competition and trade in the European Union (EU) arising from the state aid given to Lloyds Banking Group. This has placed a number of requirements on Lloyds Banking Group including an asset reduction target from a defined pool of assets by the end of 2014, known as Project Atlantic, and the disposal of certain portions of its Retail business by the end of November 2013, known as Project Verde. In June 2011 the Group issued an Information Memorandum to potential bidders, covering this retail banking business, which the European Commission confirmed met the requirements to commence the formal sale process for the sale no later than 30 November 2011. On 14 December 2011 Lloyds Banking Group announced that, having reviewed the formal offers made, its preferred option was for a direct sale and that it was entering exclusive discussions with The Co-operative Group. On 19 July 2012 Lloyds Banking Group announced that it has agreed non-binding heads of terms with The Co-operative Group for the Verde business. Lloyds Banking Group will continue to work with the Co-operative to agree a sale and purchase agreement, with completion of the divestment expected by the end of November 2013. Lloyds Banking Group continues to work closely with the FSA, EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the Restructuring Plan and will now seek formal approval for the terms of the divestment. Lloyds Banking Group is also continuing to progress an Initial Public Offering (IPO) in parallel as a fall back option.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

	Note	Half-year to 30 June 2012 £ million	Half-year to 30 June 2011 £ million
Interest and similar income		8,032	8,310
Interest and similar expense		(4,448)	(4,149)
Net interest income		3,584	4,161
Fee and commission income		828	936
Fee and commission expense		(252)	(438)
Net fee and commission income ¹		576	498
Net trading income		1,235	1,525
Insurance premium income		17	1,635
Other operating income		(234)	317
Other income	2	1,594	3,975
Total income		5,178	8,136
Insurance claims ¹		(1,053)	(2,476)
Total income, net of insurance claims		4,125	5,660
Payment protection insurance provision	14	(240)	(1,155)
Other operating expenses		(1,539)	(2,379)
Total operating expenses	3	(1,779)	(3,534)
Trading surplus		2,346	2,126
Impairment	4	(2,282)	(4,103)
Profit (loss) before tax		64	(1,977)
Taxation	5	(53)	387
Profit (loss) for the period		11	(1,590)
Profit attributable to non-controlling interests		10	12
Profit (loss) attributable to equity shareholders		1	(1,602)
Profit (loss) for the period		11	(1,590)

¹ See note 2.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

	Half-year to 30 June 2012 £ million	Half-year to 30 June 2011 £ million
Profit (loss) for the period	11	(1,590)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	268	153
Income statement transfers in respect of disposals	(140)	(6)
Income statement transfers in respect of impairment	333	509
Other income statement transfers	68	50
Taxation	(132)	(175)
	397	531
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value	409	459
Net income statement transfers	29	290
Taxation	(94)	(207)
	344	542
Currency translation differences (tax: nil)	32	(60)
Other comprehensive income for the period, net of tax	773	1,013
Total comprehensive income for the period	784	(577)
Total comprehensive income attributable to non-controlling interests	10	12
Total comprehensive income attributable to equity shareholders	774	(589)
Total comprehensive income for the period	784	(577)

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED BALANCE SHEET**

		As at 30 June 2012 £ million	As at 31 Dec 2011 £ million
	Note		
Assets			
Cash and balances at central banks		6,179	3,075
Items in course of collection from banks		339	379
Trading and other financial assets at fair value through profit or loss	6	56,183	45,347
Derivative financial instruments		36,270	36,253
Loans and receivables:			
Loans and advances to banks		119,522	91,210
Loans and advances to customers	7	330,335	357,110
Debt securities		5,172	11,276
		455,029	459,596
Available-for-sale financial assets		7,474	10,498
Investment properties		1,529	1,686
Goodwill		859	859
Value of in-force business		144	147
Other intangible assets		88	76
Tangible fixed assets		2,304	2,372
Current tax recoverable		235	338
Deferred tax assets		3,759	3,977
Retirement benefit assets		753	394
Other assets		5,094	3,002
Total assets		576,239	567,999

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED BALANCE SHEET**

	Note	As at 30 June 2012 £ million	As at 31 Dec 2011 £ million
Equity and liabilities			
Liabilities			
Deposits from banks		156,810	150,042
Customer deposits		218,485	217,048
Items in course of transmission to banks		728	332
Trading liabilities		30,238	20,805
Derivative financial instruments		32,522	33,385
Notes in circulation		1,090	1,145
Debt securities in issue	10	60,039	75,457
Liabilities arising from insurance contracts and participating investment contracts		399	385
Liabilities arising from non-participating investment contracts		24,068	22,207
Other liabilities		12,700	8,184
Retirement benefit obligations		122	107
Current tax liabilities		37	54
Deferred tax liabilities		3	1
Other provisions		740	1,064
Subordinated liabilities	11	13,302	13,613
Total liabilities		551,283	543,829
Equity			
Share capital	12	3,763	3,763
Share premium account	13	18,655	18,655
Other reserves	13	11,296	10,523
Retained profits	13	(9,169)	(9,170)
Shareholders' equity		24,545	23,771
Non-controlling interests		411	399
Total equity		24,956	24,170
Total equity and liabilities		576,239	567,999

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**

	Attributable to equity shareholders				Non-controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million		
Balance at 1 January 2012	22,418	10,523	(9,170)	23,771	399	24,170
Comprehensive income						
(Loss) profit for the period	–	–	1	1	10	11
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	397	–	397	–	397
Movements in cash flow hedging reserve, net of tax	–	344	–	344	–	344
Currency translation differences (tax: nil)	–	32	–	32	–	32
Total other comprehensive income	–	773	–	773	–	773
Total comprehensive income	–	773	1	774	10	784
Transactions with owners						
Dividends paid	–	–	–	–	(10)	(10)
Change in non-controlling interests	–	–	–	–	12	12
Total transactions with owners	–	–	–	–	2	2
Balance at 30 June 2012	22,418	11,296	(9,169)	24,545	411	24,956

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED STATEMENT OF CHANGES IN EQUITY** (continued)

	Attributable to equity shareholders				Non-controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million		
Balance at 1 January 2011	22,418	8,857	(5,415)	25,860	550	26,410
Comprehensive income						
(Loss) profit for the period	–	–	(1,602)	(1,602)	12	(1,590)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	531	–	531	–	531
Movements in cash flow hedging reserve, net of tax	–	542	–	542	–	542
Currency translation differences (tax: nil)	–	(60)	–	(60)	–	(60)
Total other comprehensive income	–	1,013	–	1,013	–	1,013
Total comprehensive income	–	1,013	(1,602)	(589)	12	(577)
Transactions with owners						
Dividends	–	–	–	–	(8)	(8)
Value of employee services:						
Share option schemes	–	–	4	4	–	4
Change in non-controlling interests	–	–	–	–	(197)	(197)
Total transactions with owners	–	–	4	4	(205)	(201)
Balance at 30 June 2011	22,418	9,870	(7,013)	25,275	357	25,632
Comprehensive income						
(Loss) profit for the period	–	–	(2,161)	(2,161)	30	(2,131)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(135)	–	(135)	–	(135)
Movements in cash flow hedging reserve, net of tax	–	734	–	734	–	734
Currency translation differences (tax: nil)	–	54	–	54	–	54
Total other comprehensive income	–	653	–	653	–	653
Total comprehensive income	–	653	(2,161)	(1,508)	30	(1,478)
Transactions with owners						
Dividends	–	–	–	–	(7)	(7)
Value of employee services:						
Share option schemes	–	–	4	4	–	4
Change in non-controlling interests	–	–	–	–	19	19
Total transactions with owners	–	–	4	4	12	16
Balance at 31 December 2011	22,418	10,523	(9,170)	23,771	399	24,170

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)**CONSOLIDATED CASH FLOW STATEMENT**

	Half-year to 30 June 2012 £ million	Half-year to 30 June 2011 £ million
Profit (loss) before tax	64	(1,977)
Adjustments for:		
Change in operating assets	(7,142)	1,865
Change in operating liabilities	8,108	(3,564)
Non-cash and other items	(1,174)	(379)
Tax paid	(6)	(66)
Net cash used in operating activities	(150)	(4,121)
Cash flows from investing activities		
Purchase of available-for-sale financial assets	(1,724)	(3,867)
Proceeds from sale and maturity of available-for-sale financial assets	4,819	8,046
Purchase of fixed assets	(272)	(372)
Proceeds from sale of fixed assets	484	916
Acquisition of businesses, net of cash acquired	(10)	(59)
Disposal of businesses, net of cash disposed	5	238
Net cash provided by investing activities	3,302	4,902
Cash flows from financing activities		
Dividends paid to non-controlling interests	(10)	(8)
Interest paid on subordinated liabilities	(326)	(405)
Repayment of subordinated liabilities	–	(92)
Change in non-controlling interests	12	(12)
Net cash used in financing activities	(324)	(517)
Effects of exchange rate changes on cash and cash equivalents	(38)	2
Change in cash and cash equivalents	2,790	266
Cash and cash equivalents at beginning of period	6,642	9,543
Cash and cash equivalents at end of period	9,432	9,809

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

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1. Accounting policies, presentation and estimates

These condensed consolidated half-year financial statements as at and for the period to 30 June 2012 have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority (FSA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union and comprise the results of HBOS plc (the Company) together with its subsidiaries (the Group). They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2011 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2011 annual report and accounts are available on the Lloyds Banking Group's website and are available upon request from Investor Relations, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the condensed consolidated half-year financial statements. In reaching this assessment, the directors have considered projections for the Group's capital and funding position and have had regard to the factors set out in Principal risks and uncertainties: Liquidity and funding on page 3.

The Group had previously included annual management charges on non-participating investment contracts within insurance claims; during the second half of 2011, in light of developing industry practice, the Group changed its treatment and these amounts (half-year to 30 June 2012: £232 million; half-year to 30 June 2011: £251 million) are now included within net fee and commission income.

As the Group's share of results of joint ventures and associates is no longer significant, this is now included within other operating income and the related asset reported within other assets; comparatives have been re-presented on a consistent basis.

Accounting policies

The accounting policies are consistent with those applied by the Group in its 2011 annual report and accounts.

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2012 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period.

In accordance with IAS 19 *Employee Benefits* and the Group's normal practice, the valuation of the Group's pension schemes will be formally updated at the year end. No adjustment has been made to the valuation at 30 June 2012.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may include amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. There have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2011.

1. Accounting policies, presentation and estimates (continued)***Payment protection insurance***

During 2011 and the first half of 2012, the Group has charged a total provision of £1,395 million in respect of payment protection insurance (PPI) policies as a result of discussions with the FSA and a judgment handed down by the UK High Court (see note 14 for more information). The provision represents management's best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties in assessing the impact of detailed implementation of the FSA Policy Statement of 10 August 2010.

The provision requires significant judgement by management in determining appropriate assumptions, which include the level of complaints, uphold rates, proactive contact and response rates, Financial Ombudsman Service (FOS) referral and uphold rates as well as redress costs for each of the many different populations of customers identified by the Group in its analyses used to determine the best estimate of the anticipated costs of redress. Following an increase in the volume of complaints received, the Group decided to increase the provision by £240 million in the first half of 2012. Going forward, if the level of policies complained about was one percentage point higher (lower) than estimated for all policies open within the last seven years then the provision would increase (decrease) by approximately £15 million. There are a large number of inter-dependent assumptions underpinning the provision; this sensitivity assumes that all assumptions, other than the level of complaints, remain constant.

The Group will re-evaluate the assumptions underlying its analysis at each reporting date as more information becomes available. As noted above, there is inherent uncertainty in making estimates; actual results in future periods may differ from the amount provided.

New accounting pronouncements

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2012. Neither of these standards or amendments to standards has had a material impact on these financial statements.

(i) Disclosures – Transfers of Financial Assets (Amendments to IFRS 7)

This Amendment to IFRS 7 requires disclosures in respect of all transferred financial assets that are not derecognised in their entirety and transferred assets that are derecognised in their entirety but with which there is continuing involvement. Where appropriate, these disclosures will be made in the Group's financial statements for the year ended 31 December 2012.

(ii) Deferred Tax: Recovery of Underlying Assets (Amendment to IAS 12)

Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis. Although this Amendment has not yet been endorsed by the EU, the Group's existing practices are consistent with this Amendment.

Details of those IFRS pronouncements which will be relevant to the Group but which will not be effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 18.

2. Other income

	Half-year to 30 June 2012 £m	Half-year 30 June 2011 £m
Fee and commission income:		
Current account fees	149	184
Credit and debit card fees	131	96
Other fees and commissions ¹	548	656
	828	936
Fee and commission expense	(252)	(438)
Net fee and commission income	576	498
Net trading income	1,235	1,525
Insurance premium income	17	1,635
Other operating income	(234)	317
Total other income	1,594	3,975

¹ In previous years the Group has included annual management charges on non-participating investment contracts within insurance claims. In light of developing industry practice, these amounts (half-year to 30 June 2012: £232 million; half-year to 30 June 2011: £251 million) are now included within net fee and commission income.

3. Operating expenses

	Half-year to 30 June 2012 £m	Half-year to 30 June 2011 £m
Administrative expenses:		
Staff costs excluding past service pensions credit	945	1,202
Past service pensions credit ¹	(258)	–
Total staff costs	687	1,202
Premises and equipment	192	259
Other expenses	521	626
	1,400	2,087
Depreciation and amortisation	139	227
Impairment of tangible fixed assets	–	65
Total operating expenses, excluding payment protection insurance provision	1,539	2,379
Payment protection insurance provision (note 14)	240	1,155
Total operating expenses	1,779	3,534

¹ Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in the half-year to 30 June 2012.

4. Impairment

	Half-year to 30 June 2012 £m	Half-year to 30 June 2011 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	2,221	4,048
Debt securities classified as loans and receivables	33	24
Impairment losses on loans and receivables (note 8)	2,254	4,072
Impairment of available-for-sale financial assets	28	32
Other credit risk provisions	–	(1)
Total impairment charged to the income statement	2,282	4,103

5. Taxation

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

	Half-year to 30 June 2012 £m	Half-year to 30 June 2011 £m
Profit (loss) before tax	64	(1,977)
Tax (charge) credit thereon at UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent)	(16)	524
Factors affecting tax (charge) credit:		
UK corporation tax rate change	(142)	(154)
Disallowed and non-taxable items	55	41
Overseas tax rate differences	43	2
Gains exempted or covered by capital losses	2	27
Policyholder tax	–	61
Tax losses where no deferred tax recognised	(25)	(135)
Deferred tax on losses not previously recognised	–	16
Adjustments in respect of previous periods	24	4
Effect of results in joint ventures and associates	3	3
Other items	3	(2)
Tax (charge) credit	(53)	387

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2012 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period. The impact of the reduction in the main rate of corporation tax to 24 per cent that passed into legislation on 26 March 2012 on the Group's deferred tax asset was accounted for in the first half of 2012.

The Finance Act 2012 (the Act) was substantively enacted on 3 July 2012. The Act further reduces the rate of corporation tax to 23 per cent with effect from 1 April 2013. This change will be accounted for in the second half of 2012.

The proposed further reduction in the rate of corporation tax by 1 per cent to 22 per cent by 1 April 2014 is expected to be enacted next year. The effect of this further change upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

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

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Trading assets	30,576	21,840
Other financial assets at fair value through profit or loss:		
Loans and advances to customers	53	54
Debt securities	4,755	4,300
Equity shares	20,799	19,153
	25,607	23,507
Total trading and other financial assets at fair value through profit or loss	56,183	45,347

Included in the above is £25,464 million (31 December 2011: £23,474 million) of assets relating to the insurance businesses.

7. Loans and advances to customers

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Agriculture, forestry and fishing	592	588
Energy and water supply	1,431	1,670
Manufacturing	2,271	2,946
Construction	5,879	6,818
Transport, distribution and hotels	17,737	20,135
Postal and communications	505	357
Property companies	36,952	42,418
Financial, business and other services	18,673	33,077
Personal:		
Mortgages	238,673	243,222
Other	13,775	12,920
Lease financing	3,374	3,840
Hire purchase	797	772
Due from fellow Group undertakings	10,872	11,698
Total loans and advances to customers before allowance for impairment losses	351,531	380,461
Allowance for impairment losses on loans and advances (note 8)	(21,196)	(23,351)
Total loans and advances to customers	330,335	357,110

Loans and advances to customers include advances securitised under the Group's securitisation and covered bond programmes. Further details are given in note 9.

8. Allowance for impairment losses on loans and receivables

	Half-year to 30 June 2012 £m	Year to 31 Dec 2011 £m
Balance at 1 January	24,499	26,607
Exchange and other adjustments	(402)	(374)
Advances written off	(4,038)	(8,650)
Recoveries of advances written off in previous years	153	66
Unwinding of discount	(177)	(171)
Charge for the half-year to 30 June (note 4)	2,254	4,072
Charge for the half-year to 31 December	–	2,949
Charge to the income statement	2,254	7,021
Balance at end of period	22,289	24,499
In respect of:		
Loans and advances to customers (note 7)	21,196	23,351
Debt securities	1,093	1,148
Balance at end of period	22,289	24,499

9. Securitisation and covered bonds

The Group's principal securitisation and covered bond programmes, together with the balances of the loans subject to these arrangements and the carrying value of the notes in issue, are listed in the table below.

	As at 30 June 2012		As at 31 December 2011	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
<i>Securitisation programmes</i>				
UK residential mortgages	48,241	35,517	91,246	68,425
US residential mortgage-backed securities	4,337	5,178	4,659	6,351
Irish residential mortgages	5,233	3,562	5,531	5,661
Credit card receivables	6,649	5,283	6,792	4,810
Dutch residential mortgages	4,732	4,856	4,960	4,817
Commercial loans	968	946	680	631
Motor vehicle loans	1,468	1,546	1,573	1,341
	71,628	56,888	115,441	92,036
Less held by the Group		(34,694)		(65,118)
Total securitisation programmes (note 10)		22,194		26,918
<i>Covered bond programmes</i>				
Residential mortgage-backed	45,531	34,529	48,521	38,882
Social housing loan-backed	3,307	2,638	3,370	2,605
	48,838	37,167	51,891	41,487
Less held by the Group		(10,373)		(13,515)
Total covered bond programmes (note 10)		26,794		27,972
Total securitisation and covered bond programmes		48,988		54,890

Securitisation programmes

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

Covered bond programmes

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 the related covered bonds in issue included within debt securities in issue.

Cash deposits of £6,756 million (31 December 2011: £13,381 million) held by the Group are restricted in use to repayment of the debt securities issued by the SPEs and other legal obligations.

10. Debt securities in issue

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Medium-term notes issued	8,916	12,489
Covered bonds (note 9)	26,794	27,972
Certificates of deposit	411	350
Securitisation notes (note 9)	22,194	26,918
Commercial paper	847	6,169
	59,162	73,898
Amounts due to fellow Group undertakings	877	1,559
Total debt securities in issue	60,039	75,457

11. Subordinated liabilities

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

	£m
At 1 January 2012	13,613
Foreign exchange and other movements	(311)
At 30 June 2012	13,302

12. Share capital

Ordinary share capital in issue is as follows:

	Number of shares (millions)	£m
Ordinary shares of 25 pence each		
At 1 January and 30 June 2012	15,053	3,763

13. Reserves

	Share premium £m	Other reserves			Total £m	Retained profits £m
		Available- for-sale £m	Cash flow hedging £m	Merger and other £m		
At 1 January 2012	18,655	(498)	859	10,162	10,523	(9,170)
Loss for the period	–	–	–	–	–	1
Change in fair value of available-for-sale assets (net of tax)	–	225	–	–	225	–
Change in fair value of hedging derivatives (net of tax)	–	–	322	–	322	–
Transfers to income statement (net of tax)	–	172	22	–	194	–
Exchange and other adjustments	–	–	–	32	32	–
At 30 June 2012	18,655	(101)	1,203	10,194	11,296	(9,169)

14. Provisions for liabilities and charges

Payment protection insurance

There has been extensive scrutiny of the Payment Protection Insurance (PPI) market in recent years. The FSA published its Policy Statement on 10 August 2010, setting out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress, as well as a requirement for firms to reassess historically rejected complaints which had to be implemented by 1 December 2010.

On 8 October 2010, the British Bankers' Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. On 20 April 2011 judgment was handed down by the High Court dismissing the BBA's application. On 9 May 2011, the BBA confirmed that the banks and the BBA did not intend to appeal the judgment.

After publication of the judgment, the Group entered into discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group conducted of compliance with applicable sales standards, which is continuing, the Group concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2011 of £1,155 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. During 2012 there has been an increase in the volume of complaints being received, although other assumptions continue to be broadly in line with expectations. As a result the Group has increased its provision by a further £240 million during the first half of 2012 to cover the anticipated redress in relation to these increased volumes. This increases the total estimated cost of redress to £1,395 million; redress payments made and expenses incurred to the end of June 2012 amounted to £943 million. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of the detailed implementation of the Policy Statement for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

Interest rate hedging products

In June 2012, a number of banks, including Lloyds Banking Group, reached agreement with the FSA to carry out a thorough assessment of sales made since 1 December 2001 of interest rate hedging products to certain small and medium-sized businesses. The Group has also agreed that on conclusion of this review it will provide redress to any of these customers where appropriate. Not all customers will be owed redress, and the exact redress will vary from customer to customer.

The estimated cost of redress and related administration costs based upon the results of the work performed on the portfolio to date have been provided. This work is not yet complete and the results are still subject to the FSA review process; consequently the ultimate cost to the Group may vary. However, based on the analysis to date, the total cost is not expected to be material.

15. Contingent liabilities and commitments

Interchange fees

On 24 May 2012, the EU General Court upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee (MIFs) in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card.

Following the judgment, MasterCard has announced its intention to appeal, and that it intends to continue to apply cross-border MIFs at the rate at which they were 'settled' prior to the judgment. It is possible that the Commission may seek to reduce this.

In parallel:

- (1) the European Commission is also considering introducing legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;
- (2) the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by VISA for the levying of the MIF in respect of cross-border payment transactions also infringe European Union competition laws. In this regard VISA reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard; and
- (3) now that the General Court judgment has been handed down, the Office of Fair Trading (OFT) may decide to renew its ongoing examination of whether the levels of interchange paid by retailers in respect of MasterCard and VISA credit cards, debit cards and charge cards in the UK infringe competition law. The OFT had placed the investigation on hold pending the outcome of the MasterCard appeal.

The ultimate impact of the investigations and any regulatory developments on Lloyds Banking Group can only be known at the conclusion of these investigations and any relevant appeal proceedings and once regulatory proposals are more certain.

Interbank offered rate setting investigations

Several government agencies in the UK, US and overseas, including the US Commodity Futures Trading Commission, the US SEC, the US Department of Justice and the FSA as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates. Certain members of the Lloyds Banking Group group of companies, were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA London interbank offered rates (LIBOR) panels. No member of the Lloyds Banking Group group of companies is or was a member of the European Banking Federation's Euribor panel. Certain members of the Lloyds Banking Group group of companies have received subpoenas and requests for information from certain government agencies and are co-operating with their investigations. In addition certain members of the Lloyds Banking Group group of companies have been named as defendants in private lawsuits, including purported class action suits in the US with regard to the setting of LIBOR. It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and private lawsuits on the Group.

Financial Services Compensation Scheme (FSCS)

The FSCS is the UK's independent statutory compensation fund for customers of authorised financial services firms and pays compensation if a firm is unable to pay claims against it. The FSCS is funded by levies on the industry (and recoveries and borrowings where appropriate). The levies raised comprise both management expenses levies and, where necessary, compensation levies on authorised firms.

15. Contingent liabilities and commitments (continued)

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. The interest rate on the borrowings with HM Treasury, which total circa £20 billion, increased from 12 month LIBOR plus 30 basis points to 12 month LIBOR plus 100 basis points on 1 April 2012. Whilst it is expected that the substantial majority of the principal will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, to the extent that there remains a shortfall, the FSCS will raise compensation levies on all deposit-taking participants. The amount of any future compensation levies payable by the Group also depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants. As such, although the Group's share of such compensation levies could be significant, the Group has not recognised a provision in respect of them in these financial statements.

FSA investigation into Bank of Scotland

In 2009, the FSA commenced a supervisory review into HBOS. The supervisory review was superseded when the FSA commenced an enforcement investigation into Bank of Scotland plc in relation to its Corporate Division between 2006 and 2008. These proceedings have now concluded. The FSA published its Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. The FSA has indicated that it intends to produce a report into HBOS. The scope and timing of such a report remain uncertain.

Shareholder complaints

Lloyds Banking Group plc and two former members of its Board of Directors have been named as defendants in a purported securities class action pending in the United States District Court for the Southern District of New York. The complaint, dated 23 November 2011, asserts claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. No quantum is specified. The Lloyds Banking Group has applied to dismiss the complaint.

In addition, a UK-based shareholder action group has threatened multi-claimant claims on a similar basis against Lloyds Banking Group plc and two former directors in the UK. No claim has yet been issued.

Lloyds Banking Group plc considers that the claims are without merit and will defend them vigorously. The claims have not been quantified and it is not possible to estimate any potential financial impact on the Lloyds Banking Group at this early stage.

Other regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters, including complaints handling, packaged bank accounts, savings accounts, product terms and conditions, interest-only mortgages, sales processes and remuneration schemes. The Group is keen to ensure that regulatory concerns are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required 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 are unclear or because further time is needed properly to assess the merits of the case and no provisions are held against such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position.

15. Contingent liabilities and commitments (continued)**Contingent liabilities and commitments arising from the banking business**

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Contingent liabilities		
Acceptances and endorsements	2	3
Other:		
Other items serving as direct credit substitutes	76	110
Performance bonds and other transaction-related contingencies	677	674
	753	784
Total contingent liabilities	755	787
Commitments		
Documentary credits and other short-term trade-related transactions	8	8
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	6,899	6,311
Other commitments	21,581	22,851
	28,480	29,162
1 year or over original maturity	5,473	16,442
Total commitments	33,961	45,612

16. Capital ratios

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Capital resources		
Core tier 1		
Shareholders' equity per balance sheet	24,545	23,771
Non-controlling interests per balance sheet	411	399
Regulatory adjustments to non-controlling interests	(345)	(333)
Regulatory adjustments:		
Defined benefit pension adjustment	(565)	(296)
Unrealised reserve on available-for-sale debt securities	402	840
Unrealised reserve on available-for-sale equity investments	(301)	(342)
Cash flow hedging reserve	(1,203)	(859)
Other items	—	(16)
	22,944	23,164
Less: deductions from core tier 1		
Goodwill	(847)	(883)
Intangible assets	(78)	(76)
50 per cent excess of expected losses over impairment	(817)	(684)
50 per cent of securitisation positions	(68)	(84)
Core tier 1 capital	21,134	21,437
Preferred securities ¹	3,032	3,070
Less: deductions from tier 1		
50 per cent of material holdings	(36)	(80)
Total tier 1 capital	24,130	24,427
Tier 2		
Undated subordinated debt	646	664
Dated subordinated debt	6,132	6,602
Unrealised gains on available-for-sale equity investments	301	342
Eligible provisions	1,161	1,203
Less: deductions from tier 2		
50 per cent excess of expected losses over impairment	(817)	(684)
50 per cent of securitisation positions	(68)	(84)
50 per cent of material holdings	(36)	(80)
Total tier 2 capital	7,319	7,963
Supervisory deductions		
Unconsolidated investments – life	(344)	(359)
– general insurance and other	(58)	(101)
Total supervisory deductions	(402)	(460)
Total capital resources	31,047	31,930
Risk-weighted assets ²	184,126	199,324
Core tier 1 capital ratio ²	11.5%	10.8%
Tier 1 capital ratio ²	13.1%	12.3%
Total capital ratio ²	16.9%	16.0%

¹ Covered by grandfathering provisions issued by FSA.

² Not within the scope of PricewaterhouseCoopers LLP's review opinion as set out on page 35.

17. Related party transactions

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

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

	As at 30 June 2012 £m	As at 31 Dec 2011 £m
Assets		
Derivative financial instruments	5,041	4,196
Loans and advances to banks	114,250	85,800
Loans and advances to customers	10,872	11,698
Trading and other financial assets as fair value through profit or loss	12,969	7,515
Other	3,560	2,681
Liabilities		
Deposits from banks	149,814	144,502
Customer deposits	14,659	16,460
Derivative financial instruments	6,781	6,703
Trading liabilities	5,671	6,690
Subordinated liabilities	442	272
Other	1,243	1,559

During the half-year to 30 June 2012 the Group earned £688 million (half-year to 30 June 2011: £399 million) of interest income and incurred £1,340 million (half-year to 30 June 2011: £891 million) of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Group undertakings.

UK Government

In January 2009, the UK Government through HM Treasury became a related party of Lloyds Banking Group plc, the Company's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 30 June 2012, HM Treasury held a 39.2 per cent (31 December 2011: 40.2 per cent) interest in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of Lloyds Banking Group plc, and therefore of the Group, during the half-year to 30 June 2012.

From 1 January 2011, in accordance with IAS 24, UK Government-controlled entities became related parties of the Group. The Group regards the Bank of England and entities controlled by the UK Government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

The Lloyds Banking Group has participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

Credit guarantee scheme

HM Treasury launched the Credit Guarantee Scheme in October 2008. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 30 June 2012, the Lloyds Banking Group had £4.9 billion of debt in issue under the Credit Guarantee Scheme (31 December 2011: £23.5 billion). During the half-year to 30 June 2012, fees of £51 million paid to HM Treasury in respect of guaranteed funding were included in the Lloyds Banking Group's income statement (half-year to 30 June 2011: £160 million).

17. Related party transactions (continued)*National Loan Guarantee Scheme*

The Lloyds Banking Group is participating in the UK Government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Lloyds Banking Group expects to provide eligible UK businesses with discounted funding over the next two years, subject to continuation of the scheme and its financial benefits, and based on the Lloyds Banking Group's existing lending criteria. Eligible businesses who take up the funding will benefit from a 1 per cent discount on their funding rate for a certain period of time.

Business Growth Fund

In May 2011 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. As at 30 June 2012, the Lloyds Banking Group had invested £37 million (31 December 2011: £20 million) in the Business Growth Fund and carried the investment at a fair value of £33 million (31 December 2011: £16 million).

Big Society Capital

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

Central bank facilities

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

Other government-related entities

There were no significant transactions with other UK Government-controlled entities (including UK Government-controlled banks) during the period that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party transactions

Other related party transactions for the half-year to 30 June 2012 are similar in nature to those for the year ended 31 December 2011.

18. Future accounting developments

The following pronouncements may have a significant effect on the Group's financial statements but are not applicable for the year ending 31 December 2012 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 <i>Presentation of Financial Statements – 'Presentation of Items of Other Comprehensive Income'</i>	Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently.	Annual periods beginning on or after 1 July 2012.
Amendments to IFRS 7 <i>Financial Instruments: Disclosures – 'Disclosures-Offsetting Financial Assets and Financial Liabilities'</i> ¹	Requires an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet.	Annual and interim periods beginning on or after 1 January 2013.
IFRS 10 <i>Consolidated Financial Statements</i> ¹	Supersedes IAS 27 <i>Consolidated and Separate Financial Statements</i> and SIC-12 <i>Consolidation – Special Purpose Entities</i> and establishes principles for the preparation of consolidated financial statements when an entity controls one or more entities.	Annual periods beginning on or after 1 January 2013.
IFRS 12 <i>Disclosure of Interests in Other Entities</i> ¹	Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.	Annual periods beginning on or after 1 January 2013.
IFRS 13 <i>Fair Value Measurement</i> ¹	The standard defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements. It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.	Annual and interim periods beginning on or after 1 January 2013.
IAS 19 <i>Employee Benefits</i>	Prescribes the accounting and disclosure by employers for employee benefits. Actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes can no longer be deferred using the corridor approach and must be recognised immediately in other comprehensive income. At 31 December 2011, unrecognised actuarial losses for Lloyds Banking Group were approximately £550 million. The income statement charge for 2011 would have been approximately £50 million lower under the revised standard.	Annual periods beginning on or after 1 January 2013.
Amendments to IAS 32 <i>Financial Instruments: Presentation – 'Offsetting Financial Assets and Financial Liabilities'</i> ¹	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement.	Annual periods beginning on or after 1 January 2014.
IFRS 9 <i>Financial Instruments</i> ^{1,2}	Replaces those parts of IAS 39 <i>Financial Instruments: Recognition and Measurement</i> relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.	Annual periods beginning on or after 1 January 2015.

¹ As at 25 July 2012, these pronouncements were awaiting EU endorsement.

² IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting, as well as a reconsideration of classification and measurement. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39.

19. Ultimate parent undertaking

HBOS plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year to 31 December 2011 and copies may be obtained from Investor Relations, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN and available for download from www.lloydsbankinggroup.com.

20. Other information

The financial information included in these condensed consolidated half-year financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2011 have been delivered to the Registrar of Companies following publication in March 2012. The auditors' report on those accounts was unqualified and did not include a statement under sections 498(2) (accounting records or returns inadequate or accounts not agreeing with records and returns) or 498(3) (failure to obtain necessary information and explanations) of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

- an indication of important events that have occurred during the six months ended 30 June 2012 and their impact on the condensed consolidated half-year financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2012 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
25 July 2012

HBOS plc board of directors:

Sir Winfried Bischoff (Chairman)
António Horta-Osório (Chief Executive)
George Culmer (Finance Director)
Lord Blackwell
Carolyn J Fairbairn
Anita Frew
David L Roberts
T Timothy Ryan, Jr
Martin A Scicluna
Anthony Watson
Sara V Weller

INDEPENDENT REVIEW REPORT TO HBOS PLC

Introduction

We have been engaged by the Company to review the condensed consolidated half-year financial statements in the half-year management report for the six months ended 30 June 2012, which comprise the consolidated income statement, consolidated statement of comprehensive income, consolidated balance sheet, consolidated statement of changes in equity, consolidated cash flow statement and related notes. We have read the other information contained in the half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed consolidated half-year financial statements.

Directors' responsibilities

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

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with International Financial Reporting Standards as adopted by the European Union. The condensed consolidated half-year financial statements included in the half-year management report have been prepared in accordance with International Accounting Standard 34, *Interim Financial Reporting*, as adopted by the European Union.

Our responsibility

Our responsibility is to express to the Company a conclusion on the condensed consolidated half-year financial statements in the half-year management report based on our review. This report, including the conclusion, has been prepared for and only for the Company for the purpose of the Disclosure and Transparency Rules of the Financial Services Authority and for no other purpose. We do not, in producing this report, 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 review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated half-year financial statements in the half-year management report for the six months ended 30 June 2012 are not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

PricewaterhouseCoopers LLP
Chartered Accountants
London
25 July 2012

Notes:

- a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the Group directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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