HBOS plc

Report and Accounts
2012

Member of Lloyds Banking Group

Contents

Directors' report

Results
The consolidated income statement on page 13 shows a profit attributable to equity shareholders for the year ended 31 December 2012 of £128 million.

Principal activities
HBOS plc (the Company) and its subsidiary undertakings (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

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

Business review
For the year ended 31 December 2012, the Group recorded a profit before tax of £255 million compared with a loss before tax in 2011 of £3,894 million; the improvement in profitability particularly reflecting a reduction in the impairment charge in 2012 and the loss on disposal of businesses in 2011.

Total income increased by £439 million, or 4 per cent, to £11,838 million in 2012 compared with £11,399 million in 2011, comprising a £1,927 million increase in other income only partly offset by a decrease of £1,488 million in net interest income.

Net interest income was £6,910 million in 2012, a decrease of £1,488 million, or 18 per cent, compared to £8,398 million in 2011. This reduction reflected a decrease in average interest-earning assets, mainly due to subdued lending demand and the disposal of assets outside of the Group's risk appetite. It was also driven by a decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds.

Other income was £1,927 million, or 64 per cent, higher at £4,928 million in 2012 compared to £3,001 million in 2011. Fee and commission income was £155 million, or 9 per cent, lower at £1,659 million compared to £1,814 million in 2011. Fee and commission expense decreased by £191 million, or 26 per cent, to £536 million compared with £727 million in 2011. Net trading income increased by £4,386 million to £3,492 million in 2012 compared to a deficit of £894 million in 2011; this increase reflected an improvement in gains on policyholder investments held within the Group's remaining insurance business, offset by a similar increase in the related claims expense. Insurance premium income was £1,621 million, or 98 per cent, lower at £36 million in 2012 compared with £1,657 million in 2011 reflecting the sale of the Group's wholly owned insurance businesses during 2011. Other operating income was £874 million, or 76 per cent, lower at £277 million in 2012 compared to £1,151 million in 2011 reflecting, in particular, the gains on capital transactions in 2011, not repeated in 2012.

Insurance claims expense was £2,010 million higher at £2,985 million in 2012 compared to £975 million in 2011; this increase in claims was matched by a similar improvement in net trading income, reflecting the improved performance of policyholder investments.

Operating expenses decreased by £1,187 million, or 22 per cent, to £4,288 million in 2012 compared with £5,475 million in 2011. Both years included significant charges in respect of regulatory provisions (2012: £1,039 million; 2011: £1,155 million); operating expenses excluding these provisions were £1,071 million, or 25 per cent, lower at £3,249 million in 2012 compared with £4,320 million in 2011; this partly reflected the disposal of the Group's wholly-owned insurance businesses during 2011. Staff costs were £709 million, or 32 per cent, lower at £1,510 million in 2012 compared with £2,219 million in 2011. Excluding the past service pension credit in 2012, staff costs were £451 million, or 20 per cent, lower at £1,768 million compared with £2,219 million in 2011 due to the impact of the sale of the Group's wholly owned insurance businesses in 2011 and the ongoing impact of headcount reductions more than offsetting the effect of annual pay rises. Premises and equipment costs were £91 million, or 20 per cent, lower at £369 million compared with £460 million in 2011. Other expenses (excluding the charges in respect of payment protection insurance and other regulatory provisions of £1,039 million from 2012 and £1,155 million from 2011) were £108 million, or 9 per cent, lower at £1,113 million in 2012 compared with £1,221 million in 2011. Depreciation and amortisation costs were £98 million, or 28 per cent, lower at £257 million in 2012 compared to £355 million in 2011. In 2011, there had been a charge of £65 million in relation to the impairment of tangible fixed assets; there was no such charge in 2012.

Impairment losses decreased by £2,794 million, or 39 per cent, to £4,310 million in 2012 compared with £7,104 million in 2011. Impairment losses in respect of loans and advances to customers were £2,709 million, or 39 per cent, lower at £4,252 million compared with £6,961 million in 2011. The overall performance of the portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although improving, unemployment.

The impairment charge in respect of debt securities classified as loans and receivables was £43 million lower at £17 million in 2012 compared to a charge of £60 million in 2011 and the impairment charge in respect of available-for-sale financial assets was £37 million, or 47 per cent, lower at £41 million in 2012 compared to £78 million in 2011.

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. These transactions resulted in a consolidated loss on disposal of £1,739 million during the year ended 31 December 2011.

In 2012, the Group recorded a tax charge of £86 million compared to a tax credit of £173 million in 2011. The tax charge of £86 million in 2012 arose on a profit before tax of £255 million, an effective rate of 34 per cent reflecting the effect on the net deferred tax asset of the reduction in the UK corporation tax rate to 23 per cent with effect from 1 April 2013 more than offsetting the benefit of non-taxable items.

Total assets at 31 December 2012 were £582,107 million, £14,108 million, or 2 per cent, higher compared to £567,999 million at 31 December 2011. This increase reflects the greater levels of intercompany funding with other Lloyds Banking Group companies, which more than offset the reduction caused by 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.

Deposits from banks increased by £21,696 million, or 14 per cent, to £171,738 million compared to £150,042 million at 31 December 2011, but customer deposits were little changed at £217,515 million.

Shareholders' equity increased by £926 million, from £23,771 million to £24,697 million at 31 December 2012, as a result of positive movements in the available-for-sale financial assets revaluation reserve and the cash flow hedging reserve.

As at 31 December 2012, the Group's capital ratios had increased with a total capital ratio of 18.6 per cent (compared to 16.0 per cent at 31 December 2011); a tier 1 capital ratio of 14.8 per cent (compared to 12.3 per cent at 31 December 2011) and a core tier 1 ratio of 13.0 per cent (compared to 10.8 per cent at

31 December 2011). During 2012 risk-weighted assets decreased by £35,272 million to £164,052 million at 31 December 2012 compared with £199,324 million at 31 December 2011; this decrease reflected risk-weighted asset reductions across the business driven by reductions in assets outside of the Group's risk appetite, lower lending balances and strong management of risk.

Financial risk management objectives and policies
Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 54 on page 96. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 7 to 11. This information is incorporated into this report by reference. Additional information can be found in the annual report of Lloyds Banking Group plc, the Company's ultimate parent, which does not form part of this report.

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 the Principal risks and uncertainties section under Liquidity and funding on page 9 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.

Directors
The names of the Directors of the Company are shown on page 5. Changes to the composition of the Board since 1 January 2012 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
S V Weller	1 February 2012	
G T Tate		6 February 2012
T J W Tookey		24 February 2012
Lord Leitch		29 February 2012
M G Culmer	16 May 2012	
Sir Julian Horn-Smith		17 May 2012
G R Moreno		17 May 2012
Lord Blackwell	1 June 2012	
C J Fairbairn	1 June 2012	

M A Scicluna and T T Ryan, Jr will retire from the Board on 31 March 2013 and 18 April 2013, respectively.

N L Luff will be appointed to the Board on 5 March 2013.

Directors' interests
The Directors are also Directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

Directors' conflicts of interest
The Board, as permitted by the Company's articles of association, has authorised all potential conflicts of interest that have been declared by individual Directors. Decisions regarding these conflicts of interest could be and were only taken by Directors who had no interest in the matter. In taking the decision, the Directors acted in a way they considered, in good faith, would be most likely to promote the Company's success. The Directors have the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given are reviewed periodically, and as a considered appropriate, and at least every 15 months. No Director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest. The Board confirms that no material conflicts were reported to it during the year.

Directors' indemnities
The Directors of the Company, including the former Directors who retired during the year and since the year end, have entered into individual deeds 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. In addition, Lloyds Banking Group plc has granted a deed of indemnity through deed poll which constituted 'third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' to the Directors of the Company's subsidiary companies, including to former Directors who retired during the year and since the year end. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors who joined the Boards in 2012 and 2013. The indemnities remain in force for the duration of a Director's period of office. The deeds indemnify the Directors to the maximum extent permitted by law. Deeds for existing Directors are available for inspection at the Company's registered office.

Share capital

Information about share capital and dividends is shown in notes 45 and 49 on pages 69 and 72 and is incorporated into this report by reference.

Employees
The Company, as part of Lloyds Banking Group is committed to providing employment practices and policies which recognise the diversity of our workforce. We will not unfairly discriminate in our recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief. We work hard to ensure Lloyds Banking Group is inclusive for all our colleagues.

To support us in this aim, Lloyds Banking Group belongs to a number of major UK employment equality campaign groups, including the Business Disability Forum, The Age and Employment Network, Stonewall and Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff. The Company, as part of Lloyds Banking Group, has a range of programmes to support colleagues who become disabled or acquire a long-term health condition. These include a workplace adjustment programme to provide physical equipment or changes to the way a job is done. The Group also runs residential Personal and Career Development Programmes to help colleagues deal positively with the impact of a disability and the colleague disability network, Access, provides peer support.

Directors' report

Employees are kept closely involved in major changes affecting them through such measures 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.

Lloyds Banking Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. We have established a full suite of communication channels, including an extensive face-to-face briefing programme, which allows us to update our employees on our performance and any financial issues throughout the year.

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. Information about the 'Prompt Payment Code' may be obtained by visiting www.promptpaymentcode.org.uk.

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 13 (2011: 14 days). 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 2012 bears to the aggregate of the amounts invoiced by suppliers during the year.

Essential business contracts
There are no persons with whom the Company has contractual or other arrangements that are considered essential to the business of the Company.

Significant contracts
Details of related party transactions are set out in note 51 on pages 79 to 81.

Research and development activities
During the ordinary course of business the Company develops new products and services.

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 Group and Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law, the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Company and of the profit or loss of the Company and Group for that period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgements and accounting estimates that are reasonable and prudent; and state whether applicable IFRSs as adopted by the European Union have been followed.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on the website www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity in relation to the Company on that website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors, whose names are shown on page 5 of this annual report, confirms that, to the best of his or her knowledge:

– the financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Company and Group and the profit or loss of the Group;
– the business review includes a fair review of the development and performance of the business and the position of the Company and Group; and
– the principal risks and uncertainties faced by the Company and the Group are set out on pages 7 to 11.

Independent 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.

A resolution will be proposed at the 2013 annual general meeting to reappoint PricewaterhouseCoopers LLP as auditors. The Company's Audit Committee is satisfied that the external auditors remain independent and effective.

On behalf of the Board

Claire A Davies
Company Secretary
1 March 2013

Company Number SC218813

Directors

Sir Winfried Bischoff *Chairman*

A Horta-Osório *Group Chief Executive*

M G Culmer *Group Finance Director*

Lord Blackwell

C J Fairbairn

A M Frew

D L Roberts

T T Ryan, Jr

M A Scicluna

A Watson CBE

S V Weller

Forward looking statements

This annual report includes certain forward looking statements within the meaning of the safe harbor provisions of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans of HBOS plc and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about HBOS plc or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, expenditures or any other financial items or ratios; statements of plans, objectives or goals of the Group or its management including in respect of certain synergy targets; statements about the future business and economic environments in the United Kingdom (UK) and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; inflation, deflation, interest rates and policies of the Bank of England, the European Central Bank and other G8 central banks; fluctuations in exchange rates, stock markets and currencies; the ability to access sufficient funding to meet the Group's liquidity needs; changes to the Group's, Lloyds Banking Group plc's or Lloyds TSB Bank plc's credit ratings; the ability to derive cost savings and other benefits including, without limitation, as a result of the integration of HBOS into Lloyds Banking Group and the Group's Simplification Programme; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets including Eurozone instability and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes; natural and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes, people and systems; terrorist acts and other acts of war or hostility and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, taxation, accounting standards or practices; regulatory capital or liquidity requirements and similar contingencies outside the Group's control; the policies and actions of governmental or regulatory authorities in the UK, the European Union (EU), the US or elsewhere; 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 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 plc's EU State Aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations, market disruptions and illiquid markets; market related trends and developments; exposure to regulatory scrutiny, legal proceedings, regulatory investigations or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services and lending companies; and the success of the Group in managing the risks of the foregoing. Please refer to the latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors.

The Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of the Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this annual report are made as of the date hereof, and HBOS plc expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this annual report to reflect any change in HBOS plc's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Principal risks and uncertainties

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

CREDIT RISK

Definition

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on or off balance sheet).

Principal risks

Arising mainly in the retail, commercial banking, and wealth, asset finance and international operations, reflecting the risks inherent in the Group's lending activities and, to a lesser extent in the Insurance operations in respect of investment holdings and exposures to reinsurers. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets and increase the Group's write-downs and allowances for impairment losses. Credit risk can be affected by a range of macroeconomic environment and other factors, including, inter alia, increased unemployment, reduced asset values, lower consumer spending, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates and/or higher tenant defaults.

Over the last five years, the global banking crisis and economic downturn has driven cyclically high bad debt charges, especially in the Group's legacy HBOS portfolios, arising from the Group's lending to both retail (including those in wealth, asset finance and international) and commercial customers (including those in wealth, asset finance and international). Group portfolios will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates being possible impacts to the Group's exposures. The Group has exposure to commercial customers in both the UK and internationally, including Europe and Ireland, particularly related to commercial real estate lending, where the Group has a high level of lending secured on secondary and tertiary assets. The possibility of further economic downside risk remains.

Mitigating actions

The Group takes many mitigating actions with respect to this principal risk. The Group manages its credit risk in a variety of ways such as:

- through prudent and through the cycle credit risk appetite and policies;
- clearly defined levels of authority (including, independently sanctioned and controlled credit limits for commercial customers and counterparties, sound credit scoring models and credit policies for retail customers);
- robust credit processes and controls; and
- well-established Group and Divisional committees that ensure distressed and impaired loans are identified, considered, controlled and appropriately escalated and appropriately impaired (taking account of the Group's latest view of current and expected market conditions, as well as refinancing risk).

Reviews are undertaken at least quarterly and incorporate internal and external audit review and challenge.

CONDUCT RISK

Definition

Conduct risk is defined as the risk of customer detriment or censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

Principal risks

Conduct risk and how Lloyds Banking Group manages its customer relationships affect all aspects of the Group's operations and are closely aligned with achievement of Lloyds Banking Group's strategic vision to be the best bank for customers. As a provider of a wide range of financial services products distributed through numerous channels to a broad and varied customer base, and as a participant in market activities the Group faces significant conduct risks, such as: products or services not meeting the needs of its customers; sales processes which could result in selling products to customers which do not meet their needs; failure to deal with a customer's complaint effectively where the Group has got it wrong and not met customer expectations; behaviours which do not meet market standards.

There remains a high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media 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 the FSA, other 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.

Mitigating actions

The Group takes many mitigating actions with respect to this principal risk; key examples include:

- The Group's Conduct Strategy and supporting framework have been designed to support its vision and strategic aim to put the customer at the heart of everything it does. The Group has developed and implemented a framework to enable it to deliver the right outcomes for its customers, which is supported by policies and standards in key areas, including product governance, customer treatment, sales, responsible lending, customers in financial difficulties, claims and complaints handling.
- The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns. The Group develops colleagues' awareness of these and other expected standards of conduct through these and other policies and standards and codes of responsibility. It also undertakes root cause analysis of complaints and makes use of technology and metrics to facilitate earlier detection and mitigation of conduct issues.

MARKET RISK

Definition

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

Principal risks

The Group has a number of market risks, the principal ones being:

- Interest rate risk: This risk to the Group's banking income 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. A further related risk arises from the level of interest rates and the margin of interbank rates over central bank rates.

- Equity risk: This risk arises from movements in equity market prices. The main equity market risks arise in the Insurance business and defined benefit pension schemes.
- Credit spread risk: This risk arises when the market perception of the creditworthiness of a particular counterparty changes. The main credit spread exposure arises in the Insurance business, defined benefit pension schemes and banking businesses.

Mitigating actions
Market 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.

High level market risk exposure is reported regularly to appropriate committees for monitoring and oversight by senior management.

A variety of risk measures are used such as:

- Sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates)
- Percentile based measures (e.g. Value at Risk)
- Scenario/stress based measures (e.g. single factor stresses, macroeconomic scenarios)

In addition, profit and loss triggers are used in the Trading Books in order to ensure that mitigating action is discussed if profit and loss becomes volatile.

- Interest rate risk: Exposure arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the non-traded market risk appetite. Exposure arising from the margin of interbank rates over central bank rates is monitored and managed within the non-traded market risk appetite through appropriate hedging activity.
- Equity and credit spread risk: The Group continues to liaise with defined benefit pension scheme Trustees with regard to appropriately de-risking their portfolio.

OPERATIONAL RISK
Definition
Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Principal risks
The principal operational risks currently facing the Group are:

- IT systems and resilience: The risk of loss resulting from the failure to develop, deliver or maintain effective IT solutions. The resilience of IT in terms of its availability to customers and colleagues is of paramount importance to the Group.
- Information security: The risk of information leakage, loss or theft. The threat profile is rapidly changing; in particular increasingly sophisticated attacks by cybercrime groups.
- External fraud: The risk of loss to the Group and/or its customers resulting from an act of deception or omission.
- Customer process: The risk of new issues, process weaknesses and control deficiencies within the Group's customer facing processes as the business continues to evolve.

Mitigating actions
The Group operates a robust control environment with regular review and investment. Contingency plans are maintained for a range of potential scenarios with a regime of regular disaster recovery exercises, both Group specific and industry wide. Significant investment has been made in IT infrastructure and systems to ensure their resilience and to enhance the services they support, in recognition of the importance of the ongoing availability of the Group's services both to its customers and to the wider UK financial infrastructure. The Group continues to invest in IT and information security control environments including user access management and records management to address evolving threats.

The Group adopts a risk based approach to external fraud management, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group's technology, process and people related controls; with emphasis on preventative controls, supported by real time detective controls – wherever feasible. The Group has developed a mature and robust fraud operating model with centralised accountability established, discharged via Group-wide policies and operational control frameworks. The Group's fraud awareness programme is a key component of its fraud control environment; in 2012 a Group-wide awareness campaign was launched specifically addressing the emerging 'cyber' threats and the role that the Group's colleagues play in helping to keep its customers safe and secure.

Material operational risks are reported regularly to appropriate committees, attracting senior management visibility, and are managed via a range of strategies – avoidance, mitigation, transfer (including insurance), and acceptance.

PEOPLE RISK
Definition
People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/ or value.

Principal risks
Lloyds Banking Group has a strategic aim to be the best bank for customers; it is committed to addressing issues within the business that could contribute to customers receiving unfair outcomes. The Group believes the quality, effectiveness and engagement of its people are fundamental to its successful delivery of this strategy. This belief coincides with the increasing external focus on the culture which underpins the performance and behaviour of employees in the development and delivery of fair outcomes to customers.

Consequently, the Group's management of material people risks is critical to its capacity to deliver against its strategic objectives. Over the coming twelve months the Group's ability to manage people risks successfully is likely to be affected by the following factors:

- The developing and increasingly rigorous and intrusive regulatory environment may challenge the Group's people strategy, remuneration practices and retention; and
- Negative political and media attention on banking sector culture, sales practices and ethical conduct may impact colleague engagement, investor sentiment and the Group's cost base.

Mitigating actions
The Group takes many mitigating actions with respect to people risk. Key examples include:

- Focusing on strengthening the risk-based culture amongst colleagues by developing and delivering a number of initiatives that reinforce risk-based behaviours to generate the best possible outcomes for customers and colleagues;
- Continuing to ensure strong management of the impact of organisational change and consolidation on colleagues;
- Embedding our Codes of Personal and Business Responsibility across the Group;
- Reviewing and developing incentives continually to ensure they promote colleagues' behaviours that meet customer needs and regulatory expectations;
- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Maintaining focus on people risk management across the Group; and
- Ensuring compliance with legal and regulatory requirements related to Approved Persons and the Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities.

LIQUIDITY AND FUNDING RISK
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.

Principal risks
Liquidity and funding continues to remain a key area of focus for Lloyds Banking Group and the industry as a whole. Like all major banks, the Group is dependent on 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. The key dependencies on successfully funding the Group's balance sheet include:

- Continued functioning of the money and capital markets.
- The continuation of Lloyds Banking Group's strategy of right-sizing the balance sheet and development of the retail deposit base which has led to a significant reduction in the wholesale funding requirement over the past year.
- Limited further deterioration in the UK's and the Group's credit rating. In June 2012 the Group experienced a one notch downgrade in its long-term rating from Moody's, following the agency's review of 114 European banks. The impact that the Group experienced following the downgrade was not material and was consistent with the modelled outcomes based on the stress testing framework. Similarly, the internal stress testing framework indicates that Moody's one notch downgrade of the UK's credt rating, announced on 22 February 2013, will not have a material impact on the Group's liquidity and funding position; and
- No significant or sudden withdrawal of customer deposits.

Mitigating actions
Liquidity and funding risk appetite for the banking businesses is set by the Board and this statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the Board.

- The Group's liquidity and funding position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term wholesale funding;
- Daily monitoring and control processes are in place to address regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group;
- The Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA on an ongoing basis. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics; and
- The Group has a contingency funding plan embedded within the 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.

INSURANCE RISK
Definition
Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

Principal risks
The major sources of insurance risk are within the Insurance business and the Group's defined benefit 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 of the Group's defined benefit pension schemes is related to longevity.

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

Mitigating actions
The Group takes many mitigating actions with respect to this principal risk, key examples include:

- Actuarial assumptions are reviewed in line with experience and in-depth reviews are conducted regularly. Longevity assumptions for the Group's defined benefit pension schemes are reviewed annually together with other IFRS assumptions. Expert judgement is required; and
- Insurance risk is controlled by robust processes including underwriting, pricing-to-risk, claims management, reinsurance and other risk mitigation techniques.

Insurance risk is reported regularly to appropriate committees and boards.

STATE FUNDING AND STATE AID
Principal risks
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.

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 the 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 divestment of certain portions of its Retail business by the end of November 2013, known as Project Verde. There is a risk that if the Group does not deliver its divestment commitments by November 2013, a Divesture Trustee would be appointed to dispose of the divestment, which could be sold at a negative price.

Mitigating actions
Lloyds Banking Group has received no indications that the Government intends to change the existing operating arrangements with regard to the role of UKFI and engagement with the Group.

Lloyds Banking Group continues to make good progress in respect to its State Aid commitments. In line with the strengthening of the balance sheet, the Group has made excellent progress against its asset reduction commitment and reached the reduction total required in December 2012, two years ahead of the mandated completion date. The Group is currently working with the European Commission to achieve formal release from this commitment.

On 19 July 2012 Lloyds Banking Group announced that it had agreed non-binding heads of terms with The Co-operative Group (the Co-operative) for the disposal of the Verde business. The Group continues 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. The Group has also undertaken planning for an Initial Public Offering (IPO) of the Verde business, should this be required as a fallback option. The Verde business will be rebranded and operating on a standalone basis within the Lloyds Banking Group during 2013 and available for sale to another third party as a further fallback option.

The 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 mitigate customer impact.

EMERGING RISKS
The Group considers the following to be emerging risks that have the potential to increase in significance and affect the performance of the Group. These risks are considered alongside Lloyds Banking Group's five year operating plan.

Macroeconomic environment
The operating plan is challenging, with a focus on improving earnings while achieving the required regulatory improvements on capital and liquidity. Any adverse movement in interest rates or deterioration in macroeconomic environment beyond the Group's assumptions would delay improvement of the earnings and return profile.

Mitigating actions
The Group is actively supporting sustainable growth in the UK economy through the focused range of products and services provided to business and personal customers, as well as through partnerships with industry and Government. Capital, liquidity and credit risk are managed conservatively and non-core asset reductions remain ahead of schedule ensuring the Group is better placed to address macroeconomic shocks.

Capital risk
Lloyds Banking Group has a strong capital position but remains exposed to the risks of lower than expected profitability, significant losses in a number of stress scenarios or volatility through accounting standards and regulatory changes.

One such area of potential regulatory change relates to the Bank of England's interim Financial Policy Committee (FPC) which published its Financial Stability Report on 29 November 2012. The report recommended that the Financial Services Authority takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. The FSA is expected to respond prior to the March FPC meeting.

Mitigating actions
The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group.

The Group has strong governance, processes and controls which, combined with our proactive management of risk, result in an appropriate level of capital. This includes:

- Rigorous stress testing exercises where the results are shared with the FSA
- Prudent internal models, based on empirical data, that meet regulatory and stringent internal requirements.

Regulatory change
The Parliamentary Commission on Banking Standards (PCBS) was asked to conduct pre-legislative scrutiny on the draft Banking Reform Bill. The PCBS published its initial report on 21 December 2012. The report contains the Commission's consideration of the Government's draft legislation which gives effect to the recommendations of the Independent Commission on Banking. The PCBS looked at 'Ring fencing', one of the UK Government's main proposals for increasing financial stability.

Mitigating actions
Actions to respond to the proposals on ring fencing are being taken forward alongside planning for recovery and resolution as part of a programme of work with senior executive sponsorship and robust governance arrangements.

Compliance and conduct
Significant legacy costs beyond current provisioning could have significant impact on capital ratios and credit ratings with consequent impact on liquidity risk. There is inherent uncertainty in making estimates of provisions required.

Mitigating actions
Prudent provisioning policy – provisions for legacy conduct issues represent management's best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses.

Principal risks and uncertainties

Group product governance controls – potential risks are monitored through product management information, new product approvals and annual product reviews leading to identification and mitigation of risks at an early stage.

Accounting standards
A number of potential changes to accounting standards are under consultation. These standards are currently scheduled for implementation between 2015 and 2018 and have the potential to add substantial volatility to the Group's reported results and capital.

Mitigating actions
The Group continues to monitor potential changes and where appropriate provide feedback.

Further information can be found under Note 57: Future accounting developments.

Independent auditors' report

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF HBOS PLC

We have audited the Group and Company financial statements (the 'financial statements') of HBOS plc for the year ended 31 December 2012 which comprise the consolidated and Company balance sheets, the consolidated income statement, the consolidated and Company statements of comprehensive income, the consolidated and Company cash flow statements, the consolidated and Company statements of changes in equity 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 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 and express an opinion on 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. In addition, we read all the financial and non-financial information in the Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

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 2012 and of the Group's profit and the Group's and Company's cash flows for the year then ended;
- the Group 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 Group 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.

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.

Philip Rivett
Senior Statutory Auditor
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
1 March 2013

(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.

Consolidated income statement

for the year ended 31 December 2012

	Note	2012 £ million	2011 £ million
Interest and similar income		**15,384**	16,565
Interest and similar expense		**(8,474)**	(8,167)
Net interest income	5	**6,910**	8,398
Fee and commission income		**1,659**	1,814
Fee and commission expense		**(536)**	(727)
Net fee and commission income	6	**1,123**	1,087
Net trading income	7	**3,492**	(894)
Insurance premium income	8	**36**	1,657
Other operating income	9	**277**	1,151
Other income		**4,928**	3,001
Total income		**11,838**	11,399
Insurance claims	10	**(2,985)**	(975)
Total income, net of insurance claims		**8,853**	10,424
Regulatory provisions		**(1,039)**	(1,155)
Other operating expenses		**(3,249)**	(4,320)
Total operating expenses	11	**(4,288)**	(5,475)
Trading surplus		**4,565**	4,949
Impairment	12	**(4,310)**	(7,104)
Loss on disposal of businesses	14	**–**	(1,739)
Profit (loss) before tax		**255**	(3,894)
Taxation	15	**(86)**	173
Profit (loss) for the year		**169**	(3,721)
Profit attributable to non-controlling interests		**41**	42
Profit (loss) attributable to equity shareholders		**128**	(3,763)
Profit (loss) for the year		**169**	(3,721)

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

Consolidated statement of comprehensive income

for the year ended 31 December 2012

The Group	2012 £ million	2011 £ million
Profit (loss) for the year	**169**	(3,721)
Other comprehensive income		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	**363**	(77)
Income statement transfers in respect of disposals	**(385)**	(72)
Income statement transfers in respect of impairment	**397**	749
Other income statement transfers	**121**	(76)
Taxation	**(123)**	(128)
	373	396
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	**730**	1,350
Net income statement transfers	**(269)**	373
Taxation	**(83)**	(447)
	378	1,276
Currency translation differences (tax: nil)	**47**	(6)
Other comprehensive income for the year, net of tax	**798**	1,666
Total comprehensive income for the year	**967**	(2,055)
Total comprehensive income attributable to non-controlling interests	**41**	42
Total comprehensive income attributable to equity shareholders	**926**	(2,097)
Total comprehensive income for the year	**967**	(2,055)

The Company	2012 £ million	2011 £ million
Profit (loss) for the year	**1,234**	(297)
Other comprehensive income		
Movements in cash flow hedging reserve:		
Net income statement transfers (tax: nil)	**–**	1
Total comprehensive income for the year	**1,234**	(296)

Consolidated balance sheet

at 31 December 2012

	Note	2012 £ million	2011 £ million
Assets			
Cash and balances at central banks		**6,112**	3,075
Items in the course of collection from banks		**416**	379
Trading and other financial assets at fair value through profit or loss	16	**62,358**	45,347
Derivative financial instruments	17	**35,855**	36,253
Loans and receivables:			
Loans and advances to banks	18	**140,085**	91,210
Loans and advances to customers	19	**313,387**	357,110
Debt securities	22	**3,979**	11,276
		457,451	459,596
Available-for-sale financial assets	24	**6,052**	10,498
Investment properties	25	**1,279**	1,686
Goodwill	27	**859**	859
Value of in-force business	28	**135**	147
Other intangible assets	29	**103**	76
Tangible fixed assets	30	**1,705**	2,372
Current tax recoverable		**576**	338
Deferred tax assets	42	**3,445**	3,977
Retirement benefit assets	41	**865**	394
Other assets	31	**4,896**	3,002
Total assets		**582,107**	567,999

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

Consolidated balance sheet

at 31 December 2012

	Note	2012 £ million	2011 £ million
Equity and liabilities			
Liabilities			
Deposits from banks	32	**171,738**	150,042
Customer deposits	33	**217,515**	217,048
Items in course of transmission to banks		**518**	332
Trading liabilities	34	**33,610**	20,805
Derivative financial instruments	17	**31,710**	33,385
Notes in circulation		**1,198**	1,145
Debt securities in issue	35	**49,521**	75,457
Liabilities arising from insurance contracts and participating investment contracts	36	**423**	385
Liabilities arising from non-participating investment contracts	38	**27,166**	22,207
Other liabilities	40	**9,726**	8,184
Retirement benefit obligations	41	**110**	107
Current tax liabilities		**58**	54
Deferred tax liabilities	42	**69**	1
Other provisions	43	**1,157**	1,064
Subordinated liabilities	44	**12,491**	13,613
Total liabilities		**557,010**	543,829
Equity			
Share capital	45	**3,763**	3,763
Share premium account	46	**18,655**	18,655
Other reserves	47	**11,321**	10,523
Retained profits	48	**(9,042)**	(9,170)
Shareholders' equity		**24,697**	23,771
Non-controlling interests		**400**	399
Total equity		**25,097**	24,170
Total equity and liabilities		**582,107**	567,999

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

The directors approved the consolidated financial statements on 1 March 2013.

Sir Winfried Bischoff
Chairman

António Horta-Osório
Chief Executive

George Culmer
Finance Director

Consolidated statement of changes in equity

for the year ended 31 December 2012

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2011	22,418	8,857	(5,415)	25,860	550	26,410
Comprehensive income						
(Loss) profit for the year	–	–	(3,763)	(3,763)	42	(3,721)
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	396	–	396	–	396
Movements in cash flow hedging reserve, net of tax	–	1,276	–	1,276	–	1,276
Currency translation differences, net of tax	–	(6)	–	(6)	–	(6)
Total other comprehensive income	–	1,666	–	1,666	–	1,666
Total comprehensive income	–	1,666	(3,763)	(2,097)	42	(2,055)
Transactions with owners						
Dividends	–	–	–	–	(15)	(15)
Value of employee services:						
Share option schemes	–	–	8	8	–	8
Change in non-controlling interests	–	–	–	–	(178)	(178)
Total transactions with owners	–	–	8	8	(193)	(185)
Balance at 31 December 2011	22,418	10,523	(9,170)	23,771	399	24,170
Comprehensive income						
Profit for the year	**–**	**–**	**128**	**128**	**41**	**169**
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**373**	**–**	**373**	**–**	**373**
Movements in cash flow hedging reserve, net of tax	**–**	**378**	**–**	**378**	**–**	**378**
Currency translation differences, net of tax	**–**	**47**	**–**	**47**	**–**	**47**
Total other comprehensive income	**–**	**798**	**–**	**798**	**–**	**798**
Total comprehensive income	**–**	**798**	**128**	**926**	**41**	**967**
Transactions with owners						
Dividends	**–**	**–**	**–**	**–**	**(22)**	**(22)**
Change in non-controlling interests	**–**	**–**	**–**	**–**	**(18)**	**(18)**
Total transactions with owners	**–**	**–**	**–**	**–**	**(40)**	**(40)**
Balance at 31 December 2012	**22,418**	**11,321**	**(9,042)**	**24,697**	**400**	**25,097**

Further details of movements in the Group's share capital and reserves are provided in notes 45, 46, 47 and 48.

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

Consolidated cash flow statement

for the year ended 31 December 2012

	Note	**2012 £ million**	2011 £ million
Profit (loss) before tax		**255**	(3,894)
Adjustments for:			
Change in operating assets	56(a)	**(11,350)**	2,110
Change in operating liabilities	56(b)	**14,226**	(6,854)
Non-cash and other items	56(c)	**(4,697)**	2,128
Tax received		**33**	16
Net cash used in operating activities		**(1,533)**	(6,494)
Cash flows from investing activities			
Purchase of available-for-sale financial assets		**(2,083)**	(6,747)
Proceeds from sale and maturity of available-for-sale financial assets		**6,759**	9,743
Purchase of fixed assets		**(476)**	(593)
Proceeds from sale of fixed assets		**1,372**	1,559
Acquisition of businesses, net of cash acquired		**(11)**	(61)
Disposal of businesses, net of cash disposed	56(e)	**37**	3,145
Net cash provided by investing activities		**5,598**	7,046
Cash flows from financing activities			
Dividends paid to non-controlling interests		**(22)**	(15)
Interest paid on subordinated liabilities		**(697)**	(750)
Repayment of subordinated liabilities		**(649)**	(2,696)
Change in stake of non-controlling interests		**20**	7
Net cash used in financing activities		**(1,348)**	(3,454)
Effects of exchange rate changes on cash and cash equivalents		**(2)**	1
Change in cash and cash equivalents		**2,715**	(2,901)
Cash and cash equivalents at beginning of year		**6,642**	9,543
Cash and cash equivalents at end of year	56(d)	**9,357**	6,642

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

Company balance sheet

at 31 December 2012

	Note	2012 £ million	2011 £ million
Assets			
Amounts owed by Group entities		**42,713**	47,378
Derivative financial instruments	17	**1,565**	1,857
Retirement benefit assets	41	**839**	375
Other assets	31	**17**	17
Investments in subsidiary undertakings	26	**23,000**	23,000
Total assets		**68,134**	72,627
Liabilities			
Amounts owed to Group entities		**29,643**	35,237
Derivative financial instruments	17	**10**	10
Other liabilities	40	**469**	457
Current tax liabilities		**307**	283
Retirement benefit obligations	41	**110**	107
Deferred tax liabilities	42	**207**	82
Subordinated liabilities	44	**9,021**	9,318
Total liabilities		**39,767**	45,494
Equity			
Issued share capital	45	**3,763**	3,763
Share premium account	46	**18,655**	18,655
Other reserves	47	**9,693**	9,693
Retained profits	48	**(3,744)**	(4,978)
Shareholders' equity		**28,367**	27,133
Total equity and liabilities		**68,134**	72,627

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

Approved by the Board on 1 March 2013 and signed on its behalf by:

Sir Winfried Bischoff
Chairman

António Horta-Osório
Chief Executive

George Culmer
Finance Director

Company statement of changes in equity

for the year ended 31 December 2012

	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million
Balance at 1 January 2011	22,418	9,692	(4,681)	27,429
Comprehensive income				
Loss for the year	–	–	(297)	(297)
Other comprehensive income				
Movements in cash flow hedging reserves, net of tax	–	1	–	1
Total comprehensive income	–	1	(297)	(296)
Balance at 31 December 2011	22,418	9,693	(4,978)	27,133
Comprehensive income[1]				
Total comprehensive income	**–**	**–**	**1,234**	**1,234**
Balance at 31 December 2012	**22,418**	**9,693**	**(3,744)**	**28,367**

[1]Total comprehensive income in 2012 comprised only the profit for the year.

There were no transactions with owners in 2011 or 2012.

Company cash flow statement

for the year ended 31 December 2012

	2012 £ million	2011 £ million
Profit before tax	**1,385**	42
Adjustments for:		
Dividend income	**(202)**	(3,126)
Change in operating assets	**1,257**	(2,760)
Change in operating liabilities	**(5,579)**	(3,887)
Non-cash and other items	**157**	4,775
Tax paid	**(1)**	(66)
Net cash used in operating activities	**(2,983)**	(5,022)
Cash flows from investing activities	**–**	–
Cash flows from financing activities		
Dividends received from subsidiaries	**202**	3,126
Repayment of subordinated liabilities	**–**	(2,602)
Interest paid on subordinated liabilities	**(455)**	(334)
Net cash (used in) provided by financing activities	**(253)**	190
Change in cash and cash equivalents	**(3,236)**	(4,832)
Cash and cash equivalents at beginning of year	**25,563**	30,395
Cash and cash equivalents at end of year	**22,327**	25,563

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

Notes to the accounts

1 Basis of preparation

The financial statements of HBOS plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) 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.

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the Principal risks and uncertainties section under Liquidity and funding on page 9 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

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.

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

(i) *Disclosures – Transfers of Financial Assets (Amendments 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. Disclosures in connection with such transfers can be found in note 53.

(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.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2012 and which have not been applied in preparing these financial statements are given in note 57.

2 Accounting policies

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

a Consolidation
The assets, liabilities and results of Group undertakings (including 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.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control are consolidated. Control arises when the Group manages the funds and also has a majority beneficial interest. In circumstances where the Group holds a majority beneficial interest, but is not the fund manager, the Group does not consolidate the entity as it does not have the fund manager's decision-making powers over the investment activities of the OEIC necessary to establish control. The interests of parties other than the Group are reported in other liabilities.

Special purpose entities (SPEs) are consolidated if, in substance, the Group controls the entity. A key indicator of such control, amongst others, is where the Group is exposed to the risks and benefits of the SPE.

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

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

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(4)) or share capital (see 2r(1)). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) Joint ventures and associates
Joint ventures are 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; goodwill 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.

c Other intangible assets
Other intangible assets include brands and both internally and externally generated capitalised software enhancements. 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 7 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

2 Accounting policies (continued)

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 below).

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 insurance and general insurance business are detailed below (see o below); those relating to leases are set out in k(2) below.

e Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets 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 trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

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

- substantially all of the risks and rewards of ownership have been transferred; or
- the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

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

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

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 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 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 a(2) above, 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 estimates and judgements: Valuation of financial instruments) and note 53 (3) (Financial instruments: 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; or
- 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 Accounting policies (continued)

(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 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. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

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

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

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

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

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 deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities 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.

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: Fair value of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

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

Derivatives embedded in financial instruments 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 derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge

2 Accounting policies (continued)

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 instruments used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

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

h Impairment of financial assets
(1) Assets accounted for at amortised cost
At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, 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.

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios 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.

Individual assessment
In respect of individually significant financial assets in the Group's wholesale lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

For impaired debt instruments which are held at amortised cost, 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.

Collective assessment
Impairment is assessed on a collective basis for (1) homogenous groups of loans that are not considered individually impaired; and (2) to cover losses which have been incurred but have not yet been identified on loans subject to individual impairment.

2 Accounting policies (continued)

Homogenous groups of loans
In respect of portfolios of smaller balance, homogenous loans, or otherwise where there is no objective evidence of individual impairment, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors, such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data about economic and credit conditions (including unemployment rates and borrowers' behaviour) 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.

Incurred but not yet identified impairment
The collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for wholesale lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of each account becoming recognised as impaired within the loss emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and twelve months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios.

Loan renegotiations and forbearance
In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

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

Debt for equity exchanges
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, held as available-for-sale. 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 above). 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; although 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.

2 Accounting policies (continued)

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 life insurance 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. 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.

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 and the remaining period of the lease.
– Leasehold improvements: shorter of 10 years and, 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.

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.

2 Accounting policies (continued)

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. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

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 insurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on shareholders' 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.

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 substantively 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 and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the 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. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts,* which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP, including FRS 27 *Life Assurance* and UK established practice.

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 gives the holder the right 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, within the constraints of the terms and conditions of the instrument 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.

Notes to the accounts

2 Accounting policies (continued)

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 the unallocated surplus (see below). Changes in the value of these liabilities are recognised in the income statement 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. Benefit claims in excess of the account balances incurred in the period are also charged through insurance claims. 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 returns (including movements in fair value and investment income) allocated to those contracts are recognised in insurance claims.

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 fee and commission expense 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 are 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.

2 Accounting policies (continued)

(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 benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

Assets arising from reinsurance contracts held – Classified as insurance 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 recoverable assets are recognised in the income statement through insurance claims.

Assets arising from reinsurance contracts held – Classified as non-participating investment contracts
These contracts are accounted for as financial assets whose value is contractually linked to the fair values of financial assets within the reinsurers' investment funds. Investment returns (including movements in fair value and investment income) allocated to these contracts are recognised in insurance claims. Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the assets arising from reinsurance contracts held.

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 and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

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

– The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
– The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see f(3) above). On disposal 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 and contingent liabilities
Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

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 Share capital
(1) Share issue costs
Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

(2) 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 Investment in subsidiaries
Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

3 Critical accounting estimates and judgements

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

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

Allowance for impairment losses on loans and receivables
At 31 December 2012 gross loans and receivables totalled £476,320 million (2011: £484,095 million) against which impairment allowances of £18,869 million (2011: £24,499 million) had been made (see note 23). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h; this note also provides an overview of the methodologies applied.

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 made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's wholesale lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of real estate collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is 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 were ten per cent lower than those estimated at 31 December 2012, the impairment charge would increase by approximately £280 million in respect of UK mortgages and a further £55 million in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Group's wholesale businesses, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £88 million (at 31 December 2011, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £135 million).

Fair value of financial instruments
In accordance with IFRS 7 *Financial Instruments: Disclosure*, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These valuation techniques involve management judgement and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information.

Valuation techniques for level 2 financial instruments use inputs that are largely based on observable market data. Level 3 financial instruments 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. Determining the appropriate assumptions to be used for level 3 financial instruments requires significant management judgement.

At 31 December 2012, the Group classified £763 million of financial assets and £68 million of financial liabilities as level 3. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 53.

Recoverability of deferred tax assets
At 31 December 2012 the Group carried deferred tax assets on its balance sheet of £3,445 million (2011: £3,977 million) and deferred tax liabilities of £69 million (2011: £1 million) (note 42). This 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 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward.

The recoverability of the Group's deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of, business plans, the five year board approved operating plan and the following future risk factors:

- The expected future economic outlook as set out in the Group Chief Executive's Review contained in the Annual Report of Lloyds Banking Group.
- The retail banking business disposal as required by the European Commission; and
- Future regulatory change.

The Group's total deferred tax asset includes £3,637 million (2011: £3,568 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc.

3 Critical accounting estimates and judgements (continued)

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. The assessment of the likely rate of recoverability of the deferred tax is expected to be slower than previously anticipated due to the more subdued and uncertain macroeconomic environment and the further provisions for legacy issues. However, the losses are still expected to be fully utilised by 2019.

As disclosed in note 42, deferred tax assets totalling £664 million (2011: £571 million) have not been recognised in respect of certain capital losses carried forward, trading losses carried forward (mainly in certain overseas companies) and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

Retirement benefit obligations

The net asset recognised in the balance sheet at 31 December 2012 in respect of the Group's retirement benefit obligations was £755 million (2011: net asset £287 million). In 2012, this comprised an asset of £865 million and a liability of £110 million (2011: an asset of £394 million and a liability of £107 million); of which an asset of £820 million (2011: an asset of £350 million) related to defined benefit pension schemes. As explained in note 2, the Group adopts the corridor approach to the recognition of actuarial gains and losses in respect of its pension schemes and as a consequence has not recognised actuarial losses of £203 million (2011: gains of £532 million). After allowing for this, the defined benefit pension schemes' net accounting surplus totalled £617 million (2011: surplus of £882 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The value of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The accounting surplus or deficit is sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variation. 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 and extrapolate the improving trend, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience.

The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in note 41.

Valuation of assets and liabilities arising from life insurance business

At 31 December 2012, the Group recognised a value of in-force business asset of £37 million (2011: £42 million) and an acquired value of in-force business asset of £98 million (2011: £105 million). The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The acquired value of in-force business asset represents the 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 note 2o(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value of in-force business assets at 31 December 2012 are set out in note 28.

At 31 December 2012, the Group carried liabilities arising from insurance contracts and participating investment contracts of £423 million (2011: £385 million). The methodology used to value these liabilities is described in note 2o(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 37.

The effect on the Group's profit before tax and shareholders' equity of changes in key assumptions used in determining the life insurance assets and liabilities is set out in note 37.

Payment protection insurance and other regulatory provisions

At 31 December 2012, the Group carried provisions of £1,059 million (2011: £905 million) against the cost of making redress payments to customers and the related administration costs in connection with historic regulatory breaches, principally the misselling of payment protection insurance. Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the number of future complaints, the extent to which they will be upheld and the average cost of redress. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

Note 43 contains more detail on the nature of the assumptions that have been made and key sensitivities.

4 Segmental analysis

IFRS 8 'Operating Segments' requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally. The chief operating decision maker has been identified as the Group Executive Committee of Lloyds Banking Group. The HBOS Group is managed on an entity basis and not by segment. The Group Executive Committee does not assess the HBOS Group's performance and allocate resources across any segments, accordingly no segmental information is provided. A brief overview of the Group's sources of income is provided in this document. The ultimate parent undertaking, Lloyds Banking Group plc, produces consolidated accounts which set out the basis of the segments through which it manages performance and allocates resources across the consolidated Lloyds Banking Group.

Geographical areas
The Group's activities are focused in the UK and the analyses of income and assets below are based on the location of the branch or entity recording the income or assets.

	2012			2011		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
Total income	**11,267**	**571**	**11,838**	9,427	1,972	11,399
Total assets	**523,613**	**58,494**	**582,107**	514,190	53,809	567,999

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

5 Net interest income

	Weighted average effective interest rate			
	2012 %	2011 %	2012 £m	2011 £m
Interest and similar income:				
Loans and advances to customers, excluding lease and hire purchase receivables	**3.87**	3.77	**13,428**	14,779
Loans and advances to banks	**0.93**	1.06	**1,243**	811
Debt securities held as loans and receivables	**3.80**	3.15	**300**	507
Lease and hire purchase receivables	**3.87**	3.21	**163**	174
Interest receivable on loans and receivables	**3.08**	3.32	**15,134**	16,271
Available-for-sale financial assets	**4.34**	3.06	**250**	294
Total interest and similar income	**3.09**	3.32	**15,384**	16,565
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	**1.25**	0.94	**(2,094)**	(1,422)
Customer deposits, excluding liabilities under sale and repurchase agreements	**2.21**	2.27	**(4,503)**	(4,525)
Debt securities in issue	**1.33**	1.39	**(784)**	(1,241)
Subordinated liabilities	**4.83**	5.22	**(657)**	(780)
Liabilities under sale and repurchase agreements	**1.70**	2.15	**(50)**	(96)
Interest payable on liabilities held at amortised cost	**1.81**	1.75	**(8,088)**	(8,064)
Other	**11.73**	1.82	**(386)**	(103)
Total interest and similar expense	**1.89**	1.76	**(8,474)**	(8,167)
Net interest income			**6,910**	8,398

Included within interest and similar income is £889 million (2011: £1,041 million) in respect of impaired financial assets. Net interest income also includes a credit of £269 million (2011: a charge of £373 million) transferred from the cash flow hedging reserve (see note 47).

Notes to the accounts

6 Net fee and commission income

	2012 £m	2011 £m
Fee and commission income:		
Current accounts	**281**	357
Credit and debit card fees	**262**	214
Other	**1,116**	1,243
Total fee and commission income	**1,659**	1,814
Fee and commission expense	**(536)**	(727)
Net fee and commission income	**1,123**	1,087

As discussed in note 2d, 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

	2012 £m	2011 £m
Foreign exchange translation gains	**19**	465
Gains on foreign exchange trading transactions	**41**	97
Total foreign exchange	**60**	562
Investment property losses (note 25)	**(116)**	(65)
Securities and other gains (losses) (see below)	**3,548**	(1,391)
Net trading income (expense)	**3,492**	(894)

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

	2012 £m	2011 £m
Net income (expense) arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	**501**	504
Equity shares	**2,857**	(1,038)
Total net income (expense) arising on assets held at fair value through profit or loss	**3,358**	(534)
Net gains (losses) on financial instruments held for trading	**190**	(857)
Securities and other gains (losses)	**3,548**	(1,391)

8 Insurance premium income

	2012 £m	2011 £m
Life insurance		
Gross premiums	**61**	1,441
Ceded reinsurance premiums	**(25)**	(104)
Net earned premiums	**36**	1,337
Non-life insurance		
Gross written premiums	**–**	320
Ceded reinsurance premiums	**–**	(3)
Net written premiums	**–**	317
Change in provision for unearned premiums (note 36(2))	**–**	16
Change in provision for ceded unearned premiums (note 36(2))	**–**	(13)
Net earned premiums	**–**	320
Total net earned premiums	**36**	1,657

Life insurance gross premiums can be further analysed as follows:

	2012 £m	2011 £m
Life and pensions	**61**	1,366
Annuities	**–**	73
Other	**–**	2
Gross premiums	**61**	1,441

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

	2012 £m	2011 £m
Credit protection	**–**	74
Home	**–**	246
Gross written premiums	**–**	320

9 Other operating income

	2012 £m	2011 £m
Operating lease rental income	**139**	254
Rental income from investment properties (note 25)	**85**	135
Other rents receivable	**12**	10
Gains on disposal of available-for-sale financial assets	**385**	73
Liability management (losses) gains	**(40)**	610
Movement in value of in-force business (note 28)	**(5)**	9
Share of results of joint ventures and associates (note 13)	**28**	26
Other income	**(327)**	34
Total other operating income	**277**	1,151

During December 2011, the Lloyds Banking Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and the Company for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call before 31 December 2012. This exchange resulted in a gain for the Group on extinguishment of the existing securities of £610 million being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

10 Insurance claims

Insurance claims comprise:

	2012 £m	2011 £m
Life insurance and participating investment contracts		
Claims and surrenders:		
Gross (see below)	**48**	2,395
Reinsurers' share	**(20)**	(81)
	28	2,314
Change in insurance and participating investment contracts (note 36(1)):		
Change in gross liabilities	**38**	(837)
Change in assets arising from reinsurance contracts held	**(4)**	(187)
	34	(1,024)
Change in gross non-participating investment contracts:		
Change in gross liabilities	**2,923**	(435)
Change in assets arising from reinsurance contracts held	**–**	(42)
	2,923	(477)
Change in unallocated surplus (note 39)	**–**	41
Total life insurance and participating investment contracts	**2,985**	854
Non-life insurance		
Claims and claims paid:		
Gross	**–**	158
Reinsurers' share	**–**	(3)
	–	155
Change in liabilities (note 36(2)):		
Gross	**–**	(42)
Reinsurers' share	**–**	8
	–	(34)
Total non-life insurance	**–**	121
Total insurance claims	**2,985**	975

Life insurance and participating investment contract gross claims can also be analysed as follows:

	2012 £m	2011 £m
Deaths	**10**	239
Maturities	**7**	244
Surrenders	**20**	1,689
Annuities	**–**	89
Other	**11**	134
Total life insurance gross claims	**48**	2,395

11 Operating expenses

	2012 £m	2011 £m
Staff costs:		
Salaries	1,360	1,723
Social security costs	128	162
Pensions and other post-retirement benefit schemes (note 41):		
Past service credits and curtailment gain[1]	(258)	–
Other	184	182
	(74)	182
Restructuring costs	–	62
Other staff costs	96	90
	1,510	2,219
Premises and equipment:		
Rent and rates	196	264
Hire of equipment	2	3
Repairs and maintenance	29	37
Other	142	156
	369	460
Other expenses:		
Communications and data processing	245	263
Advertising and promotion	106	159
Professional fees	31	88
Financial services compensation scheme levy (note 52)	104	86
Other	627	625
	1,113	1,221
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 30)	236	326
Amortisation of acquired value of in-force non-participating investment contracts (note 28)	7	11
Amortisation of other intangible assets (note 29)	14	18
	257	355
Impairment of tangible fixed assets (note 30)	–	65
Total operating expenses, excluding regulatory provisions	3,249	4,320
Regulatory provisions:		
Payment protection insurance provision (note 43)	850	1,155
Other regulatory provisions (note 43)	189	–
	1,039	1,155
Total operating expenses	4,288	5,475

[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 2012.

11 Operating expenses (continued)

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

	2012	2011
UK	45,716	50,340
Overseas	1,104	1,689
Total	**46,820**	52,029

Fees payable to the Company's auditors

During the year the auditors earned the following fees:

	2012 £m	2011 £m
Fees payable for the audit of the Company's current year annual report	0.6	0.6
Fees payable for other services:		
Audit of the Company's subsidiaries pursuant to legislation	6.0	8.2
Other services supplied pursuant to legislation	0.7	1.0
Other services – audit related fees	0.1	0.4
Taxation compliance services	–	0.1
All other taxation advisory services	0.1	0.5
Services relating to corporate finance transactions	–	0.5
All other services	0.2	0.5
Total fees payable to the Company's auditors by the Group	**7.7**	11.8

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

	2012 £m	2011 £m
Audits of Group pension schemes	0.1	0.1
Reviews of the financial position of corporate and other borrowers	1.3	3.7

12 Impairment

	2012 £m	2011 £m
Impairment losses on loans and receivables (note 23):		
Loans and advances to customers	4,252	6,961
Debt securities classified as loans and receivables	17	60
Total impairment losses on loans and receivables	4,269	7,021
Impairment of available-for-sale financial assets	41	78
Other credit risk provisions (note 43)	–	5
Total impairment charged to the income statement	**4,310**	7,104

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	
	2012 £m	2011 £m	**2012 £m**	2011 £m	**2012 £m**	2011 £m
Share of income statement amounts:						
Income	**278**	312	**63**	160	**341**	472
Expenses	**(229)**	(262)	**(68)**	(161)	**(297)**	(423)
Impairment	**(6)**	(20)	**(1)**	1	**(7)**	(19)
Profit (loss) before tax	**43**	30	**(6)**	–	**37**	30
Tax	**(9)**	(4)	**–**	–	**(9)**	(4)
Share of post-tax results	**34**	26	**(6)**	–	**28**	26
Share of balance sheet amounts:						
Current assets	**3,097**	3,341	**127**	246	**3,224**	3,587
Non-current assets	**1,596**	2,148	**581**	976	**2,177**	3,124
Current liabilities	**(729)**	(713)	**(128)**	(293)	**(857)**	(1,006)
Non-current liabilities	**(3,672)**	(4,471)	**(566)**	(904)	**(4,238)**	(5,375)
Share of net assets at 31 December	**292**	305	**14**	25	**306**	330
Movement in investments over the year:						
At 1 January	**305**	326	**25**	102	**330**	428
Additional investments	**10**	8	**1**	3	**11**	11
Disposals	**(44)**	(47)	**(6)**	(79)	**(50)**	(126)
Share of post-tax results	**34**	26	**(6)**	–	**28**	26
Dividends paid	**(13)**	(5)	**–**	–	**(13)**	(5)
Exchange and other adjustments	**–**	(3)	**–**	(1)	**–**	(4)
Share of net assets at 31 December	**292**	305	**14**	25	**306**	330

During 2012, the Group recognised a net £10 million (2011: £8 million) of losses of associates not previously recognised. The Group's unrecognised share of losses of joint ventures is £126 million in 2012 (2011: £85 million in respect of joint ventures and £8 million in respect of associates). 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 £31 million (2011: £56 million) and of joint ventures is £329 million (2011: £299 million).

The Group's principal joint venture investment at 31 December 2012 was in Sainsbury's Bank plc; the Group owns 50 per cent of the ordinary share capital of Sainsbury's Bank plc, whose business is banking and principal area of operation is the UK. Sainsbury's Bank plc is incorporated in the UK and the Group's interest is held by a subsidiary.

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.

14 Disposal of businesses

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 for a total consideration of £3,013 million. This resulted in a consolidated loss on disposal of £1,739 million in the year ended 31 December 2011.

15 Taxation

a Analysis of tax credit (charge) for the year

	2012 £m	2011 £m
UK corporation tax:		
Current tax on profit (loss) for the year	**157**	322
Adjustments in respect of prior years	**170**	(95)
	327	227
Foreign tax:		
Current tax on profit (loss) for the year	**(25)**	(23)
Adjustments in respect of prior years	**(7)**	19
	(32)	(4)
Current tax credit	**295**	223
Deferred tax (note 42):		
Origination and reversal of temporary differences	**1**	209
Reduction in UK corporation tax rate	**(300)**	(332)
Adjustments in respect of prior years	**(82)**	73
	(381)	(50)
Tax (charge) credit	**(86)**	173

The tax (charge) credit for 2012 is based on a UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent).

The above income tax (charge) credit is made up as follows:

	2012 £m	2011 £m
Tax (charge) credit attributable to policyholders	**(74)**	190
Shareholder tax charge	**(12)**	(17)
Tax (charge) credit	**(86)**	173

b Factors affecting the tax (charge) credit for the year
A reconciliation of the (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 for the year is given below:

	2012 £m	2011 £m
Profit (loss) before tax	**255**	(3,894)
Tax (charge) credit thereon at UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent)	**(62)**	1,032
Factors affecting credit:		
UK corporation tax rate change	**(300)**	(332)
Disallowed and non-taxable items	**189**	23
Overseas tax rate differences	**72**	(12)
Gains exempted or covered by capital losses	**(10)**	(459)
Policyholder tax	**(56)**	140
Adjustments in respect of previous years	**81**	(3)
Effect of results of joint ventures and associates	**9**	7
Tax losses surrendered for no payment	**–**	(1)
Tax losses where no deferred tax recognised	**(13)**	(246)
Deferred tax on tax losses not previously recognised	**–**	40
Other items	**4**	(16)
Tax (charge) credit on loss on ordinary activities	**(86)**	173

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

	2012 £m	2011 £m
Trading assets	**32,201**	21,840
Other financial assets at fair value through profit or loss	**30,157**	23,507
Total	**62,358**	45,347

These assets are comprised as follows:

	2012		2011	
	Trading assets £m	**Other financial assets at fair value through profit or loss £m**	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	**28,350**	**22**	17,381	54
Loans and advances to banks	**729**	**–**	1,355	–
Debt securities:				
Government securities	**184**	**2,002**	992	1,471
Other public sector securities	**–**	**154**	–	185
Bank and building society certificates of deposit	**2,239**	**160**	1,384	92
Asset-backed securities:				
Mortgage-backed securities	**–**	**18**	–	9
Other asset-backed securities	**4**	**–**	203	–
Corporate and other debt securities	**410**	**3,976**	301	2,543
	2,837	**6,310**	2,880	4,300
Equity shares	**–**	**23,825**	–	19,153
Treasury and other bills	**285**	**–**	224	–
Total	**32,201**	**30,157**	21,840	23,507

At 31 December 2012 £38,591 million (2011: £28,113 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 £29,765 million (2011: £23,474 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.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £28,993 million for the Group (2011: £18,729 million). Collateral is held with a fair value of £33,946 million for the Group (2011: £23,655 million), all of which the Group is able to repledge. At 31 December 2012, £30,191 million had been repledged by the Group (2011: £20,055 million).

For amounts included above which are subject to repurchase agreements see note 54.

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 and cash flow 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.

17 Derivative financial instruments (continued)

– 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.

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

	2012			2011		
Group	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading						
Exchange rate contracts:						
Spot, forwards and futures	**543**	**36**	**44**	1,294	112	55
Currency swaps	**35,785**	**828**	**806**	55,004	1,595	996
Options purchased	**139**	**3**	**–**	56	1	–
Options written	**51**	**–**	**–**	138	–	4
	36,518	**867**	**850**	56,492	1,708	1,055
Interest rate contracts:						
Interest rate swaps	**454,087**	**23,293**	**24,646**	496,685	23,026	23,666
Forward rate agreements	**9,902**	**12**	**14**	203,645	80	66
Options purchased	**8,866**	**764**	**–**	11,629	823	–
Options written	**11,268**	**–**	**889**	14,143	–	1,002
Futures	**44,548**	**–**	**1**	113,213	–	–
	528,671	**24,069**	**25,550**	839,315	23,929	24,734
Credit derivatives	**435**	**–**	**57**	204	10	75
Equity and other contracts	**7,241**	**996**	**766**	6,890	1,018	811
Total derivative assets/liabilities held for trading	**572,865**	**25,932**	**27,223**	902,901	26,665	26,675
Hedging						
Derivatives designated as fair value hedges:						
Interest rate swaps	**42,602**	**4,713**	**491**	35,757	4,165	581
Cross currency swaps	**27,299**	**450**	**219**	19,100	557	138
	69,901	**5,163**	**710**	54,857	4,722	719
Derivatives designated as cash flow hedges:						
Interest rate swaps	**111,889**	**4,745**	**3,745**	161,463	4,690	5,901
Cross currency swaps	**2,704**	**14**	**32**	25,732	176	90
Options	**–**	**–**	**–**	–	–	–
Futures	**49,527**	**1**	**–**	103,467	–	–
	164,120	**4,760**	**3,777**	290,662	4,866	5,991
Derivatives designated as net investment hedges:						
Cross currency swaps	**–**	**–**	**–**	–	–	–
Total derivative assets/liabilities held for hedging	**234,021**	**9,923**	**4,487**	345,519	9,588	6,710
Total recognised derivative assets/liabilities	**806,886**	**35,855**	**31,710**	1,248,420	36,253	33,385

17 Derivative financial instruments (continued)

Hedged cash flows

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

2012	**0-1 years £m**	**1-2 years £m**	**2-3 years £m**	**3-4 years £m**	**4-5 years £m**	**5-10 years £m**	**10-20 years £m**	**Over 20 years £m**	**Total £m**
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	**73**	**123**	**248**	**206**	**88**	**243**	**76**	**119**	**1,176**
Forecast payable cash flows	**(101)**	**(60)**	**(42)**	**(53)**	**(57)**	**(405)**	**(456)**	**(30)**	**(1,204)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**114**	**168**	**233**	**162**	**73**	**237**	**70**	**119**	**1,176**
Forecast payable cash flows	**(123)**	**(54)**	**(47)**	**(55)**	**(63)**	**(408)**	**(433)**	**(21)**	**(1,204)**

2011	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	52	140	377	277	136	260	5	28	1,275
Forecast payable cash flows	(154)	(173)	(94)	(65)	(28)	(119)	(409)	(55)	(1,097)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	117	147	328	263	167	221	4	28	1,275
Forecast payable cash flows	(207)	(144)	(70)	(65)	(43)	(130)	(408)	(30)	(1,097)

There were no transactions for which cash flow hedge accounting had to be ceased in 2012 or 2011 as a result of the highly probable cash flows no longer being expected to occur.

At 31 December 2012 £31,907 million of total recognised derivative assets of the Group and £29,447 million of total recognised derivative liabilities of the Group (2011: £32,892 million of assets and £30,209 million of liabilities) had a contractual residual maturity of greater than one year.

	2012			2011		
Company	**Contract/ notional amount £m**	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Hedging						
Derivatives designated as fair value hedges:						
Currency swaps	**6,478**	**1,430**	**–**	5,600	1,715	10
Interest rate swaps	**597**	**135**	**10**	508	142	–
Total recognised derivative assets/liabilities, held for hedging	**7,075**	**1,565**	**10**	6,108	1,857	10

At 31 December 2012 £1,564 million of total recognised derivative assets of the Company and £nil of total recognised derivative liabilities of the Company (2011: £1,687 million of assets and £nil of liabilities) had a contractual residual maturity of greater than one year.

The principal amount of a contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group and the Company should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 54.

18 Loans and advances to banks of the Group

	2012 £m	2011 £m
Lending to banks	**135,338**	85,854
Money market placements with banks	**4,747**	5,356
Total loans and advances to banks	**140,085**	91,210

No allowance for impaired loans was carried against these exposures at 31 December 2012 or 31 December 2011.

18 Loans and advances to banks of the Group (continued)

At 31 December 2012 £90,463 million (2011: £50,614 million) of loans and advances to banks had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £83 million (2011: £2,950 million). Collateral is held with a fair value of £83 million (2011: £2,950 million), all of which the Group is able to repledge.

19 Loans and advances to customers of the Group

	2012 £m	2011 £m
Agriculture, forestry and fishing	**501**	588
Energy and water supply	**1,200**	1,670
Manufacturing	**1,842**	2,946
Construction	**3,956**	6,818
Transport, distribution and hotels	**14,898**	20,135
Postal and telecommunications	**297**	357
Property companies	**30,163**	42,418
Financial, business and other services	**14,419**	33,077
Personal:		
Mortgages	**237,466**	243,222
Other	**13,302**	12,920
Lease financing	**2,953**	3,840
Hire purchase	**506**	772
Due from fellow Group undertakings	**9,765**	11,698
Total loans and advances to customers before allowance for impairment losses	**331,268**	380,461
Allowance for impairment losses (note 23)	**(17,881)**	(23,351)
Total loans and advances to customers	**313,387**	357,110

At 31 December 2012 £276,042 million (2011: £290,167 million) of loans and advances to customers had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £nil (2011: £14,250 million). Collateral is held with a fair value of £nil (2011: £14,254 million), all of which the Group is able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £2 million (2011: £34 million).

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

	2012 £m	2011 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**676**	616
Later than 1 year and not later than 5 years	**1,188**	1,665
Later than 5 years	**1,978**	2,896
	3,842	5,177
Unearned future finance income on finance leases	**(886)**	(1,337)
Rentals received in advance	**(3)**	–
Net investment in finance leases	**2,953**	3,840

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

	2012 £m	2011 £m
Not later than 1 year	**553**	444
Later than 1 year and not later than 5 years	**871**	1,215
Later than 5 years	**1,529**	2,181
Net investment in finance leases	**2,953**	3,840

19 Loans and advances to customers of the Group (continued)

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2012 and 2011 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 £30 million (2011: £89 million).

The unguaranteed residual values included in finance lease receivables were as follows:

	2012 £m	2011 £m
Not later than 1 year	**30**	35
Later than 1 year and not later than 5 years	**72**	73
Later than 5 years	**7**	12
Total unguaranteed residual values	**109**	120

20 Securitisations and covered bonds

Securitisation programmes
Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote 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 described below, the Group sponsors a conduit programme, Grampian (note 21).

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

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

	2012		2011	
	Loans and advances securitised £m	**Notes in issue £m**	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes				
UK residential mortgages	**44,647**	**32,201**	91,246	68,425
US residential mortgage-backed securities	**3,909**	**5,237**	4,659	6,351
Irish residential mortgages	**5,194**	**3,509**	5,531	5,661
Credit card receivables	**7,001**	**3,794**	6,792	4,810
Dutch residential mortgages	**4,551**	**4,692**	4,960	4,817
Commercial loans	**675**	**675**	680	631
Motor vehicle loans	**1,039**	**1,086**	1,573	1,341
	67,016	**51,194**	115,441	92,036
Less held by the Group		**(33,570)**		(65,118)
Total securitisation programmes (note 35)		**17,624**		26,918
Covered bond programmes				
Residential mortgage-backed	**46,311**	**33,414**	48,521	38,882
Social housing loan-backed	**2,934**	**2,400**	3,370	2,605
	49,245	**35,814**	51,891	41,487
Less held by the Group		**(10,226)**		(13,515)
Total covered bond programmes (note 35)		**25,588**		27,972
Total securitisation and covered bond programmes		**43,212**		54,890

Cash deposits of £12,710 million (2011: £13,381 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.

21 Special purpose entities

In addition to the SPEs discussed in note 20, which are used for securitisation and covered bond programmes, the Group sponsors an asset-backed conduit, Grampian, which invests in debt securities. All the external assets in this conduit are consolidated in the Group's financial statements. The total consolidated exposures in this conduit are set out in the table below:

	2012 £m	2011 £m
Loans and advances	59	197
Debt securities:		
Classified as loans and receivables – asset-backed securities	358	2,004
Classified as available-for-sale financial assets – asset-backed securities	143	796
Total debt securities	501	2,800
Total assets	**560**	**2,997**

22 Debt securities classified as loans and receivables of the Group

Debt securities accounted for as loans and receivables comprise:

	2012 £m	2011 £m
Asset-backed securities:		
Mortgage-backed securities	4,280	7,258
Other asset-backed securities	416	4,738
Corporate and other debt securities	271	428
Total debt securities classified as loans and receivables before allowance for impairment losses	**4,967**	12,424
Allowance for impairment losses (note 23)	(988)	(1,148)
Total debt securities classified as loans and receivables	**3,979**	11,276

At 31 December 2012, £3,872 million (2011: £11,065 million) of debt securities classified as loans and receivables of the Group had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 54.

23 Allowances for impairment losses on loans and receivables

	Loans and advances to customers £m	Debt securities £m	Total £m
Balance at 1 January 2011	25,316	1,291	26,607
Exchange and other adjustments	(385)	11	(374)
Advances written off	(8,428)	(222)	(8,650)
Recoveries of advances written off in previous years	58	8	66
Unwinding of discount	(171)	–	(171)
Charge to the income statement (note 12)	6,961	60	7,021
At 31 December 2011	23,351	1,148	24,499
Exchange and other adjustments	(305)	(41)	(346)
Advances written off	(9,572)	(151)	(9,723)
Recoveries of advances written off in previous years	484	15	499
Unwinding of discount	(329)	–	(329)
Charge to the income statement (note 12)	4,252	17	4,269
At 31 December 2012	**17,881**	**988**	**18,869**

Of the Group's total allowance in respect of loans and advances to customers, £16,726 million (2011: £21,876 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date. Of the total allowance in respect of loans and advances to customers, £3,724 million (2011: £4,075 million) was assessed on a collective basis.

24 Available-for-sale financial assets of the Group

	2012 £m	2011 £m
Debt securities:		
Government securities	**113**	163
Bank and building society certificates of deposit	**25**	32
Asset-backed securities:		
Mortgage-backed securities	**882**	789
Other asset-backed securities	**306**	83
Corporate and other debt securities	**4,256**	7,550
	5,582	8,617
Equity shares	**470**	1,881
Total available-for-sale financial assets	**6,052**	10,498

At 31 December 2012 £4,997 million (2011: £8,457 million) of available-for-sale financial assets had a contractual residual maturity of greater than one year.

For amounts included above which are subject to repurchase agreements see note 54.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2h(2). At 31 December 2012 no available-for-sale debt securities have been individually determined to be impaired (2011: gross amount before impairment allowances £2 million, in respect of which no collateral was held).

25 Investment properties

	2012 £m	2011 £m
At 1 January	**1,686**	3,356
Exchange and other adjustments	**25**	–
Additions:		
Acquisitions of new properties	**162**	183
Consolidation of new subsidiary undertakings	**411**	920
Additional expenditure on existing properties	**27**	10
Total additions	**600**	1,113
Disposals	**(916)**	(713)
Changes in fair value (note 7)	**(116)**	(65)
Disposal of businesses (note 14)	**–**	(2,005)
At 31 December	**1,279**	1,686

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:

	2012 £m	2011 £m
Rental income (note 9)	**85**	135
Direct operating expenses arising from investment properties that generate rental income	**5**	7

Capital expenditure in respect of investment properties:

	2012 £m	2011 £m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	**–**	6

26 Investment in subsidiary undertakings

	2012 £m	2011 £m
At 1 January	**23,000**	26,923
Exchange and other adjustments	–	128
Impairment	–	(4,051)
At 31 December	**23,000**	23,000

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:

	Share class	Company's interest in ordinary share capital and voting rights	Country of incorporation	Principal business
Bank of Scotland plc	Ordinary	100%	UK	Banking, financial and related services
HBOS Insurance & Investment Group Limited	Ordinary	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 Commission approval of state aid received, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain Group preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc also 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 could have been 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.

27 Goodwill

	2012 £m	2011 £m
At 1 January	**859**	850
Adjustment on acquisition	–	9
At 31 December	**859**	859
Cost[1]	**1,847**	1,847
Accumulated impairment losses	**(988)**	(988)
At 31 December	**859**	859

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. This compares the 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 £859 million (2011: £859 million), £478 million (or 55 per cent of the total) has been allocated to insurance and investment businesses and £356 million (or 41 per cent of the total) to retail banking activities.

The recoverable amount of goodwill carried at 31 December 2012 has been based upon value in use. This calculation uses cash flow projections based upon the five year business plan where the main assumptions used for planning purposes relate to the current economic outlook and opinions in respect of economic growth, unemployment, property markets, interest rates and credit quality. Cash flows for the period subsequent to the term of the business plan are not considered for the purposes of impairment testing. The discount rate used in discounting the projected cash flows is 11 per cent (post-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.

28 Value of in-force business

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

	2012 £m	2011 £m
Acquired value of in-force non-participating investment contracts	**98**	105
Value of in-force insurance and participating investment contracts	**37**	42
Total value of in-force business	**135**	147

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

	2012 £m	2011 £m
At 1 January	**105**	136
Amortisation taken to income statement (note 11)	**(7)**	(11)
Disposal of businesses (note 14)	**–**	(20)
At 31 December	**98**	105

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

	2012 £m	2011 £m
At 1 January	**42**	3,035
Exchange and other adjustments	**–**	48
New business	**–**	108
Existing business:		
Expected return	**(5)**	(168)
Experience variances	**–**	(30)
Non-economic assumption changes	**–**	51
Economic variance	**–**	48
Movement in the value of in-force business taken to income statement (note 9)	**(5)**	9
Disposal of businesses (note 14)	**–**	(3,050)
At 31 December	**37**	42

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. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value 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 economic 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 a risk-free rate and all cash flows are discounted at a 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 risk-free rate assumed in valuing the non-annuity in-force business is the 15 year government bond yield for the appropriate territory.

28 Value of in force business (continued)

The table below shows the risk-free rate and other key assumptions at 31 December for UK business:

	2012 %	2011 %
Risk-free rate (value of in-force non-annuity business)	**1.80**	2.48
Retail price inflation	**2.50**	3.35
Expense inflation	**3.40**	4.01

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, reinsurer default and the with-profit funds there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

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

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

Lapse (persistency) and paid-up rates
Lapse and paid up rates assumptions are reviewed each year. The most recent experience is considered along with the results of previous analyses and management's views on future experience. 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 and any known or expected trends in underlying data.

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. Explicit allowance is made for future expense inflation.

These assumptions are intended to represent a best estimate of future experience, and further information about the effect of changes in key assumptions is given in note 37.

29 Other intangible assets

Group	Brands £m	Capitalised software enhancements £m	Total £m
Cost:			
At 1 January 2011	24	303	327
Exchange and other adjustments	–	6	6
Additions	–	35	35
Disposals	–	(12)	(12)
Disposal of businesses (note 14)	–	(30)	(30)
At 31 December 2011	24	302	326
Additions	–	45	45
Disposals	–	(76)	(76)
At 31 December 2012	24	271	295
Accumulated amortisation:			
At 1 January 2011	24	229	253
Exchange and other adjustments	–	(1)	(1)
Charge for the year (note 11)	–	18	18
Disposals	–	(12)	(12)
Disposal of businesses (note 14)	–	(8)	(8)
At 31 December 2011	24	226	250
Exchange and other adjustments	–	4	4
Charge for the year (note 11)	–	14	14
Disposals	–	(76)	(76)
At 31 December 2012	24	168	192
Balance sheet amount at 31 December 2012	–	103	103
Balance sheet amount at 31 December 2011	–	76	76

Company	Brands £m
Cost:	
At 1 January 2011	10
At 31 December 2011	10
At 31 December 2012	**10**
Accumulated amortisation:	
At 1 January 2011	10
At 31 December 2011	10
At 31 December 2012	**10**
Balance sheet amount at 31 December 2012	**–**
Balance sheet amount at 31 December 2011	–

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

Notes to the accounts

30 Tangible fixed assets

	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:				
At 1 January 2011	1,463	2,633	3,569	7,665
Exchange and other adjustments	–	(10)	(27)	(37)
Additions	34	147	184	365
Disposals	(59)	(150)	(1,563)	(1,772)
Disposal of businesses (note 14)	(38)	(114)	(330)	(482)
At 31 December 2011	1,400	2,506	1,833	5,739
Exchange and other adjustments	**1**	**(4)**	**(320)**	**(323)**
Additions	**49**	**156**	**41**	**246**
Disposals	**(20)**	**(204)**	**(544)**	**(768)**
Write-offs	**–**	**(608)**	**–**	**(608)**
At 31 December 2012	**1,430**	**1,846**	**1,010**	**4,286**
Accumulated depreciation and impairment:				
At 1 January 2011	741	2,036	1,406	4,183
Exchange and other adjustments	–	10	(8)	2
Impairment charged to the income statement (note 11)	–	65	–	65
Depreciation charge for the year (note 11)	57	114	155	326
Disposals	(5)	(108)	(799)	(912)
Disposal of businesses (note 14)	(12)	(90)	(195)	(297)
At 31 December 2011	781	2,027	559	3,367
Exchange and other adjustments	**(1)**	**(4)**	**(98)**	**(103)**
Depreciation charge for the year (note 11)	**49**	**101**	**86**	**236**
Disposals	**(11)**	**(152)**	**(148)**	**(311)**
Write-offs	**–**	**(608)**	**–**	**(608)**
At 31 December 2012	**818**	**1,364**	**399**	**2,581**
Balance sheet amount at 31 December 2012	**612**	**482**	**611**	**1,705**
Balance sheet amount at 31 December 2011	619	479	1,274	2,372

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

	2012 £m	2011 £m
Receivable within 1 year	**128**	171
1 to 5 years	**200**	464
Over 5 years	**216**	627
Total future minimum rentals receivable	**544**	1,262

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2012 and 2011 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £nil at 31 December 2012 (2011: £nil) is expected to be received under non-cancellable sub-leases of the Group's premises.

31 Other assets

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Assets arising from reinsurance contracts held (notes 36 and 38)	**42**	38	**–**	–
Deferred acquisition costs (see below)	**938**	772	**–**	–
Settlement balances	**537**	357	**–**	–
Investments in joint ventures and associates (note 13)	**306**	330	**–**	–
Other assets and prepayments	**3,073**	1,505	**17**	17
Total other assets	**4,896**	3,002	**17**	17

Deferred acquisition costs of the Group:	**2012 £m**	2011 £m
At 1 January	**772**	1,047
Exchange and other adjustments	**–**	(1)
Acquisition costs deferred, net of amounts amortised to the income statement	**166**	(274)
At 31 December	**938**	772

32 Deposits from banks of the Group

	2012 £m	2011 £m
Liabilities in respect of securities sold under repurchase agreements	**2,612**	952
Other deposits from banks	**169,126**	149,090
Total deposits from banks	**171,738**	150,042

At 31 December 2012 £146,769 million (2011: £120,160 million) of deposits from banks had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £15,845 million (2011: £28,040 million) and a fair value of £14,427 million (2011: £28,180 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £4 million (2011: £nil).

33 Customer deposits of the Group

	2012 £m	2011 £m
Non-interest bearing current accounts	**11,955**	11,204
Interest bearing current accounts	**19,788**	26,093
Savings and investment accounts	**161,059**	147,004
Liabilities in respect of securities sold under repurchase agreements	**–**	3,662
Other customer deposits	**24,713**	29,085
Total customer deposits	**217,515**	217,048

At 31 December 2012 £53,284 million (2011: £41,670 million) of customer deposits had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £262 million (2011: £5,306 million) and a fair value of £268 million (2011: £5,655 million).

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £192 million (2011: £323 million).

34 Trading liabilities of the Group

	2012 £m	2011 £m
Liabilities in respect of securities sold under repurchase agreements	**32,449**	19,069
Short positions in securities	**1,146**	1,736
Other	**15**	–
Trading liabilities	**33,610**	20,805

At 31 December 2012 £7,848 million (2011: £5,937 million) of trading liabilities had a contractual residual maturity of greater than one year.

35 Debt securities in issue

	2012 £m	2011 £m
Medium-term notes issued	**5,615**	12,489
Covered bonds (note 20)	**25,588**	27,972
Certificates of deposit	**29**	350
Securitisation notes (note 20)	**17,624**	26,918
Commercial paper	**130**	6,169
	48,986	73,898
Amounts due to fellow Group undertakings	**535**	1,559
Total debt securities in issue	**49,521**	75,457

At 31 December 2012 £39,895 million (2011: £59,830 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

(1) Life insurance
Insurance contract and participating investment contract liabilities at 31 December 2011 and 2012 related to life insurance business.

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

	Insurance contracts £m	Participating investment contracts £m	Gross £m	Reinsurance £m	Net £m
At 1 January 2011	34,440	4,984	39,424	(1,546)	37,878
Exchange and other adjustments	(15)	(2)	(17)	2	(15)
New business	803	4	807	(164)	643
Changes in existing business	(1,185)	(459)	(1,644)	(23)	(1,667)
Change in liabilities charged to the income statement (note 10)	(382)	(455)	(837)	(187)	(1,024)
Disposal of business (note 14)	(33,658)	(4,527)	(38,185)	1,693	(36,492)
At 31 December 2011	385	–	385	(38)	347
Exchange and other adjustments					
New business	**–**	**–**	**–**	**–**	**–**
Changes in existing business	**38**	**–**	**38**	**(4)**	**34**
Change in liabilities charged to the income statement (note 10)	**38**	**–**	**38**	**(4)**	**34**
At 31 December 2012	**423**	**–**	**423**	**(42)**	**381**

Liabilities for life insurance contracts and participating investment contracts at 31 December 2011 and 2012 related to non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

Non-profit fund liabilities
(i) Business description
The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types 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.

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.

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

(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 guidelines set by local regulatory bodies, 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, 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 (persistency)

Lapse rates are allowed for on some non-profit fund contracts. 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 purpose 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. 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 2011 resulted in no significant impacts on profit before tax. This takes into account the impacts of movements in liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

With-profit fund realistic liabilities

In July 2011 the Group disposed of its with-profit fund within Clerical Medical Investment Group Limited.

(2) Non-life insurance

The Group's non-life insurance contract liabilities all arose in businesses sold in 2011 (see note 14).

The movements in non-life insurance contract liabilities and reinsurance assets over 2011 were as follows:

	Gross £m	Reinsurance £m	Net £m
Provisions for unearned premiums			
At I January 2011	329	(19)	310
Increase in the year	271	(3)	268
Release in the year	(287)	16	(271)
Change in provision for unearned premiums charged to income statement (note 8)	(16)	13	(3)
Disposal of businesses (note 14)	(313)	6	(307)
At 31 December 2011	–	–	–

	Gross £m	Reinsurance £m	Net £m
Claims outstanding			
At 1 January 2011	323	(13)	310
Cash paid for claims settled in the year	(161)	24	(137)
Increase (decrease) in liabilities:			
Arising from current year claims	123	(13)	110
Arising from prior year claims	(4)	(3)	(7)
Change in liabilities charged to income statement (note 10)	(42)	8	(34)
Disposal of businesses (note 14)	(281)	5	(276)
At 31 December 2011	–	–	–

37 Insurance sensitivities 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.

Following the sale of the Group's wholly-owned life and pensions subsidiaries in 2011 (see note 14) the Group's insurance activities are no longer significant.

31 December 2012	**Change in variable**	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
Non-annuitant mortality[1]	**5% reduction**	–	–
Lapse rates[2]	**10% reduction**	–	–
Future maintenance and investment expenses[3]	**10% reduction**	–	–
Risk-free rate[4]	**0.25% reduction**	–	–

31 December 2011	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
Non-annuitant mortality[1]	5% reduction	1	1
Lapse rates[2]	10% reduction	(3)	(2)
Future maintenance and investment expenses[3]	10% reduction	–	–
Risk-free rate[4]	0.25% reduction	(1)	(1)

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

[1]This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

[2]This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

[3]This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

[4]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.

38 Liabilities arising from non-participating investment contracts

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

	Gross £m	**Reinsurance £m**	**Net £m**
At 1 January 2011	35,136	(65)	35,071
Exchange and other adjustments	1	–	1
New business	3,916	(1)	3,915
Changes in existing business	(3,617)	4	(3,613)
Disposal of businesses (note 14)	(13,229)	62	(13,167)
At 31 December 2011	22,207	–	22,207
New business	**4,088**	**–**	**4,088**
Changes in existing business	**871**	**–**	**871**
At 31 December 2012	**27,166**	**–**	**27,166**

Notes to the accounts

39 Unallocated surplus within insurance businesses

The movement in the unallocated surplus within long-term insurance businesses, which all arose in businesses sold in 2011 (see note 14), over 2011 was analysed as follows:

	2012 £m	2011 £m
At 1 January	–	321
Exchange and other adjustments	–	2
Change in unallocated surplus recognised in the income statement (note 10)	–	41
Disposal of businesses (note 14)	–	(364)
At 31 December	–	–

40 Other liabilities

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Settlement balances	1,254	1,239	–	–
Unitholders' interest in Open Ended Investment Companies	3,950	2,505	–	–
Other creditors and accruals	4,522	4,440	469	457
	9,726	8,184	469	457

41 Retirement benefit obligations

	2012 £m	2011 £m
(Credit) charge to the Group income statement		
Past service pension credit[1]	(258)	–
Other	116	77
Defined benefit pension schemes	(142)	77
Other post-retirement benefit schemes	5	4
Total defined benefit schemes	(137)	81
Defined contribution pension schemes	63	101
Total (credit) charge to the Group income statement	(74)	182

[1]In 2012, there was a credit of £258 million following the Group's decision to link discretionary pension increases in the HBOS Final Salary Pension Scheme to the Consumer Price Index (see note 11).

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Amounts recognised in the balance sheet:				
Retirement benefit assets	865	394	839	375
Retirement benefit obligations	(110)	(107)	(110)	(107)
Total amounts recognised in the balance sheet	755	287	729	268

The total amount recognised in the balance sheet relates to:

	Group		Company	
	2012 £m	2011 £m	2012 £m	2011 £m
Defined benefit pension schemes	820	350	794	331
Other post-retirement benefit schemes	(65)	(63)	(65)	(63)
Total amounts recognised in the balance sheet	755	287	729	268

41 Retirement benefit obligations (continued)

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 pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2012 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The latest full valuation of the HFSPS was carried out as at 30 June 2011; the results have been updated to 31 December 2012 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 expects to pay contributions of approximately £300 million to its defined benefit schemes in 2013.

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Amount included in the balance sheet				
Present value of funded obligations	**(9,881)**	(8,999)	**(9,682)**	(8,832)
Fair value of scheme assets	**10,498**	9,881	**10,353**	9,748
	617	882	**671**	916
Unrecognised actuarial losses (gains)	**203**	(532)	**123**	(585)
Net amount recognised in the balance sheet	**820**	350	**794**	331

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Movements in the defined benefit obligation				
At 1 January	**(8,999)**	(8,382)	**(8,832)**	(8,219)
Current service cost	**(152)**	(145)	**(151)**	(144)
Employee contributions	**(1)**	(1)	**(1)**	(1)
Interest cost	**(433)**	(453)	**(426)**	(445)
Actuarial losses	**(835)**	(285)	**(803)**	(274)
Benefits paid	**284**	252	**281**	249
Past service cost and settlements	**(19)**	(10)	**(15)**	(10)
Curtailments	**258**	12	**258**	4
Exchange and other adjustments	**16**	13	**7**	8
At 31 December	**(9,881)**	(8,999)	**(9,682)**	(8,832)

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Changes in the fair value of scheme assets				
At 1 January	**9,881**	8,483	**9,748**	8,355
Expected return	**488**	520	**482**	511
Employer contributions	**330**	321	**322**	311
Actuarial gains (losses)	**96**	823	**91**	830
Benefits paid	**(284)**	(252)	**(281)**	(249)
Employee contributions	**1**	1	**1**	1
Exchange and other adjustments	**(14)**	(15)	**(10)**	(11)
At 31 December	**10,498**	9,881	**10,353**	9,748
Actual return on scheme assets	**584**	1,343	**573**	1,341

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	
	2012 %	2011 %
Discount rate	**4.60**	5.00
Rate of inflation		
Retail Prices Index	**2.90**	3.00
Consumer Price Index	**2.00**	2.00
Rate of salary increases	**2.00**	2.00
Rate of increase for pensions in payment	**2.80**	3.20

	2012 Years	2011 Years
Life expectancy for member aged 60, on the valuation date:		
Men	**26.9**	26.8
Women	**29.4**	28.5
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**28.0**	28.3
Women	**30.6**	30.1

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 2012 is assumed to live for, on average, 26.9 years for a male and 29.4 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

Sensitivity analysis

The effect of changes in key assumptions on the pension charge in the Group's income statement and on the net defined benefit pension scheme asset is set out below:

	Increase (decrease) in the income statement charge		**Increase (decrease) in the net defined benefit pension scheme asset**	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Inflation[1]:				
Increase of 0.2 per cent	**3**	3	**(267)**	(284)
Decrease of 0.2 per cent	**–**	(3)	**216**	274
Discount rate[2]:				
Increase of 0.2 per cent	**(7)**	(7)	**364**	315
Decrease of 0.2 per cent	**6**	6	**(380)**	(332)
Expected life expectancy of members:				
Increase of one year	**14**	14	**(211)**	(214)
Decrease of one year	**(15)**	(14)	**211**	222

[1]At 31 December 2012, the assumed rate of inflation is 2.90 per cent (2011: 3.00 per cent)

[2]At 31 December 2012, the assumed discount rate is 4.60 per cent (2011: 5.00 per cent)

41 Retirement benefit obligations (continued)

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

	Group and Company	
	2012 %	2011 %
Equities and alternative assets	**7.3**	8.3
Fixed interest gilts	**3.0**	4.0
Index linked gilts	**2.8**	3.9
Non-Government bonds	**4.9**	4.9
Property	**6.6**	7.3
Money market instruments and cash	**2.6**	3.9

The expected return on scheme assets in 2013 will be calculated using the following assumptions:

	2013 %
Equities and alternative assets	**6.8**
Fixed interest gilts	**2.3**
Index linked gilts	**2.8**
Non-Government bonds	**3.1**
Property	**6.8**
Money market instruments and cash	**2.4**

With effect from 1 January 2013 the Group will adopt amendments to IAS 19 *Employee Benefits*. These amendments will change the calculation of the Group's defined benefit schemes' income statement expense, replacing expected return on plan assets and interest cost with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset) (see note 57 on page 112). The above expected return on plan assets will be used in determining the effect of this new accounting policy on the Group's 2013 income statement expense.

Composition of scheme assets:

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Equities	**4,075**	3,588	**4,037**	3,510
Fixed interest gilts	**402**	501	**402**	501
Index linked gilts	**993**	1,089	**993**	1,089
Non-Government bonds	**1,891**	1,162	**1,844**	1,121
Property	**325**	333	**321**	329
Money market instruments, cash and other assets and liabilities	**2,812**	3,208	**2,756**	3,198
At 31 December	**10,498**	9,881	**10,353**	9,748

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

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 HFSPS and other schemes (since the date of adoption of IAS 19):

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Present value of defined benefit obligation	**(9,881)**	(8,999)	(8,382)	(8,276)	(6,709)	(7,623)
Fair value of scheme assets	**10,498**	9,881	8,483	7,442	7,241	7,329
Surplus (deficit)	**617**	882	101	(834)	532	(294)
Experience (losses) gains on scheme liabilities	**797**	(19)	(32)	38	(22)	(95)
Experience gains (losses) on scheme assets	**96**	823	330	(176)	(615)	76

41 Retirement benefit obligations (continued)

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

	2012 £m	2011 £m
Current service cost	**152**	145
Interest cost	**433**	453
Expected return on scheme assets	**(488)**	(520)
Amortisation – outside corridor	**–**	1
Settlements	**4**	–
Curtailment gains (see below)	**(258)**	(12)
Past service cost	**15**	10
Total defined benefit pension (credit) expense	**(142)**	77

Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in the HFSPS 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 2012.

Defined contribution schemes
The Group operates a number of defined contribution schemes in the UK and overseas.

During the year ended 31 December 2012 the charge to the income statement in respect of defined contribution schemes was £76 million (2011: £101 million), representing the contributions payable by the employer in accordance with each scheme's rules.

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

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 4 November 2009; this valuation has been updated to 31 December 2012 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 4.60 per cent (2011: 5.00 per cent).

Movements in the other post-retirement benefits obligation:

	Group and Company	
	2012 £m	2011 £m
At 1 January	**(63)**	(56)
Exchange and other adjustments	**(7)**	(6)
Charge for the year	**5**	(4)
Benefits paid	**–**	3
At 31 December	**(65)**	(63)

42 Deferred tax

The movement in the net deferred tax balance is as follows:	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Asset (liability) at 1 January	**3,976**	4,015	**(82)**	(27)
Exchange and other adjustments	**(16)**	(19)	**1**	–
Disposal of businesses (note 14)	**–**	606	**–**	–
Income statement (charge) credit (note 15):				
Due to change in UK corporation tax rate	**(300)**	(332)	**15**	6
Other	**(81)**	282	**(141)**	(61)
	(381)	(50)	**(126)**	(55)
Amount charged to equity:				
Available-for-sale financial assets (note 47)	**(120)**	(129)	**–**	–
Cash flow hedges (note 47)	**(83)**	(447)	**–**	–
	(203)	(576)	**–**	–
Asset (liability) at 31 December	**3,376**	3,976	**(207)**	(82)

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 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Statutory position				
Deferred tax asset	**3,445**	3,977	**–**	–
Deferred tax liability	**(69)**	(1)	**(207)**	(82)
Net deferred tax asset (liability)	**3,376**	3,976	**(207)**	(82)
Tax disclosure				
Deferred tax asset	**4,386**	4,668	**1**	–
Deferred tax liability	**(1,010)**	(692)	**(208)**	(82)
Net deferred tax asset (liability)	**3,376**	3,976	**(207)**	(82)

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

	2012 £m	2011 £m
Accelerated capital allowances	**11**	105
Pensions and other post-retirement benefits	**(123)**	(56)
Tax on long-term assurance business	**(72)**	188
Tax losses carried forward	**236**	(277)
Allowances for impairment losses	**(317)**	(38)
Other temporary differences	**(116)**	28
Deferred tax charge in the income statement	**(381)**	(50)

42 Deferred tax (continued)

Deferred tax assets and liabilities are comprised as follows:

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Deferred tax assets:				
Allowances for impairment losses	**190**	507	**–**	–
Employee benefits	**–**	7	**–**	–
Other provisions	**48**	277	**–**	–
Available-for-sale asset revaluation	**291**	269	**–**	–
Tax losses carried forward	**3,637**	3,568	**–**	–
Other temporary differences	**220**	40	**1**	–
Total deferred tax assets	**4,386**	4,668	**1**	–

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Deferred tax liabilities:				
Pensions and other post-retirement benefits	**(208)**	(85)	**(208)**	(82)
Accelerated capital allowances	**(219)**	(230)	**–**	–
Tax on long-term assurance business	**(81)**	(9)	**–**	–
Derivatives	**(353)**	(274)	**–**	–
Effective interest rate	**(33)**	(44)	**–**	–
Other temporary differences	**(116)**	(50)	**–**	–
Total deferred tax liabilities	**(1,010)**	(692)	**(208)**	(82)

On 21 March 2012, the Government announced that the corporation tax rate applicable from 1 April 2012 would be 24 per cent. This change passed into legislation on 26 March 2012. In addition, the Finance Act 2012, which was substantively enacted on 3 July 2012, included legislation to reduce the main rate of corporation tax from 24 per cent to 23 per cent with effect from 1 April 2013. The change in the main rate of corporation tax from 25 per cent to 23 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2012 of £268 million, comprising the £300 million charge included in the income statement and a £32 million credit included in equity.

The proposed further reduction in the rate of corporation tax by 2 per cent to 21 per cent by 1 April 2014 is expected to be enacted during 2013. The effect of this further change upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

Deferred tax assets
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 £3,637 million for the Group and £nil for the Company (2011: £3,568 million for the Group and £nil for the Company) in relation to trading 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 £131 million for the Group and £nil for the Company (2011: £43 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 £493 million for the Group and £nil for the Company (2011: £488 million for the Group and £nil for the Company) have not been recognised in respect of trading losses carried forward, arising in overseas companies, as there are limited predicted future trading profits to offset them. Trading losses can be carried forward indefinitely except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2012 of £40 million for the Group and £nil for the Company (2011: £40 million for the Group and £nil 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 commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2012	16	780	125	143	1,064
Exchange and other adjustments	(3)	–	12	(33)	(24)
Provisions applied	(4)	(879)	(18)	(60)	(961)
Charge for the year	–	850	189	39	1,078
At 31 December 2012	9	751	308	89	1,157

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

Payment protection insurance
Following the unsuccessful legal challenge by the British Bankers' Association against the FSA and the Financial Ombudsman Service, the Lloyds Banking Group held discussions with the FSA with a view to seeking clarity around the detailed implementation of the FSA Policy Statement which set out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress in respect of payment protection insurance (PPI) sales standards. As a result, the Lloyds Banking Group concluded that there are certain circumstances where customer 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 redress, including administration expenses.

During the first half of 2012 there was an increase in the volume of complaints being received and, although the level of complaints has declined during the second half of 2012, they are higher than had been anticipated at 31 December 2011. As a consequence, the Group believes that it is appropriate to increase its provision by a further £850 million at 31 December 2012. This increases the total estimated cost of redress, including administration expenses, to £2,005 million; redress payments made and expenses incurred on the some 300,000 claims paid to the end of December 2012 amounted to £1,254 million. However, there are still a number of uncertainties as to the eventual redress costs, in particular the total number of complaints and the activities of claims management companies and regulatory bodies.

The Group has calculated the provision by making a number of assumptions based upon current and expected experience. The principal sensitivities are as follows:

- the number of claims received: an increase of 100,000 from the level assumed would increase the provision for redress costs by £43 million;
- uphold rate of claims reviewed: an increase of one percentage point in this assumption would increase the provision by £6 million;
- average future redress payment: an increase of £100 in this assumption would increase the provision by £21 million.

The Group will reassess the continued appropriateness of the assumptions underlying its analysis at each reporting date in the light of current experience and other relevant evidence.

Other regulatory provisions
Interest rate hedging products
In June 2012, a number of banks, including the 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 (IRHP) to certain small and medium-sized businesses. The Lloyds Banking Group agreed that on conclusion of this review it would provide redress to any of these customers where appropriate.

Following the completion of a pilot review of IRHP sales to small and medium-sized businesses and agreement reached with the FSA on 30 January 2013 on the principles to be adopted during the course of the wider review, the Group has provided £139 million for the estimated cost of redress and related administration costs. At 31 December 2012, £10 million of the provision had been utilised. A number of uncertainties remain as to the eventual costs given the inherent difficulties in determining the number of customers within the scope of the review and the average compensation to customers.

Other regulatory matters
In the course of its business, the Lloyds Banking Group is engaged in discussions with the FSA or other regulators in relation to a range of matters. In 2012 a provision of £50 million was made in respect of certain UK retail and other matters; however, the ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

Vacant leasehold property and other
Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging 3 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	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Preference shares	**–**	–	**–**	–
Preferred securities	**3,374**	3,472	**–**	–
Undated subordinated liabilities	**673**	759	**1,997**	2,071
Dated subordinated liabilities	**8,444**	9,382	**7,024**	7,247
Total subordinated liabilities	**12,491**	13,613	**9,021**	9,318

	Group		Company	
The movement in subordinated liabilities during the year was as follows:	**2012 £m**	2011 £m	**2012 £m**	2011 £m
At 1 January	**13,613**	16,674	**9,318**	11,617
Repurchases and redemptions during the year	**(649)**	(2,696)	**–**	(2,604)
Foreign exchange and other movements	**(473)**	(365)	**(297)**	305
At 31 December	**12,491**	13,613	**9,021**	9,318

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of the specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of the holders of the dated subordinated liabilities. Neither the Group nor the Company has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2011: none).

	Group		Company	
Preference shares	**2012 £m**	2011 £m	**2012 £m**	2011 £m
6% Non-cumulative Redeemable preference shares	**–**	–	**–**	–

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 shares waived its right to payment for the period from 1 March 2010 to 1 March 2012.

		Group	
Preferred securities	Note	**2012 £m**	2011 £m
6.071% Non-cumulative Perpetual Preferred Securities (US$750 million)		**497**	537
6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million)	b	**859**	918
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		**604**	603
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	b, c	**262**	260
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		**151**	151
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		**326**	322
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	b, d	**339**	350
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	a	**34**	30
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		**151**	151
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		**151**	150
Total preferred securities		**3,374**	3,472

44 Subordinated liabilities (continued)

Undated subordinated liabilities	Note	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)	a	**4**	4	**4**	4
6.071% Undated Subordinated Fixed to Floating Rate Instruments (US$750 million)		**–**	–	**464**	484
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	a	**81**	90	**81**	90
Floating Rate Undated Subordinated Notes (€500 million)	a	**49**	53	**49**	53
5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	a	**9**	11	**9**	11
5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	a	**59**	67	**59**	67
5.75% Undated Subordinated Step-up Notes (£600 million)		**4**	4	**4**	4
6.85% Undated Subordinated Notes (US$1,000 million)		**–**	–	**611**	640
Fixed to Floating Rate Undated Subordinated Notes (£600 million)		**–**	–	**604**	603
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	b, e	**21**	22	**21**	22
7.5% Undated Subordinated Step-up Notes (£300 million)		**4**	6	**4**	6
8.625% Perpetual Subordinated Notes (£200 million)	a	**23**	26	**–**	–
Floating Rate Undated Subordinated Step-up Notes (€300 million)	b	**32**	33	**32**	33
Floating Rate Primary Capital Notes (US$250 million)		**111**	118	**–**	–
7.375% Subordinated Undated Instruments (£150 million)	a	**74**	78	**–**	–
4.25% Instruments (¥17 billion)		**138**	174	**–**	–
10.25% Subordinated Undated Instruments (£100 million)	a	**1**	1	**–**	–
12% Perpetual Subordinated Bonds (£100 million)	a	**22**	26	**–**	–
8.75% Perpetual Subordinated Bonds (£100 million)	a	**5**	5	**–**	–
13.625% Perpetual Subordinated Bonds (£75 million)	a	**14**	17	**–**	–
9.375% Perpetual Subordinated Bonds (£50 million)	a	**15**	18	**–**	–
5.75% Undated Subordinated Step-up Notes (£500 million)		**7**	6	**7**	6
4.939% Undated Fixed to Floating Rate Subordinated Notes (€750 million)		**–**	–	**34**	34
Undated Perpetual Preferred Securities (£750 million)		**–**	–	**14**	14
Total undated subordinated liabilities		**673**	759	**1,997**	2,071

Notes to the accounts

44 Subordinated liabilities (continued)

Dated subordinated liabilities	Note	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		**–**	658	**–**	–
6.25% Instruments 2012 (€12.8 million)		**–**	8	**–**	–
6.125% Notes 2013 (€325 million)		**280**	287	**–**	–
4.25% Subordinated Guaranteed Notes 2013 (US$1,000 million)		**630**	676	**621**	649
11% Subordinated Bonds 2014 (£250 million)		**276**	276	**–**	–
4.875% Subordinated Notes 2015 (€1,000 million)		**918**	951	**846**	868
Callable Floating Rate Subordinated Notes 2016 (€500 million)		**139**	143	**139**	143
Callable Floating Rate Subordinated Notes 2016 (€500 million)		**193**	198	**193**	198
Subordinated Callable Notes 2016 (US$750 million)		**307**	321	**307**	321
Subordinated Callable Notes 2017 (€1,000 million)	f	**375**	385	**375**	385
Subordinated Callable Notes 2017 (US$1,000 million)	f	**301**	315	**301**	315
Subordinated Callable Floating Rate Instruments 2017 (Aus$400 million)	f	**43**	44	**43**	44
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 (Aus$200 million)		**11**	11	**11**	11
5.109% Callable Fixed to Floating Rate Notes 2017 (Can$500 million)		**17**	18	**17**	18
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 (£500 million)		**35**	37	**35**	37
10.5% Subordinated Bonds 2018 (£150 million)		**164**	164	**–**	–
6.75% Subordinated Fixed Rate Notes 2018 (US$2,000 million)		**1,365**	1,455	**1,365**	1,455
6.375% Instruments 2019 (£250 million)		**330**	328	**–**	–
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		**662**	700	**617**	633
9.375% Subordinated Bonds 2021 (£500 million)		**685**	667	**–**	–
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		**173**	172	**173**	172
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		**183**	174	**183**	174
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		**670**	667	**670**	667
6.00% Subordinated Notes 2033 (US$750 million)		**687**	727	**463**	484
7.881% Subordinated Extendable Maturity Notes 2048 (£245 million)		**–**	–	**326**	326
Fixed to Floating Rate Subordinated Extendable Maturity Notes 2048 (€415 million)		**–**	–	**339**	347
Total dated subordinated liabilities		**8,444**	9,382	**7,024**	7,247

a) In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.

b) These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.

c) The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.

d) The fixed rate on this security was reset from 7.627 per cent to 3 months Euribor plus 2.875 per cent with effect from 9 December 2011.

e) The fixed rate on this security was reset from 6.05 per cent to 3 months Euribor plus 2.25 per cent with effect from 23 November 2011.

f) The floating interest rate payable on these securities reset during 2012.

At 31 December 2012 £11,581 million (2011: £12,947 million) of subordinated liabilities of the Group and £8,400 million (2011: £9,318 million) of the Company has a contractual residual maturity of greater than one year.

45 Share capital

(1) Authorised share capital

	Group and Company			
	2012 Number of shares	2011 Number of shares	**2012 £m**	2011 £m
Sterling				
Ordinary shares of 25p	**15,139,999,999**	15,139,999,999	**3,785**	3,785
6.125% non-cumulative redeemable preference shares of £1	**200,000,000**	200,000,000	**200**	200
8.117% non-cumulative perpetual preference shares class 'A' of £10 each	**250,000**	250,000	**3**	3
7.754% non-cumulative perpetual preference shares class 'B' of £10 each	**150,000**	150,000	**2**	2
Preference shares of £1 each	**2,596,834,398**	2,596,834,398	**2,597**	2,597
			6,587	6,587
US dollars			**US$m**	US$m
Preference shares of US$1 each	**4,997,750,000**	4,997,750,000	**4,998**	4,998
Euro			**€m**	€m
Preference shares of €1 each	**3,000,000,000**	3,000,000,000	**3,000**	3,000
Japanese yen			**¥m**	¥m
Preference shares of ¥250 each	**400,000,000**	400,000,000	**100,000**	100,000
Canadian dollars			**CAD$m**	CAD$m
Preference shares of CAD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000
Australian dollars			**AUD$m**	AUD$m
Preference shares of AUD$1 each	**1,000,000,000**	1,000,000,000	**1,000**	1,000

(2) Issued share capital

	Group and Company			
	2012 Number of shares	2011 Number of shares	**2012 £m**	2011 £m
Ordinary shares of 25p each				
At 1 January and 31 December	**15,053,262,841**	15,053,262,841	**3,763**	3,763
Issued and fully paid preference shares				
Preference shares of £1 each				
At 1 January and 31 December	**100**	100	**–**	–
Total share capital at 31 December	**15,053,262,941**	15,053,262,941	**3,763**	3,763

46 Share premium account

	Group and Company	
	2012 £m	2011 £m
At 1 January and 31 December	**18,655**	18,655

47 Other reserves

	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Other reserves comprise:				
Merger and other reserves	**10,051**	10,051	**9,537**	9,537
Capital redemption reserve	**141**	141	**141**	141
Revaluation reserve in respect of available-for-sale financial assets	**(125)**	(498)	**–**	–
Cash flow hedging reserve	**1,237**	859	**(1)**	(1)
Foreign currency translation reserve	**17**	(30)	**16**	16
At 31 December	**11,321**	10,523	**9,693**	9,693

Movements in other reserves were as follows:

	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Merger and other reserves				
At 1 January and 31 December	**10,051**	10,051	**9,537**	9,537

	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Capital redemption reserve				
At 1 January and 31 December	**141**	141	**141**	141

47 Other reserves (continued)

	Group 2012 £m	Group 2011 £m
Revaluation reserve in respect of available-for-sale financial assets		
At 1 January	**(498)**	(894)
Change in fair value of available-for-sale financial assets	**363**	(77)
Deferred tax	**(77)**	45
Current tax	**(3)**	1
	283	(31)
Income statement transfers:		
Disposals	**(385)**	(72)
Deferred tax	**74**	(28)
	(311)	(100)
Impairment	**397**	749
Deferred tax	**(87)**	(166)
	310	583
Other transfers to income statement	**121**	(76)
Deferred tax	**(30)**	20
	91	(56)
At 31 December	**(125)**	(498)

	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Cash flow hedging reserve				
At 1 January	**859**	(417)	**(1)**	(2)
Change in fair value of hedging derivatives	**730**	1,350	**–**	–
Deferred tax	**(145)**	(354)	**–**	–
	585	996	**–**	–
Income statement transfers	**(269)**	373	**–**	1
Deferred tax	**62**	(93)	**–**	–
	(207)	280	**–**	1
At 31 December	**1,237**	859	**(1)**	(1)

	Group 2012 £m	Group 2011 £m	Company 2012 £m	Company 2011 £m
Foreign currency translation reserve				
At 1 January	**(30)**	(24)	**16**	16
Currency translation differences arising in the year	**(8)**	20	**–**	–
Foreign currency gains (losses) on net investment hedges (tax: £nil)	**55**	(26)	**–**	–
At 31 December	**17**	(30)	**16**	16

48 Retained profits

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
At 1 January	**(9,170)**	(5,415)	**(4,978)**	(4,681)
Profit (loss) for the year[1]	**128**	(3,763)	**1,234**	(297)
Employee share option schemes – value of employee services	**–**	8	**–**	–
At 31 December	**(9,042)**	(9,170)	**(3,744)**	(4,978)

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

49 Dividends

No dividends were paid on the Company's ordinary shares in 2012 or 2011.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Lloyds Banking Group, Lloyds Banking Group plc 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. Lloyds Banking Group plc also 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, the Company was prevented from making dividend payments on its ordinary shares during this period.

50 Share-based payments

Share-based payment scheme details
During the year ended 31 December 2012 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the HBOS Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group plc are set out below; these are managed and operated on a Lloyds Banking Group-wide basis.

The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 11), was £114 million (2011: £155 million).

Deferred bonus plans
Bonuses in respect of the performance in 2012 of employees within certain of the Group's bonus plans have been recognised in these financial statements in full. The amounts to be settled in shares are included within the total charge to the income statement detailed above.

Lloyds Banking Group executive share option schemes
The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between March 2004 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5.

Performance conditions for executive options
For options granted in 2004
The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Group's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Group was ranked first. A performance multiplier (of between nil and 100 per cent) was applied below this level to calculate the number of shares in respect of which options granted to Executive Directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than Executive Directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 14 per cent for Executive Directors, 24 per cent for Managing Directors, and 100 per cent for all other executives.

For options granted in 2005
The same conditions applied as for grants made in 2004, except that:

- the performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- if the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- the full grant of options became exercisable only if the Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

50 Share-based payments (continued)

Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted.

Movements in the number of share options outstanding under the executive share option schemes during 2011 and 2012 are set out below:

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**10,174,869**	**225.15**	13,363,301	233.09
Forfeited	**(2,129,973)**	**225.92**	(2,140,790)	225.91
Lapsed	–	–	(1,047,642)	324.92
Outstanding at 31 December	**8,044,896**	**224.95**	10,174,869	225.15
Exercisable at 31 December	**8,044,896**	**224.95**	10,174,869	225.15

No options were exercised during 2012 or 2011. The weighted average remaining contractual life of options outstanding at the end of the year was 1.9 years (2011: 2.9 years). The fair values of the executive share options have been determined using a standard Black-Scholes model.

Save-As-You-Earn schemes
Eligible employees may enter into contracts through the Save-As-You-Earn 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 the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

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

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**453,019,032**	**49.74**	668,044,034	49.59
Exercised	–	–	(2,497,658)	47.34
Forfeited	**(8,427,262)**	**49.15**	(18,408,624)	50.52
Cancelled	**(88,340,810)**	**49.83**	(181,350,614)	47.78
Expired	**(41,678,937)**	**62.67**	(12,768,106)	69.08
Outstanding at 31 December	**314,572,023**	**48.01**	453,019,032	49.74
Exercisable at 31 December	**119,141**	**86.50**	25,490,233	77.82

No options were exercised in 2012. The weighted average share price at the time that the options were exercised during 2011 was £0.54. The weighted average remaining contractual life of options outstanding at the end of the year was 0.8 years (2011: 1.7 years).

No SAYE options were granted in 2012 or 2011. The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2012 or 2011. The options outstanding at 31 December 2012 had an exercise price of £1.8066 (2011: £1.8066) and a weighted average remaining contractual life of 2.1 years (2011: 2.0 years).

Other share option plans
Lloyds Banking Group Executive Share Plan 2003
The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan's usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

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

	2012		2011	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**53,000,069**	**Nil**	47,694,757	Nil
Granted	**34,345,366**	**Nil**	16,395,016	Nil
Exercised	**(41,290,412)**	**Nil**	(7,591,526)	Nil
Forfeited	**(440,873)**	**Nil**	(3,498,178)	Nil
Outstanding at 31 December	**45,614,150**	**Nil**	53,000,069	Nil
Exercisable at 31 December	**3,065,531**	**Nil**	2,310,418	Nil

The weighted average fair value of options granted in the year was £0.30 (2011: £0.46). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2012 was £0.33 (2011: £0.51). The weighted average remaining contractual life of options outstanding at the end of the year was 3.7 years (2011: 2.1 years).

50 Share-based payments (continued)

Lloyds Banking Group Share Buy Out Awards
As part of arrangements to facilitate the recruitment of certain Executives, options have been granted by individual deed and, where appropriate, in accordance with the Listing Rules of the UK Listing Authority.

The awards were granted in recognition that the Executives' outstanding awards over shares in their previous employing company lapsed on accepting employment with the Group.

Movements in the number of options outstanding are set out below:

	2012		2011	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**21,321,237**	**Nil**	–	–
Granted	–	–	21,728,172	Nil
Exercised	–	–	(406,935)	Nil
Outstanding at 31 December	**21,321,237**	**Nil**	21,321,237	Nil
Exercisable at 31 December	**16,509,862**	**Nil**	2,398,593	Nil

No options were granted or exercised in 2012. The weighted average fair value of options granted during 2011 was £0.38. The weighted average share price at the time that the options were exercised during 2011 was £0.54. The weighted average remaining contractual life of options outstanding at the end of the year was 8.6 years (2011: 9.6 years).

Participants are entitled to any dividends paid during the vesting period. This amount will be paid in cash unless the Remuneration Committee decides it will be paid in shares.

The fair values of the majority of options granted have been determined using a standard Black-Scholes model. The fair values of the remaining options have been determined by Monte Carlo simulation.

HBOS share option plans
The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option 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 granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

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

	2012		2011	
	Number of options	**Weighted average exercise price (pence)**	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**22,058,552**	**394.30**	24,695,494	415.70
Forfeited	**(319,134)**	**572.22**	(213,498)	253.88
Lapsed	**(1,881,726)**	**686.47**	(2,423,444)	624.75
Outstanding at 31 December	**19,857,692**	**363.76**	22,058,552	394.30
Exercisable at 31 December	**19,857,692**	**363.76**	14,227,020	582.82

No options were exercised during 2012 or 2011. The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2012 had exercise prices in the range of £0.5183 to £5.80 (2011: £0.5183 to £8.7189) and a weighted average remaining contractual life of 1.1 years (2011: 2.0 years).

Other share plans
Lloyds Banking Group Long-Term Incentive Plan
The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the Plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares.

The performance conditions for awards made in April, May and September 2009 were as follows:

(i) **Earnings per share (EPS):** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2008.

If the growth in EPS reached 26 per cent, 25 per cent of this element of the award, being the threshold, would vest. If growth in EPS reached 36 per cent, 100 per cent of this element would vest.

50 Share-based payments (continued)

(ii) **Economic Profit (EP):** relevant to 50 per cent of the award. Performance was measured based on the extent to which cumulative EP targets were achieved over the three-year period.

If the absolute improvement in adjusted EP reached 100 per cent, 25 per cent of this element of the award, being the threshold, would vest. If the absolute improvement in adjusted EP reached 202 per cent, 100 per cent of this element would vest.

The EPS and EP performance measures applying to this 2009 LTIP award were set on the basis that the Group would enter into the Government Asset Protection Scheme. As the Group did not participate in the Government Asset Protection Scheme, in June 2010 the Remuneration Committee approved restated performance measures on a basis consistent with the EPS and EP measures used for the 2010 LTIP awards. At the end of the relevant period, neither of the performance conditions had been met and the awards lapsed.

An additional discretionary award was made in April, May and September 2009. The performance conditions for those awards were as follows:

(i) **Synergy Savings:** The release of 50 per cent of the shares was dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award was broken down into three equally weighted annual tranches. Performance was assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets were achieved determined the proportion of shares to be banked each year. Any release of shares was subject to the Remuneration Committee judging the overall success of the delivery of the integration programme.

(ii) **Integration Balanced Scorecard:** The release of the remaining 50 per cent of the shares was dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element was broken down into three equally weighted tranches. The tranches were crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

The performance conditions were met and, as a consequence, the share awards vested in full in March 2012 for all participants, with the exception of current and former Executive Directors.

The performance conditions for awards made in March and August 2010 were as follows:

(i) **EPS:** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2009.

If the absolute improvement in adjusted EPS reached 158 per cent, 25 per cent of this element of the award, being the threshold, would vest. If absolute improvement in adjusted EPS reached 180 per cent, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. Performance was measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 EP base.

If the compounded annual growth rate of adjusted EP reached 57 per cent per annum, 25 per cent of this element of the award, being the threshold, would vest. If the compounded annual growth rate of adjusted EP reached 77 per cent per annum, 100 per cent of this element would vest.

Vesting between threshold and maximum would be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Share Price, relevant to 28 per cent of the award. Performance will be measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date. If the share price at the end of the performance period is 75 pence or less, none of this element of the award will vest. If the share price is 114 pence or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element may only be released if both the EPS and EP performance measures have been satisfied at the threshold level or above. The EPS and EP performance conditions each relate to 36 per cent of the total award.

At the end of the performance period for the EPS and EP measures, it has been assessed that neither of the performance conditions has been met and, therefore, the awards will not vest.

The performance conditions for awards made in March and September 2011 are as follows:

(i) **EPS:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EPS outcome.

If the adjusted EPS reaches 6.4p, 25 per cent of this element of the award, being the threshold, will vest.

If adjusted EPS reaches 7.4p, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **EP:** relevant to 50 per cent of the award. The performance target is based on 2013 adjusted EP outcome.

If the adjusted EP reaches £567 million, 25 per cent of this element of the award, being the threshold, will vest. If the adjusted EP reaches £1,234 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

For awards made to Executive Directors, a third performance condition was set, relating to Absolute Total Shareholder Return, relevant to one third of the award. Performance will be measured based on the annualised Absolute Total Shareholder Return over the three year performance period. If the annualised Absolute Total Shareholder Return at the end of the performance period is less than 8 per cent, none of this element of the award will vest. If the Absolute Total Shareholder Return is 8 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the Absolute Total Shareholder Return is 14 per cent or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis. The EPS and EP performance conditions will each relate to 33.3 per cent of the total award.

50 Share-based payments (continued)

The performance conditions for awards made in March and September 2012 are as follows:

(i) **EP:** relevant to 30 per cent of the award. The performance target is based on 2014 adjusted EP outcome.

If the adjusted EP reaches £160 million, 25 per cent of this element of the award, being the threshold, will vest.

If the adjusted EP reaches £1,653 million, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(ii) **Absolute Total Shareholder Return (ATSR):** relevant to 30 per cent of the award. Performance will be measured against the annualised return over the three year period ending 31 December 2014.

If the ATSR reaches 12 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest.

If the ATSR reaches 30 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iii) **Short-term funding as a percentage of total funding:** relevant to 10 per cent of the award. Performance will be measured relative to 2014 targets.

If the average percentage reaches 20 per cent, 25 per cent of this element of the award, being the threshold, will vest.

If the average percentage reaches 15 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(iv) **Non-core assets at the end of 2014:** relevant to 10 per cent of the award. Performance will be measured by reference to balance sheet non-core assets at 31 December 2014.

If non-core assets amount to £95 billion or less, 25 per cent of this element of the award, being the threshold, will vest.

If non-core assets amount to £80 billion or less, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(v) **Net simplification benefits:** relevant to 10 per cent of the award. Performance will be measured by reference to the run rate achieved by the end of 2014.

If a run rate of net simplification benefits of £1.5 billion is achieved, 25 per cent of this element of the award, being the threshold, will vest.

If a run rate of net simplification benefits of £1.8 billion is achieved, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

(vi) **Customer satisfaction:** relevant to 10 per cent of the award. Performance will be measured by reference to the total number of FSA reportable complaints per 1,000 customers over the three year period to 31 December 2014.

If complaints per 1,000 customers average 1.5 per annum or less over three years, 25 per cent of this element of the award, being the threshold, will vest.

If complaints per 1,000 customers average 1.3 per annum or less over three years, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

	2012 Number of shares	2011 Number of shares
Outstanding at 1 January	**543,738,186**	447,142,491
Granted	**265,011,679**	147,280,077
Vested	**(71,591,014)**	(3,918,013)
Forfeited	**(221,207,334)**	(46,766,369)
Outstanding at 31 December	**515,951,517**	543,738,186

The weighted average fair value of the share awards granted in 2012 was £0.24 (2011: £0.54). The fair values of the majority of share awards granted have been determined using a standard Black-Scholes model. The fair values of the remaining share awards have been determined by Monte Carlo simulation.

Scottish Widows Investment Partnership Long-Term Incentive Plan

The Scottish Widows Investment Partnership (SWIP) Long-Term Incentive Plan applicable to senior executives and employees of SWIP, which had previously been a cash-only scheme, was amended in May 2012 for awards granted on or after that date. The amendment introduced the receipt of shares in Lloyds Banking Group plc as an element of the total award. The other element will continue to be cash based, with the split between cash based and share based determined by the Remuneration Committee. The amendment is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of SWIP over a three year period. Awards are made within limits set by the rules of the Plan, with the maximum limits for combined cash and shares awarded equating to 3.5 times annual salary. In exceptional circumstances this may increase to 4 times annual salary.

The performance conditions for share-based awards made in June 2012 are as follows:

(i) **Profitability:** relevant to 40 per cent of the award. The performance target is based on a cumulative 3 year profit before tax. If cumulative profit before tax reaches a specified target level, 100 per cent of this element will vest. If cumulative profit before tax reaches 90 per cent of the target level, 25 per cent of this element of the award, being the threshold, will vest. If cumulative profit before tax reaches 110 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

50 Share-based payments (continued)

(ii) **Investment performance:** relevant to 40 per cent of the award. The performance target is based on the percentage of SWIP funds achieving at or above benchmark performance (on a competitor median or index basis) over the 3 year period. If 50 per cent of funds exceed benchmark performance, 25 per cent of this element of the award, being the threshold, will vest. If 55 per cent of funds exceed benchmark performance, 100 per cent of this element, being the target, will vest. If 70 per cent of funds exceed benchmark performance, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

(iii) **Funds under management (FUM) growth:** relevant to 20 per cent of the award. The performance target is based on growth in the value of third party assets managed by SWIP by the end of the 3 year period. If third party FUM reaches a specified target level, 100 per cent of this element of the award will vest. If third party FUM reaches 80 per cent of the target level, 25 per cent of this element, being the threshold, will vest. If third party FUM reaches 120 per cent of the target level, 200 per cent of this element of the award, being the maximum, will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

For awards made to SWIP's Code Staff (as defined by FSA), a fourth performance condition was set, relating to an internal measure of operational risk. This additional measure is relevant to 15 per cent of the award for these individuals, with a corresponding 5 per cent reduction in each of the weightings for the other three measures described above. As with the other measures, this performance condition has a target value at which 100 per cent of the award will vest, a maximum value at which 200 per cent of the award will vest, and a threshold value at which 25 per cent of the award will vest.

No award will be made where performance is below the threshold. Vesting between threshold and target and between target and maximum will be on a straight line basis.

The relevant period commenced on 1 January 2012 and ends on 31 December 2014.

	2012 Number of shares	2011 Number of shares
Outstanding at 1 January	**–**	–
Granted	**5,452,877**	–
Outstanding at 31 December	**5,452,877**	–

The fair value of the share awards granted in 2012 was £0.27. The fair values of share awards granted have been determined using a standard Black-Scholes model.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

	Executive schemes			**SAYE schemes**			**Other share option plans**		
	Weighted average exercise price (pence)	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**	**Weighted average exercise price (pence)**	**Weighted average remaining life (years)**	**Number of options**
At 31 December 2012									
Exercise price range									
£0 to £1	**–**	**–**	**–**	**46.79**	**0.8**	**311,648,405**	**5.43**	**4.9**	**74,766,919**
£1 to £2	**199.91**	**1.6**	**233,714**	**178.14**	**1.8**	**2,923,618**	**–**	**–**	**–**
£2 to £3	**225.69**	**1.9**	**7,811,182**	**–**	**–**	**–**	**–**	**–**	**–**
£3 to £4	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
£5 to £6	**–**	**–**	**–**	**–**	**–**	**–**	**566.89**	**0.9**	**12,026,160**

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
At 31 December 2011									
Exercise price range									
£0 to £1	–	–	–	47.94	1.7	446,965,447	4.94	4.1	82,152,838
£1 to £2	199.91	2.6	233,714	179.16	2.0	5,563,072	–	–	–
£2 to £3	225.74	2.9	9,941,155	214.16	0.9	490,513	–	–	–
£3 to £4	–	–	–	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	582.82	1.8	14,227,020

50 Share-based payments (continued)

The fair value calculations at 31 December 2012 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Executive Share Plan 2003	LTIP	Share Buy Out Awards	SWIP LTIP
Weighted average risk-free interest rate	**0.45%**	**0.52%**	**0.86%**	**0.38%**
Weighted average expected life	**2.5 years**	**3.0 years**	**1.3 years**	**2.8 years**
Weighted average expected volatility	**63%**	**78%**	**51%**	**81%**
Weighted average expected dividend yield	**4.1%**	**4.3%**	**1.6%**	**4.5%**
Weighted average share price	**£0.33**	**£0.35**	**£0.41**	**£0.31**
Weighted average exercise price	**Nil**	**Nil**	**Nil**	**Nil**

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

Share incentive plan

Free shares

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to a maximum of £3,000. The percentage is normally announced concurrently with the Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

The last award of free shares was made in 2008.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these matching shares are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2012 was 36,158,343 (2011: 30,999,387), with an average fair value of £0.34 (2011: £0.42), based on market prices at the date of award.

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 2012, the Group's key management personnel are the members of the Lloyds Banking Group plc group executive committee together with its non-executive directors.

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

	2012 £m	2011 £m
Compensation		
Salaries and other short-term benefits	**6**	6
Share-based payments	**7**	6
Total compensation	**13**	12

The aggregate of the emoluments of the directors was £3.8 million (2011: £4.3 million). The total for the highest paid director (António Horta-Osório) was £1,699,000, (2011: (António Horta-Osório) £2,061,000).

	2012 million	2011 million
Share options over Lloyds Banking Group plc shares		
At 1 January	**22**	6
Granted (includes entitlement of appointed key management personnel)	**8**	20
Exercised/lapsed (includes entitlements of former key management personnel)	**(5)**	(4)
At 31 December	**25**	22

	2012 million	2011 million
Share incentive plans settled in Lloyds Banking Group plc shares		
At 1 January	**58**	56
Granted (includes entitlements of appointed key management personnel)	**45**	35
Exercised/lapsed (includes entitlements of former key management personnel)	**(33)**	(33)
At 31 December	**70**	58

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

	2012 £m	2011 £m
Loans		
At 1 January	**3**	3
Advanced (includes loans of appointed key management personnel)	**3**	1
Repayments (includes loans of former key management personnel)	**(4)**	(1)
At 31 December	**2**	3

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 2.5 per cent and 29.95 per cent in 2012 (2011: 1.09 per cent and 27.5 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2011: £nil).

	2012 £m	2011 £m
Deposits		
At 1 January	**6**	4
Placed (includes deposits of appointed key management personnel)	**39**	17
Withdrawn (includes deposits of former key management personnel)	**(35)**	(15)
At 31 December	**10**	6

Deposits placed by key management personnel attracted interest rates of up to 3.8 per cent in 2012 (2011: 5 per cent).

At 31 December 2012, the Group did not provide any guarantees in respect of key management personnel (2011: none).

51 Related party transactions (continued)

At 31 December 2012, transactions, arrangements and agreements entered into by the Lloyds Banking Group's banking subsidiaries with directors and connected persons of the Group included amounts outstanding in respect of loans and credit card transactions of £1 million with five directors and three connected persons. (2011: £3 million with four directors and three connected persons).

Balances and transactions with fellow Lloyds Banking Group undertakings
Balances and transactions between members of the HBOS group
In accordance with IAS 27 *Consolidated and separate financial statements*, transactions and balances between the Company and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Company has a significant number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Company as follows:

	2012 £m	2011 £m
Assets, included within:		
Amounts owed by Group entities	**33,476**	36,607
Derivative financial instruments	**1,565**	1,857
	35,041	38,464
Liabilities, included within:		
Amounts owed to Group entities	**22,619**	27,509
Subordinated liabilities	**2,940**	3,035
	25,559	30,544

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2012 the Company earned interest income on the above asset balances of £1,189 million (2011: £1,539 million) and incurred interest expense on the above liability balances of £297 million (2011: £654 million).

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

	Group		Company	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Assets included within:				
Derivative financial instruments	**6,803**	4,196	**–**	–
Loans and receivables:				
Loans and advances to banks	**135,316**	85,800	**–**	–
Loans and advances to customers	**9,765**	11,698	**6,713**	8,611
Trading and other financial assets at fair value through profit or loss	**14,977**	7,515	**–**	–
Other	**3,347**	2,681	**2,524**	2,160
	170,208	111,890	**9,237**	10,771
Liabilities included within:				
Deposits from banks	**164,624**	144,502	**1,619**	–
Customer deposits	**12,246**	16,460	**5,415**	7,394
Derivative financial instruments	**7,601**	6,703	**–**	–
Subordinated liabilities	**415**	272	**15**	18
Trading financial liabilities	**8,479**	6,690	**–**	–
Other liabilities	**1,853**	1,559	**–**	345
	195,218	176,186	**7,049**	7,757

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2012 the Group earned £1,427 million and the Company earned £153 million of interest income on the above asset balances (2011: Group £920 million; Company £103 million); the Group incurred £2,549 million and the Company incurred £335 million of interest expense on the above liability balances (2011: Group £1,974 million; Company £200 million).

In July 2011, as a result of a restructuring of the insurance operations of the Lloyds Banking Group, the life, pensions and general insurance subsidiaries of the Group were sold to fellow subsidiaries of the Lloyds Banking Group. Further details are provided in note 14.

UK Government
In January 2009, the UK Government through HM Treasury became a related party of Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2012, HM Treasury held a 39.2 per cent (31 December

51 Related party transactions (continued)

2011: 40.2 per cent) interest in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Company during the year ended 31 December 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.

Since 31 December 2011, the Group has had the following significant transactions with the UK Government or UK Government-related entities:

Government and central bank facilities
During the year ended 31 December 2012, the Lloyds Banking Group 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 31 December 2011, the Lloyds Banking Group had £23.5 billion of debt in issue under the Credit Guarantee Scheme but this was all repaid during 2012. During the year ended 31 December 2012, fees of £59 million paid to HM Treasury in respect of guaranteed funding were included in the Lloyds Banking Group's income statement (2011: £291 million).

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 is providing eligible UK businesses with discounted funding, 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 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 31 December 2012, the Lloyds Banking Group had invested £50 million (2011: £20 million) in the Business Growth Fund and carried the investment at a fair value of £44 million (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 invested £12 million in the Fund during 2012.

Funding for Lending
In August 2012 the Lloyds Banking Group announced its support for the UK Government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Lloyds Banking Group. The initiative supports a broad range of UK-based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. The Lloyds Banking Group drew down £3.0 billion during 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
Other than the transactions referred to above, there were no other significant transactions with the UK Government and 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 disclosures
Pension Funds
At 31 December 2012 there were customer deposits of £25 million (2011: £32 million) and investment and insurance contract liabilities of £435 million (2011: £383 million) related to the Group's pension arrangements.

Open Ended Investment Companies (OEICs)
The Group manages 32 (2011: 30) Open Ended Investment Companies (OEICs), and of these 25 (2011: 22) are consolidated. The Group invested £505 million (2011: £649 million) and redeemed £146 million (2011: £393 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £1,503 million (2011: £933 million) at 31 December. The Group earned fees of £60 million from the unconsolidated OEICs (2011: £65 million).

Joint ventures and associates
The Group provides both administration and processing services to its principal joint venture, Sainsbury's Bank plc. The amounts receivable by the Group during the year were £32 million (2011: £21 million), of which £16 million is outstanding at the year end (2011: £10 million). At 31 December 2012, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £1,229 million (2011: £1,173 million), deposits by banks of £1,268 million (2011: £780 million) and trading liabilities of £nil (2011: £340 million).

At 31 December 2012 there were loans and advances to customers of £3,424 million (2011: £5,185 million) outstanding and balances within customer deposits of £45 million (2011: £88 million) relating to joint ventures and associates.

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 2012, these companies had total assets of approximately £6,309 million (2011: £7,330 million), total liabilities of approximately £6,151 million (2011: £6,528 million) and for the year ended 31 December 2012 had turnover of approximately £4,035 million (2011: £3,950 million) and made a net loss of approximately £535 million (2011: net loss of £86 million). In addition, the Group has provided £3,602 million (2011: £4,588 million) of financing to these companies on which it received £116 million (2011: £27 million) of interest income in the year.

Taxation
Group relief was surrendered for no payment, as per note 15.

52 Contingent liabilities and commitments

Interchange fees
On 24 May 2012, the General Court of the European Union 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.

MasterCard has appealed the General Court's judgment to the Court of Justice of the European Union. MasterCard is supported by several card issuers, including Lloyds Banking Group. Judgment is not expected until late 2013 or later.

In parallel:

- the European Commission is also considering further action, including introducing legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;
- 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 credit card 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 fee for cross-border debit card transactions to the interim levels agreed by MasterCard; and
- the Office of Fair Trading (OFT) may decide to renew its ongoing examination of whether the levels of interchange fees 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 to the General Court.

The ultimate impact of the investigations and any regulatory developments on the 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
A number of government agencies in the UK, US and elsewhere, including the UK Financial Services Authority, the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the US Department of Justice and a number of State Attorneys General, as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates including the BBA London Interbank Offered Rates (LIBOR) and the European Banking Federation's Euribor. Certain Lloyds Banking Group companies were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA LIBOR panels. No Lloyds Banking Group company is or was a member of the Euribor panel. Certain Lloyds Banking Group companies have received subpoenas and requests for information from certain government agencies and the Lloyds Banking Group is co-operating with their investigations. In addition certain Lloyds Banking Group companies, together with other panel banks, 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 Lloyds Banking Group.

Financial Services Compensation Scheme
The Financial Services Compensation Scheme (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.

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. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

In determining an appropriate accrual in respect of the management expenses levy, certain assumptions have been made including the proportion of total protected deposits held by the Lloyds Banking Group, the level and timing of repayments to be made by the FSCS to HM Treasury and the interest rate to be charged by HM Treasury. For the year ended 31 December 2012, the Group has charged £53 million (2011: £86 million;) to the income statement in respect of the management expenses levy.

The substantial majority of the principal balance of the £20 billion loan between the FSCS and HM Treasury 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. In March 2012, the FSCS confirmed that it expects a shortfall of approximately £802 million and that it expects to recover that amount by raising compensation levies on all deposit-taking participants over a three year period. In addition to the management expenses levy detailed above, the Group has also charged £51 million (2011: £nil) to the income statement in respect of compensation levies. The amount of future compensation levies payable by the Group 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.

FSA investigation into Bank of Scotland and report on HBOS
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 committed to producing a public interest report on HBOS. The FSA has indicated that the report is expected to be published in the summer.

Shareholder complaints
In November 2011 the Lloyds Banking Group and two former members of the Lloyds Banking Group's Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted 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. In October 2012 the court dismissed the complaint. An appeal against this decision has been filed. The Lloyds Banking Group continues to consider that the allegations are without merit.

52 Contingent liabilities and commitments (continued)

Other legal actions and regulatory matters
In addition, during the ordinary course of business the Lloyds Banking 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 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 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 Lloyds Banking Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

Contingent liabilities and commitments arising from the banking business
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	
	2012 £m	2011 £m
Contingent liabilities		
Acceptances and endorsements	**2**	3
Other:		
Other items serving as direct credit substitutes	**28**	110
Performance bonds and other transaction-related contingencies	**565**	674
	593	784
Total contingent liabilities	**595**	787

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	
	2012 £m	2011 £m
Commitments		
Documentary credits and other short-term trade-related transactions	**4**	8
Undrawn formal standby facilities, credit lines and other commitments to lend:	**–**	–
Less than 1 year original maturity:		
Mortgage offers made	**6,346**	6,311
Other commitments	**20,828**	22,851
	27,174	29,162
1 year or over original maturity	**7,664**	16,442
Total commitments	**34,842**	45,612

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £12,922 million (2011: £15,087 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:

	2012 £m	2011 £m
Not later than 1 year	**133**	139
Later than 1 year and not later than 5 years	**446**	478
Later than 5 years	**680**	789
Total operating lease commitments	**1,259**	1,406

52 Contingent liabilities and commitments (continued)

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), there was no capital expenditure contracted but not provided for at 31 December 2012 (2011: £nil).

53 Financial instruments

(1) Measurement basis of financial assets and liabilities
The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

		At fair value through profit or loss						
Group	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2012								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	6,112	–	6,112
Items in the course of collection from banks	–	–	–	–	–	416	–	416
Trading and other financial assets at fair value through profit or loss	–	32,201	30,157	–	–	–	–	62,358
Derivative financial instruments	9,923	25,932	–	–	–	–	–	35,855
Loans and receivables:								
Loans and advances to banks	–	–	–	–	140,085	–	–	140,085
Loans and advances to customers	–	–	–	–	313,387	–	–	313,387
Debt securities	–	–	–	–	3,979	–	–	3,979
	–	–	–	–	457,451	–	–	457,451
Available-for-sale financial assets	–	–	–	6,052	–	–	–	6,052
Total financial assets	9,923	58,133	30,157	6,052	457,451	6,528	–	568,244
Financial liabilities								
Deposits from banks	–	–	–	–	–	171,738	–	171,738
Customer deposits	–	–	–	–	–	217,515	–	217,515
Items in course of transmission to banks	–	–	–	–	–	518	–	518
Trading liabilities	–	33,610	–	–	–	–	–	33,610
Derivative financial instruments	4,487	27,223	–	–	–	–	–	31,710
Notes in circulation	–	–	–	–	–	1,198	–	1,198
Debt securities in issue	–	–	–	–	–	49,521	–	49,521
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	423	423
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	27,166	27,166
Financial guarantees	–	–	14	–	–	–	–	14
Subordinated liabilities	–	–	–	–	–	12,491	–	12,491
Total financial liabilities	4,487	60,833	14	–	–	452,981	27,589	545,904

53 Financial instruments (continued)

Group	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2011								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	3,075	–	3,075
Items in the course of collection from banks	–	–	–	–	–	379	–	379
Trading and other financial assets at fair value through profit or loss	–	21,840	23,507	–	–	–	–	45,347
Derivative financial instruments	9,588	26,665	–	–	–	–	–	36,253
Loans and receivables:								
Loans and advances to banks	–	–	–	–	91,210	–	–	91,210
Loans and advances to customers	–	–	–	–	357,110	–	–	357,110
Debt securities	–	–	–	–	11,276	–	–	11,276
	–	–	–	–	459,596	–	–	459,596
Available-for-sale financial assets	–	–	–	10,498	–	–	–	10,498
Total financial assets	9,588	48,505	23,507	10,498	459,596	3,454	–	555,148
Financial liabilities								
Deposits from banks	–	–	–	–	–	150,042	–	150,042
Customer deposits	–	–	–	–	–	217,048	–	217,048
Items in course of transmission to banks	–	–	–	–	–	332	–	332
Trading liabilities	–	20,805	–	–	–	–	–	20,805
Derivative financial instruments	6,710	26,675	–	–	–	–	–	33,385
Notes in circulation	–	–	–	–	–	1,145	–	1,145
Debt securities in issue	–	–	–	–	–	75,457	–	75,457
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	385	385
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	22,207	22,207
Financial guarantees	–	–	17	–	–	–	–	17
Subordinated liabilities	–	–	–	–	–	13,613	–	13,613
Total financial liabilities	6,710	47,480	17	–	–	457,637	22,592	534,436

Company	Derivatives designated as hedging instruments £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2012				
Financial assets				
Derivative financial instruments	**1,565**	**–**	**–**	**1,565**
Loans and receivables:				
Amounts due from fellow Lloyds Banking Group undertakings	**–**	**42,713**	**–**	**42,713**
Total financial assets	**1,565**	**42,713**	**–**	**44,278**
Financial liabilities				
Derivative financial instruments	**10**	**–**	**–**	**10**
Subordinated liabilities	**–**	**–**	**9,021**	**9,021**
Total financial liabilities	**10**	**–**	**9,021**	**9,031**

53 Financial instruments (continued)

Company	Derivatives designated as hedging instruments £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2011				
Financial assets				
Derivative financial instruments	1,857	–	–	1,857
Loans and receivables:				
Amounts due from fellow Lloyds Banking Group undertakings	–	47,378	–	47,378
Total financial assets	1,857	47,378	–	49,235
Financial liabilities				
Derivative financial instruments	10	–	–	10
Subordinated liabilities	–	–	9,318	9,318
Total financial liabilities	10	–	9,318	9,328

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

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

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

(2) Reclassification of financial assets
No assets were reclassified in 2012 or 2011.

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 financial assets 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.

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

	31 December 2012		31 December 2011		31 December 2010		31 December 2009		31 December 2008	
	Carrying value £m	**Fair value £m**	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	**–**	**–**	269	254	949	965	1,428	1,120	–	–
From held for trading to available-for-sale	**867**	**1,104**	1,980	1,890	6,116	6,431	10,478	10,176	13,542	13,542
From available-for-sale financial assets to loans and receivables	**3,573**	**3,914**	10,052	9,258	21,508	21,522	29,153	27,820	37,173	36,191
Total carrying value and fair value	**4,440**	**5,018**	12,301	11,402	28,573	28,918	41,059	39,116	50,715	49,733

During the year ended 31 December 2012, the carrying value of reclassified assets decreased by £7,861 million due to sales and maturities of £7,732 million, foreign exchange and other movements of £221 million less accretion of discount of £92 million.

No financial assets have been reclassified in accordance with the amendment to IAS 39 since 2009; the following disclosures relate to those assets which were reclassified in 2008 and 2009.

53 Financial instruments (continued)

a) 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.

For assets reclassified in 2009

	2012 £m	2011 £m	2010 £m	2009 £m
From held for trading to loans and receivables	7	11	14	13
From available-for-sale financial assets to loans and receivables	–	–	–	70
Total additional fair value gains	7	11	14	83

For assets reclassified in 2008

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to available-for-sale financial assets	285	26	136	904	981
From available-for-sale financial assets to loans and receivables	724	130	(134)	1,147	708
Total additional fair value gains	1,009	156	2	2,051	1,689

b) Actual amounts recognised in respect of reclassified assets
After reclassification the reclassified financial assets contributed the following amounts to the Group income statement:

For assets reclassified from held for trading to loans and receivables in 2009

	2012 £m	2011 £m	2010 £m	2009 £m
Net interest income	3	16	23	45
Impairment losses	(2)	(13)	–	(110)
(Losses) gains on disposal	(10)	32	109	17
Total additional fair value (losses) gains	(9)	35	132	(48)

For assets reclassified from held for trading to available-for-sale financial assets in 2008

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Net interest income	13	141	184	281	442
Impairment losses	–	(8)	1	(305)	(215)
(Losses) gains on disposal	(91)	(26)	95	70	–
Total additional fair value (losses) gains	(78)	107	280	46	227

For assets reclassified from available-for-sale financial assets to loans and receivables in 2009

	2012 £m	2011 £m	2010 £m	2009 £m
Net interest income	–	–	14	25
(Losses) gains on disposal	–	–	(9)	–
Total additional fair value gains	–	–	5	25

For assets reclassified from available-for-sale financial assets to loans and receivables in 2008

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Net interest income	31	213	443	377	82
Impairment losses	(25)	(6)	(33)	(371)	(558)
(Losses) gains on disposal	(439)	(323)	(128)	(152)	16
Total additional fair value (losses) gains	(433)	(116)	282	(146)	(460)

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.

	2012		2011	
Group	**Carrying value £m**	**Fair value £m**	Carrying value £m	Fair value £m
Financial assets				
Cash and balances at central banks	**6,112**	**6,112**	3,075	3,075
Items in the course of collection from banks	**416**	**416**	379	379
Trading and other financial assets at fair value through profit or loss	**62,358**	**62,358**	45,347	45,347
Derivative financial instruments	**35,855**	**35,855**	36,253	36,253
Loans and receivables:				
Loans and advances to banks	**140,085**	**140,086**	91,210	91,172
Loans and advances to customers	**313,387**	**303,987**	357,110	344,150
Debt securities	**3,979**	**4,163**	11,276	9,479
Available-for-sale financial assets	**6,052**	**6,052**	10,498	10,498
Financial liabilities				
Deposits from banks	**171,738**	**171,812**	150,042	150,140
Customer deposits	**217,515**	**219,106**	217,048	217,860
Items in course of transmission to banks	**518**	**518**	332	332
Trading liabilities	**33,610**	**33,610**	20,805	20,805
Derivative financial instruments	**31,710**	**31,710**	33,385	33,385
Notes in circulation	**1,198**	**1,198**	1,145	1,145
Debt securities in issue	**49,521**	**50,028**	75,457	73,167
Liabilities arising from non-participating investment contracts	**27,166**	**27,166**	22,207	22,207
Financial guarantees	**14**	**14**	17	17
Subordinated liabilities	**12,491**	**10,585**	13,613	8,447

Company	**Carrying value £m**	**Fair value £m**	Carrying value £m	Fair value £m
Financial assets				
Derivative financial instruments	**1,565**	**1,565**	1,857	1,857
Amounts due from subsidiaries	**42,713**	**42,713**	47,378	47,378
Financial liabilities				
Derivative financial instruments	**10**	**10**	10	10
Subordinated liabilities	**9,021**	**8,375**	9,318	7,516

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.

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.

53 Financial instruments (continued)

Fair value of financial instruments carried at amortised cost
Cash and balances at central banks and items in the course of collection from banks
The fair value approximates carrying value due to their short-term nature.

Loans and receivables
The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of variable rate loans, loans relating to lease financing and impaired lending is assumed to be fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. These techniques take account of expected credit losses and changes in interest rates and expected future cash flows in establishing fair value. 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 the counterparty's 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 asset-backed securities 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 deposits
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. The difference between fair value and carrying value is principally interest rate driven on fixed deposits.

Items in course of transmission to banks
The fair value approximates carrying value due to their short-term nature.

Notes in circulation
The fair value of notes in circulation which are payable on demand is considered to be equal to their carrying value.

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. The difference between fair value and amortised cost is driven both by interest rates and the Group's credit rating.

Valuation of financial instruments carried at fair value
The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

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 equity shares, treasury bills and other 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. 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 and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

Valuation control framework
The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

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.

Valuation hierarchy

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2012				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	28,372	–	28,372
Loans and advances to banks	–	729	–	729
Debt securities:				
Government securities	184	2,002	–	2,186
Other public sector securities	–	154	–	154
Bank and building society certificates of deposit	–	2,399	–	2,399
Asset-backed securities:				
Mortgage-backed securities	–	18	–	18
Other asset-backed securities	–	4	–	4
Corporate and other debt securities	–	4,372	14	4,386
	184	8,949	14	9,147
Equity shares	23,676	–	149	23,825
Treasury and other bills	285	–	–	285
Total trading and other financial assets at fair value through profit or loss	24,145	38,050	163	62,358
Available-for-sale financial assets				
Debt securities:				
Government securities	113	–	–	113
Bank and building society certificates of deposit	–	25	–	25
Asset-backed securities:				
Mortgage-backed securities	–	882	–	882
Other asset-backed securities	–	285	21	306
Corporate and other debt securities	22	4,234	–	4,256
	135	5,426	21	5,582
Equity shares	16	47	407	470
Total available-for-sale financial assets	151	5,473	428	6,052
Derivative financial instruments	–	35,683	172	35,855
Total financial assets carried at fair value	24,296	79,206	763	104,265
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	32,449	–	32,449
Short positions in securities	1,146	–	–	1,146
Other	15	–	–	15
Total trading liabilities	1,161	32,449	–	33,610
Derivative financial instruments	–	31,656	54	31,710
Financial guarantees	–	–	14	14
Total financial liabilities carried at fair value	1,161	64,105	68	65,334

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

53 Financial instruments (continued)

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2011				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	17,435	–	17,435
Loans and advances to banks	–	1,355	–	1,355
Debt securities:				
Government securities	992	1,471	–	2,463
Other public sector securities	–	185	–	185
Bank and building society certificates of deposit	–	1,476	–	1,476
Asset-backed securities:				
Mortgage-backed securities	–	9	–	9
Other asset-backed securities	–	–	203	203
Corporate and other debt securities	–	2,805	39	2,844
	992	5,946	242	7,180
Equity shares	18,960	3	190	19,153
Treasury and other bills	224	–	–	224
Total trading and other financial assets at fair value through profit or loss	20,176	24,739	432	45,347
Available-for-sale financial assets				
Debt securities:				
Government securities	74	89	–	163
Bank and building society certificates of deposit	–	32	–	32
Asset-backed securities:				
Mortgage-backed securities	–	789	–	789
Other asset-backed securities	–	57	26	83
Corporate and other debt securities	23	7,515	12	7,550
	97	8,482	38	8,617
Equity shares	51	43	1,787	1,881
Total available-for-sale financial assets	148	8,525	1,825	10,498
Derivative financial instruments	–	35,902	351	36,253
Total financial assets carried at fair value	20,324	69,166	2,608	92,098
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	19,069	–	19,069
Short positions in securities	1,736	–	–	1,736
Total trading liabilities	1,736	19,069	–	20,805
Derivative financial instruments	–	33,354	31	33,385
Financial guarantees	–	–	17	17
Total financial liabilities carried at fair value	1,736	52,423	48	54,207

53 Financial instruments (continued)

Valuation methodology

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 security is reported as level 3. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

Equity investments (including venture capital)

Unlisted equities and fund investments are accounted for as trading and other financial assets at fair value through profit or loss or as available-for-sale financial assets. These investments are valued using different techniques as a result of the variety of investments across the portfolio in accordance with the Group's valuation policy and are calculated using International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation. The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

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 (CDS) curves are valued using 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.

Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

53 Financial instruments (continued)

Movements in level 3 portfolio

The table below analyses movements in the level 3 financial assets 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 1 January 2011	996	2,067	265	3,328
Exchange and other adjustments	(6)	(39)	–	(45)
Gains recognised in the income statement	34	78	39	151
Losses recognised in other comprehensive income	–	(163)	–	(163)
Purchases	6	341	–	347
Sales	(389)	(474)	–	(863)
Transfers into the level 3 portfolio	331	28	47	406
Transfers out of the level 3 portfolio	(128)	(13)	–	(141)
Disposal of businesses (note 14)	(412)	–	–	(412)
At 31 December 2011	432	1,825	351	2,608
Exchange and other adjustments	**9**	**(60)**	**–**	**(51)**
Gains (losses) recognised in the income statement	**5**	**(356)**	**(169)**	**(520)**
Losses recognised in other comprehensive income	**–**	**(60)**	**–**	**(60)**
Purchases	**22**	**218**	**–**	**240**
Sales	**(305)**	**(1,138)**	**(10)**	**(1,453)**
Transfers out of the level 3 portfolio	**–**	**(1)**	**–**	**(1)**
At 31 December 2012	**163**	**428**	**172**	**763**
Losses recognised in the income statement relating to those assets held at 31 December 2012	**(16)**	**(33)**	**(169)**	**(218)**
Losses recognised in other comprehensive income relating to those assets held at 31 December 2012	**–**	**(26)**	**–**	**(26)**
Gains recognised in the income statement relating to those assets held at 31 December 2011	23	31	74	128
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	–	(147)	–	(147)

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

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2011	34	12	46
Losses recognised in the income statement	3	5	8
Transfers into the level 3 portfolio	14	–	14
Transfers out of the level 3 portfolio	(20)	–	(20)
At 31 December 2011	31	17	48
Losses (gains) recognised in the income statement	**22**	**(3)**	**19**
Transfers into the level 3 portfolio	**16**	**–**	**16**
Redemptions	**(15)**	**–**	**(15)**
At 31 December 2012	**54**	**14**	**68**
(Losses) gains recognised in the income statement relating to those liabilities held at 31 December 2012	**(22)**	**3**	**(19)**
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	(1)	(5)	(6)

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

Included within the gains (losses) recognised in the income statement are losses of £237 million (2011: gains of £122 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

53 Financial instruments (continued)

Included within the gains (losses) recognised in other comprehensive income are losses of £26 million (2011: losses of £147 million) related to financial instruments that are held in the level 3 portfolio at the year end.

Level 3 portfolio

Sensitivity of level 3 valuations

			At 31 December 2012			At 31 December 2011		
				Effect of reasonably possible alternative assumptions			Effect of reasonably possible alternative assumptions	
	Valuation basis/ technique	Main assumptions	Carrying value £m	Favourable changes £m	Unfavourable changes £m	Carrying value £m	Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Asset-backed securities	Lead manager or broker quote/ consensus pricing from market data provider	Use of single pricing source	–	–	–	203	1	(1)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	**163**	**29**	**(8)**	229	16	(19)
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	–	–	–	–	–	–
			163			432		
Available-for-sale financial assets								
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	**428**	**36**	**(11)**	1,825	183	(88)
Derivative financial assets								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**172**	**27**	**(19)**	351	58	(23)
Financial assets			**763**			2,608		
Derivative financial liabilities								
	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	**54**	–	–	31	–	–
Financial guarantees			**14**	–	–	17	–	–
Financial liabilities			**68**			48		

Asset-backed securities
Reasonably possible alternative valuations have been calculated for asset-backed securities by using alternative pricing sources and calculating an absolute difference. The pricing difference is defined as the absolute difference between the actual price used and the closest, alternative price available.

Derivative financial instruments
(i) In respect of the embedded equity conversion feature of the enhanced capital notes, the sensitivity was based on the absolute difference between the actual price of the enhanced capital note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.

(ii) In respect of credit default swaps written on level 3 negative basis asset-backed securities, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

Venture capital and equity investments
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 valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment, as described in the valuation methodology section above. Reasonably possible alternative valuations for these investments have been calculated by reference to the relevant approach taken as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

53 Financial instruments (continued)

- for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
- the discount rates used in discounted cash flow valuations; and
- in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

(4) Transfers of financial assets

A. Transferred financial assets that continue to be recognised in full

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets concerned. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 20, included within loans and receivables are loans securitised under the Group's securitisation programmes. The Group retains all or a majority of the risks and rewards associated with these loans and they are retained on the Group's balance sheet. Assets transferred into the Group's securitisation programmes are not available to be used by the Group during the term of those arrangements.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities leading transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 35). Except as noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
At 31 December 2012		
Repurchase and securities lending transactions		
Trading and other financial assets at fair value through profit or loss	**703**	**189**
Available-for-sale financial assets	**2,439**	**464**
Loans and receivables:		
Loans and advances to customers	**44,451**	**5,300**
Debt securities classified as loans and receivables	**493**	**403**
Securitisation programmes		
Loans and receivables:		
Loans and advances to customers[1]	**67,016**	**17,624**[2]

[1] Includes US residential mortage-backed securities and associated liabilities whose carrying values were £185 million and £221 million respectively; the associated liabilities have recourse only to the securities transferred and, at 31 December 2012, the fair values of the securities and the associated liabilities were £244 million and £311 million respectively, a difference of £67 million.

[2] Excludes securitisation notes held by the Group (£33,570 million).

B. Transferred financial assets derecognised in their entirety with ongoing exposure

The following information by type of ongoing exposure relates to assets and liabilities arising from contractual rights or obligations retained or obtained in connection with financial assets that have been derecognised in their entirety.

	Carrying amount of ongoing exposure in balance sheet			
		At fair value through profit or loss		
	Loans and receivables £m	Designated upon initial recognition £m	Fair value of ongoing exposure £m	Maximum exposure to loss £m
At 31 December 2012				
Debt securities	**199**	**–**	**237**	**199**[1]
Liquidity facilities	**56**	**–**	**55**	**56**[1]
Fund investments	**–**	**70**	**70**	**100**[2]
Total	**255**	**70**	**362**	**355**

[1] Amount represents the carrying amount of the asset.

[2] Amount represents the carrying amount of the asset plus undrawn commitments of £30 million.

Debt securities shown in the table above are notes held in non-controlled securitisation vehicles representing the Group's ongoing involvement in financial assets transferred into those securitisation vehicles in prior years. The debt securities, which benefit from significant credit enhancement, are classified as available-for-sale financial assets and are managed on a similar basis to the Group's other non-traded asset backed securities.

Fund investments shown in the table above are equity and debt interests in an investment fund representing the Group's ongoing involvement in financial assets transferred into the fund in a prior year. The fund investments were designated at fair value through profit or loss and are managed on a similar basis to the Group's trading assets.

Liquidity facilities are to asset-backed conduits of Lloyds TSB Bank plc which include assets previously recognised by the Group.

The Group has no obligation or option to repurchase any of the assets transferred.

53 Financial instruments (continued)

Amounts recognised in the income statement in 2012
In respect of debt securities and liquidity facilities shown above, an amount of £3 million was recognised during the year (£14 million cumulatively since derecognition) within net interest income.

In respect of fund investments shown above, an amount of £3 million was recognised during the year (£55 million cumulatively since derecognition) within net trading income.

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

(1) Credit risk
The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom, the European Union, Australia and the United States. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems on inputs and measure the credit risk of loans and advances to customers and banks at a counterparty level using three components; (i) the probability of default by the counterparty on its contractual obligations; (ii) the current exposures to the counterparty and their likely future development, from which the Group derives the exposure at default; and (iii) the likely loss ratio on the defaulted obligations, the loss given default. The Group uses a range of approaches to mitigate credit risk, including internal control policies, obtaining collateral, using master netting agreements and other credit risk transfers, such as asset sales and credit derivative based transactions.

A. Maximum credit exposure
The maximum credit risk exposure of the Group in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss which includes amounts held to cover unit-linked and with-profit fund liabilities, 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	
	2012 £m	2011 £m
Loans and receivables:		
Loans and advances to banks, net[1]	**140,085**	91,210
Loans and advances to customers, net[1]	**313,387**	357,110
Debt securities, net[1]	**3,979**	11,276
Deposit amounts available for offset[2]	**(1,362)**	(2)
	456,089	459,594
Available-for-sale financial assets (excluding equity shares)	**5,582**	8,617
Trading and other financial assets at fair value through profit or loss (excluding equity shares)[3]:		
Loans and advances	**29,101**	18,790
Debt securities, treasury and other bills	**9,432**	7,404
	38,533	26,194
Derivative assets:		
Derivative assets, before offsetting under master netting arrangements	**35,855**	36,253
Amounts available for offset under master netting arrangements[2]	**(20,733)**	(22,816)
	15,122	13,437
Assets arising from reinsurance contracts held	**42**	38
Financial guarantees	**5,330**	6,011
Irrevocable loan commitments and other credit-related contingencies[4]	**13,517**	15,874
Maximum credit risk exposure	**534,215**	529,765
Maximum credit risk exposure before offset items	**556,310**	552,583

[1]Amounts shown net of related impairment allowances.

[2]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.

[3]Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's With-Profits funds for which credit risk is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

[4]See note 52 – Contingent liabilities and commitments for further information.

54 Financial risk management (continued)

B. Credit quality of assets
Loans and receivables
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.

Loans and advances

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2012						
Neither past due nor impaired	**4,769**	**219,939**	**12,703**	**39,811**	**272,453**	**14,340**
Past due but not impaired	**–**	**10,554**	**391**	**1,147**	**12,092**	**–**
Impaired – no provision required	**–**	**409**	**635**	**965**	**2,009**	**–**
– provision held	**–**	**6,564**	**424**	**27,961**	**34,949**	**–**
Gross	**4,769**	**237,466**	**14,153**	**69,884**	**321,503**	**14,340**
Allowance for impairment losses (note 23)	**–**	**(2,542)**	**(371)**	**(14,968)**	**(17,881)**	**–**
Net	**4,769**	**234,924**	**13,782**	**54,916**	**303,622**	**14,340**
Due from fellow Lloyds Banking Group undertakings	**135,316**				**9,765**	**14,761**
	140,085				**313,387**	**29,101**
31 December 2011						
Neither past due nor impaired	5,404	226,256	12,715	68,006	306,977	11,051
Past due but not impaired	–	10,329	439	1,821	12,589	–
Impaired – no provision required	6	940	689	2,935	4,564	–
– provision held	–	5,697	533	38,403	44,633	–
Gross	5,410	243,222	14,376	111,165	368,763	11,051
Allowance for impairment losses (note 23)	–	(2,432)	(499)	(20,420)	(23,351)	–
Net	5,410	240,790	13,877	90,745	345,412	11,051
Due from fellow Lloyds Banking Group undertakings	85,800				11,698	7,739
	91,210				357,110	18,790

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 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 £28,970 million (2011: £41,984 million).

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54 Financial risk management (continued)

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2012						
Good quality	**4,737**	**214,017**	**8,820**	**10,949**		**14,306**
Satisfactory quality	**24**	**4,227**	**3,248**	**11,972**		**25**
Lower quality	**–**	**542**	**282**	**12,473**		**6**
Below standard, but not impaired	**8**	**1,153**	**353**	**4,417**		**3**
Total loans and advances which are neither past due nor impaired	**4,769**	**219,939**	**12,703**	**39,811**	**272,453**	**14,340**
31 December 2011						
Good quality	5,319	219,014	7,823	25,630		11,047
Satisfactory quality	38	5,035	3,858	17,560		4
Lower quality	–	951	410	17,777		–
Below standard, but not impaired	47	1,256	624	7,039		–
Total loans and advances which are neither past due nor impaired	5,404	226,256	12,715	68,006	306,977	11,051

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.

Loans and advances which are past due but not impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2012						
0-30 days	**–**	**4,902**	**297**	**654**	**5,853**	**–**
30-60 days	**–**	**2,166**	**67**	**107**	**2,340**	**–**
60-90 days	**–**	**1,460**	**21**	**281**	**1,762**	**–**
90-180 days	**–**	**2,026**	**5**	**18**	**2,049**	**–**
Over 180 days	**–**	**–**	**1**	**87**	**88**	**–**
Total loans and advances which are past due but not impaired	**–**	**10,554**	**391**	**1,147**	**12,092**	**–**
31 December 2011						
0-30 days	–	4,746	324	974	6,044	–
30-60 days	–	2,120	91	386	2,597	–
60-90 days	–	1,524	19	151	1,694	–
90-180 days	–	1,939	4	114	2,057	–
Over 180 days	–	–	1	196	197	–
Total loans and advances which are past due but not impaired	–	10,329	439	1,821	12,589	–

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

54 Financial risk management (continued)

Debt securities classified as loans and receivables

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

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2012							
Asset-backed securities:							
Mortgage-backed securities	**600**	**943**	**646**	**704**	**312**	**909**	**4,114**
Other asset-backed securities	**120**	**–**	**167**	**–**	**128**	**1**	**416**
	720	**943**	**813**	**704**	**440**	**910**	**4,530**
Corporate and other debt securities	**–**	**–**	**–**	**–**	**–**	**271**	**271**
	720	**943**	**813**	**704**	**440**	**1,181**	**4,801**
Due from fellow Group undertakings: Mortgage-backed securities							**166**
Total debt securities classified as loans and receivables							**4,967**
At 31 December 2011							
Asset-backed securities:							
Mortgage-backed securities	1,770	2,043	1,087	909	307	918	7,034
Other asset-backed securities	3,603	374	331	126	304	–	4,738
	5,373	2,417	1,418	1,035	611	918	11,772
Corporate and other debt securities	–	–	25	–	–	403	428
	5,373	2,417	1,443	1,035	611	1,321	12,200
Due from fellow Group undertakings: Mortgage-backed securities							224
Total debt securities classified as loans and receivables							12,424

54 Financial risk management (continued)

Available-for-sale financial assets (excluding equity shares)
An analysis of available-for-sale financial assets is included in note 24. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2012							
Debt securities:							
Government securities	**113**	**–**	**–**	**–**	**–**	**–**	**113**
Bank and building society certificates of deposit	**–**	**–**	**25**	**–**	**–**	**–**	**25**
Asset-backed securities:							
Mortgage-backed securities	**796**	**43**	**–**	**–**	**43**	**–**	**882**
Other asset-backed securities	**285**	**21**	**–**	**–**	**–**	**–**	**306**
	1,081	**64**	**–**	**–**	**43**	**–**	**1,188**
Corporate and other debt securities	**272**	**211**	**568**	**599**	**85**	**22**	**1,757**
	1,466	**275**	**593**	**599**	**128**	**22**	**3,083**
Due from fellow Group undertakings: Corporate and other debt securities							**2,499**
Total held as available-for-sale financial assets							**5,582**
At 31 December 2011							
Debt securities:							
Government securities	89	74	–	–	–	–	163
Bank and building society certificates of deposit	–	–	32	–	–	–	32
Asset-backed securities:							
Mortgage-backed securities	469	121	116	83	–	–	789
Other asset-backed securities	83	–	–	–	–	–	83
	552	121	116	83	–	–	872
Corporate and other debt securities	1,591	856	2,315	303	–	67	5,132
	2,232	1,051	2,463	386	–	67	6,199
Treasury and other bills	–	–	–	–	–	–	–
	2,232	1,051	2,463	386	–	67	6,199
Due from fellow Group undertakings: Corporate and other debt securities							2,418
Total held as available-for-sale financial assets							8,617

54 Financial risk management (continued)

Debt securities, treasury and other bills held at fair value through profit or loss:
An analysis of trading and other financial assets at fair value through profit or loss is included in note 16. The credit quality of debt securities, treasury and other bills held at fair value through profit or loss is set out below.

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
At 31 December 2012							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets							
Government securities	184	–	–	–	–	–	184
Bank and building society certificates of deposit	–	1,636	603	–	–	–	2,239
Other asset-backed securities	–	–	4	–	–	–	4
Corporate and other debt securities	320	90	–	–	–	–	410
Total debt securities held as trading assets	504	1,726	607	–	–	–	2,837
Treasury and other bills	285	–	–	–	–	–	285
Total held as trading assets	789	1,726	607	–	–	–	3,122
Other assets held at fair value through profit or loss							
Government securities	1,469	359	–	174	–	–	2,002
Other public sector securities	119	26	3	6	–	–	154
Bank and building society certificates of deposit	–	26	134	–	–	–	160
Asset-backed securities							
Mortgage-backed securities	–	–	18	–	–	–	18
Other asset-backed securities	–	–	–	–	–	–	–
	–	–	18	–	–	–	18
Corporate and other debt securities	192	673	764	483	1,584	64	3,760
Total other assets held at fair value through profit or loss	1,780	1,084	919	663	1,584	64	6,094
	2,569	2,810	1,526	663	1,584	64	9,216
Due from fellow Group undertakings:							
Corporate and other debt securities							216
Total held at fair value through profit or loss							9,432
At 31 December 2011							
Debt securities, treasury and other bills held at fair value through profit or loss							
Trading assets							
Government securities	992	–	–	–	–	–	992
Bank and building society certificates of deposit	–	1,062	322	–	–	–	1,384
Other asset-backed securities	–	151	52	–	–	–	203
Corporate and other debt securities	201	–	–	100	–	–	301
Total debt securities held as trading assets	1,193	1,213	374	100	–	–	2,880
Treasury and other bills	224	–	–	–	–	–	224
Total held as trading assets	1,417	1,213	374	100	–	–	3,104
Other assets held at fair value through profit or loss							
Government securities	1,386	39	44	2	–	–	1,471
Other public sector securities	97	86	2	–	–	–	185
Bank and building society certificates of deposit	–	62	30	–	–	–	92
Asset-backed securities							
Mortgage-backed securities	7	–	2	–	–	–	9
Corporate and other debt securities	341	550	437	433	692	90	2,543
Total other assets held at fair value through profit or loss	1,831	737	515	435	692	90	4,300
Total held at fair value through profit or loss	3,248	1,950	889	535	692	90	7,404

54 Financial risk management (continued)

Credit risk in respect of trading and other financial assets at past value through profit or loss held within the Group's unit-linked funds is borne by the policyholders and credit risk in respect of with-profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back those contract liabilities.

Derivative assets
An analysis of derivative assets is given in note 17. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £15,122 million (2011: £13,437 million), cash collateral of £2,638 million (2011: £2,249 million) was held and a further £439 million was due from OECD banks (2011: £1,303 million).

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
Derivative financial instruments							
At 31 December 2012							
Trading	**152**	**6,505**	**7,805**	**1,683**	**3,848**	**95**	**20,088**
Hedging	**–**	**4,575**	**3,607**	**77**	**703**	**2**	**8,964**
	152	**11,080**	**11,412**	**1,760**	**4,551**	**97**	**29,052**
Due from fellow Group undertakings							**6,803**
Total derivative financial instruments							**35,855**
At 31 December 2011							
Trading	166	10,095	6,117	2,709	1,769	1,705	22,561
Hedging	–	6,051	2,831	590	2	23	9,497
	166	16,146	8,948	3,299	1,771	1,728	32,058
Due from fellow Group undertakings							4,195
Total derivative financial instruments							36,253

Assets arising from reinsurance contracts held
Of the assets arising from reinsurance contracts held at 31 December 2012 of £42 million (2011: £38 million), of which £42 million (2011: £38 million) were due from insurers with a credit rating of AA or above.

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

C. Collateral held as security for financial assets
The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables
The disclosures below are produced under the combined businesses approach used for the Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant acquisition, such as the acquisition of HBOS in 2009, this combined businesses basis, which includes the allowance for loan losses at the acquisition on a gross basis, more fairly reflects the underlying provisioning status of the loans.

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

Loans and advances to banks
The Group may require collateral before entering into a credit commitment with another bank, depending on the type of financial product and the counterparty involved, and netting arrangements are obtained whenever possible and to the extent that such agreements are legally enforceable. Collateral is held as part of reverse repurchase or securities borrowing transactions.

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £83 million (2011: £2,950 million), against which the Group held collateral with a fair value of £83 million (2011: £2,950 million), all of which the Group is able to repledge.

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

Loans and advances to customers
The Group holds collateral against loans and advances to customers in the form of 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.

54 Financial risk management (continued)

Retail lending

Mortgages

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

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2012				
Less than 70 per cent	**81,549**	**2,491**	**1,152**	**85,192**
70 per cent to 80 per cent	**44,178**	**1,620**	**713**	**46,511**
80 per cent to 90 per cent	**38,670**	**1,950**	**951**	**41,571**
90 per cent to 100 per cent	**26,631**	**1,737**	**969**	**29,337**
Greater than 100 per cent	**28,911**	**2,756**	**3,188**	**34,855**
Total	**219,939**	**10,554**	**6,973**	**237,466**

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2011				
Less than 70 per cent	85,775	2,382	1,055	89,212
70 per cent to 80 per cent	42,089	1,532	672	44,293
80 per cent to 90 per cent	38,666	1,874	890	41,430
90 per cent to 100 per cent	29,329	1,798	972	32,099
Greater than 100 per cent	30,397	2,743	3,048	36,188
Total	226,256	10,329	6,637	243,222

Other

No collateral is held in respect of retail credit cards or overdrafts, or unsecured personal loans. For non-mortgage retail lending to small businesses, collateral will often include second charges over residential property and the assignment of life cover.

The majority of non-mortgage retail lending is unsecured. At 31 December 2012, impaired non-mortgage lending amounted to £688 million, net of an impairment allowance of £371 million (2011: £723 million net of an impairment allowance of £499 million). The fair value of the collateral held in respect of this lending was £8 million (2011: £9 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £13,094 million (2011: £13,154 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are monitored throughout the credit lifecycle in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state. The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. Key management personnel review collateral information on a case-by-case basis; no aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Wholesale lending

Reverse repurchase transactions

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £nil (2011: £14,250 million), against which the Group held collateral with a fair value of £nil (2011: £14,254 million), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £2 million (2011: £34 million). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Impaired secured lending

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

At 31 December 2012, impaired secured wholesale lending amounted to £14,531 million, net of an impairment allowance of £13,291 million (2011: £20,490 million, net of an impairment allowance of £18,576 million). The fair value of the collateral held in respect of impaired secured wholesale lending was £7,379 million (2011: £12,301 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for

54 Financial risk management (continued)

each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

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

Unimpaired secured lending
Unimpaired secured wholesale lending amounted to £30,137 million (2011: £55,625 million). Wholesale lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor. Although lending decisions are predominantly based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted; this will have a financial impact on the amount of net interest income recognised and on internal loss-given-default estimates that contribute to the determination of asset quality.

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

Unimpaired secured wholesale lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured wholesale lending portfolio is provided to key management personnel.

Trading and other financial assets at fair value through profit or loss (excluding equity shares)
In respect of trading and other financial assets at fair value through profit or loss, the fair value of collateral accepted under reverse repurchase transactions which are accounted for as collateralised loans that the Group is permitted by contract or custom to sell or repledge was £33,946 million (2011: £23,655 million). Of this, £30,191 million was sold or repledged (2011: £20,055 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £44,181 million (2011: £53,395 million). Of this amount, £43,246 million (2011: £44,896 million) had been resold or repledged as collateral for the Group's own transactions.

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

Derivative assets, after offsetting of amounts under master netting arrangements
The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £15,122 million (2011: £13,437 million), cash collateral of £2,638 million (2011: £2,249 million) was held.

Irrevocable loan commitments and other credit-related contingencies
At 31 December 2012, there were irrevocable loan commitments and other credit-related contingencies of £13,517 million (2011: £15,874 million). Collateral is held as security, in the event that lending is drawn down, on £3,502 million (2011: £4,204 million) of these balances.

Lending decisions in respect of irrevocable loan commitments are based on the obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. For wholesale unimpaired lending, it is the Group's practice to request sufficient collateral for secured irrevocable loan commitments. For retail mortgage commitments, the majority are for mortgages with a loan-to-value ratio of less than 100 per cent. Aggregated collateral information covering the entire balance of irrevocable loan commitments over which security will be taken is not provided to key management personnel.

D. Collateral pledged as security
Repo and stock lending transactions
The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

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 £52,226 million (2011: £57,892 million). In addition, the following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

Assets pledged

	2012 £m	2011 £m
Trading and other financial assets at fair value through profit or loss	**513**	1,550
Loans and advances to customers	**38,434**	47,400
Debt securities classified as loans and receivables	**63**	1,071
Available-for-sale financial assets	**1,903**	1,733
	40,913	51,754

54 Financial risk management (continued)

In addition to the assets defaulted above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 20 and 21.

E. Collateral repossessed

	2012 £m	2011 £m
Residential property	**778**	801
Other	**1**	8
	779	809

In respect of retail portfolios, the Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations. In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

(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 capital issuances.

At 31 December 2012 the aggregate notional principal of interest rate swaps designated as fair value hedges was £42,602 million (2011: £35,757 million) with a net fair value asset of £4,222 million (2011: £3,584 million) (see note 17). The losses on the hedging instruments were £16 million (2011: gains of £873 million). The gains on the hedged items attributable to the hedged risk were £17 million (2011: losses of £875 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 five years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2012 was £111,889 million (2011: £161,463 million) with a net fair value asset of £1,000 million (2011: liability of £1,211 million) (see note 17). In 2012, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £6 million (2011: loss of £13 million).

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.

54 Financial risk management (continued)

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 2012 £m	Group 2011 £m
Functional currency of Group operations		
Euro:		
Gross exposure	**14**	(393)
Net investment hedge	**(836)**	(897)
	(822)	(1,290)
Australian Dollar:		
Gross exposure	**1,133**	1,237
Net investment hedge	**(1,074)**	(1,226)
	59	11
US Dollar:		
Gross exposure	**77**	145
Net investment hedge	**(78)**	(122)
	(1)	23
Other non-sterling	**1**	–
Total structural foreign currency exposures, after net investment hedges	**(763)**	(1,256)

(3) Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The table below analyses financial instrument liabilities of the Group, 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. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012						
Deposits from banks	**98,379**	**5,871**	**3,636**	**35,959**	**29,646**	**173,491**
Customer deposits	**145,878**	**7,085**	**22,197**	**43,429**	**6,520**	**225,109**
Trading liabilities	**12,132**	**5,100**	**9,855**	**3,303**	**3,280**	**33,670**
Debt securities in issue	**4,956**	**647**	**7,522**	**32,411**	**8,685**	**54,221**
Liabilities arising from non-participating investment contracts	**–**	**–**	**–**	**–**	**27,166**	**27,166**
Subordinated liabilities	**14**	**317**	**102**	**4,830**	**9,226**	**14,489**
Total non-derivative financial liabilities	**261,359**	**19,020**	**43,312**	**119,932**	**84,523**	**528,146**
Derivative financial liabilities:						
Gross settled derivative – outflow	**5,622**	**1,324**	**3,271**	**21,335**	**18,703**	**50,255**
Gross settled derivative – inflow	**(5,428)**	**(1,119)**	**(3,106)**	**(20,292)**	**(17,484)**	**(47,429)**
Gross settled derivative – netflow	**194**	**205**	**165**	**1,043**	**1,219**	**2,826**
Net settled derivative liabilities	**25,750**	**193**	**1,017**	**2,861**	**686**	**30,507**
Total derivative financial liabilities	**25,944**	**398**	**1,182**	**3,904**	**1,905**	**33,333**

54 Financial risk management (continued)

Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2011						
Deposits from banks	1,218	71,230	5,365	49,210	62,652	189,675
Customer deposits	201,470	36,820	23,216	57,719	41,485	360,710
Trading liabilities	10,574	2,338	2,979	2,442	2,486	20,819
Debt securities in issue	116,648	12,562	8,322	40,880	9,391	187,803
Liabilities arising from non-participating investment contracts	–	–	–	–	22,207	22,207
Subordinated liabilities	30	449	2,883	7,794	19,362	30,518
Total non-derivative financial liabilities	329,940	123,399	42,765	158,045	157,583	811,732
Derivative financial liabilities:						
Gross settled derivative – outflow	1,882	9,485	7,114	21,670	20,367	60,518
Gross settled derivative – inflow	(1,401)	(8,680)	(6,741)	(20,487)	(19,324)	(56,633)
Gross settled derivative – netflow	481	805	373	1,183	1,043	3,885
Net settled derivative liabilities	24,983	200	1,302	4,018	892	31,395
Total derivative financial liabilities	25,464	1,005	1,675	5,201	1,935	35,280

Company	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2012						
Amounts owed to fellow Group undertakings	**1,619**	**–**	**–**	**–**	**28,024**	**29,643**
Subordinated liabilities	**–**	**–**	**–**	**3,542**	**5,479**	**9,021**
Total non-derivative financial liabilities	**1,619**	**–**	**–**	**3,542**	**33,503**	**38,664**
At 31 December 2011						
Amounts owed to fellow Group undertakings	606	24,162	359	6,682	8,422	40,231
Subordinated liabilities	–	–	1,167	4,759	10,159	16,085
Total non-derivative financial liabilities	606	24,162	1,526	11,441	18,581	56,316

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £5,330 million at 31 December 2012 (2011: £6,011 million) with £2,019 million expiring within one year; £784 million between one and three years; £560 million between three and five years; and £1,967 million over five years (2011: £727 million expiring within one year; £2,070 million between one and three years; £870 million between three and five years; and £2,344 million over five years).

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £16 million (2011: £16 million) for the Group and £nil (2011: £11 million) for the Company per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

The majority of the Group's non-participating investment contract liabilities are unit-lined. These unit-lined products are invested in accordance with unit fund mandates. Classes are included in policyholder contracts to permit the deferral of sales, where necessary, so that linked assets can be released without being a forced seller.

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**
As at 31 December 2012	**–**	**–**	**–**	**–**	**423**	**423**
As at 31 December 2011	–	–	–	–	385	385

For insurance and participating investment contracts which are neither unit-linked nor in the Group's with-profit funds, in particular annuity liabilites, the aim is to invest in assets such that the cash flows on investments match those on the projected future liabilities.

54 Financial risk management (continued)

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

Group	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2012					
Acceptances and endorsements	**2**	**–**	**–**	**–**	**2**
Other contingent liabilities	**380**	**140**	**57**	**16**	**593**
Total contingent liabilities	**382**	**140**	**57**	**16**	**595**
Lending commitments	**27,959**	**2,987**	**2,052**	**1,840**	**34,838**
Other commitments	**4**	**–**	**–**	**–**	**4**
Total commitments	**27,963**	**2,987**	**2,052**	**1,840**	**34,842**
Total contingents and commitments	**28,345**	**3,127**	**2,109**	**1,856**	**35,437**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
31 December 2011					
Acceptances and endorsements	3	–	–	–	3
Other contingent liabilities	366	71	198	149	784
Total contingent liabilities	369	71	198	149	787
Lending commitments	28,781	11,181	4,869	773	45,604
Other commitments	8	–	–	–	8
Total commitments	28,789	11,181	4,869	773	45,612
Total contingents and commitments	29,158	11,252	5,067	922	46,399

(4) Insurance risk

Insurance risk is the risk of reductions in earnings' capital 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.

The Group's appetite for solvency and earnings in insurance entities is reviewed and approved annually by the Board. Insurance risks are measured using a variety of techniques including stress and scenario testing, and, where appropriate, stochastic modelling. Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations, as well as evaluating the effectiveness of controls put in place to manage insurance risk.

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 depending on level of subordination and ability to absorb losses. Core tier 1 capital as defined in the FSA letter to the British Bankers' Association in May 2009, comprises mainly shareholders' equity and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected loss over accounting provisions and certain securitisation positions. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and Available-for-Sale assets. Tier 1 capital, as defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook (GENPRU), is core tier 1 capital plus tier 1 capital securities less 50 per cent of material holdings in financial companies. Tier 2 capital, defined by GENPRU, comprises qualifying subordinated debt and some additional Provisions and reserves after deducting 50 per cent of the excess of expected loss over accounting provisions, and certain securitisation positions and material holdings in financial companies. Total capital is the sum of tier 1 and tier 2 capital after deducting investments in subsidiaries 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:

	2012 £m	2011 £m
Tier 1 capital	**24,345**	24,427
Tier 2 capital	**6,648**	7,963
	30,993	32,390
Supervisory deductions	**(423)**	(460)
Total capital	**30,570**	31,930

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; for example the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital.

The minimum total capital required under Pillar 1 of the Basel II framework is the Capital Resources Requirement (CRR) calculated as 8 per cent of risk weighted assets. In addition to the minimum requirements for total capital, the FSA has made statements to explain it also operates a framework of targets and expected buffers for core tier 1 and tier 1 capital.

In order to address the requirements of Pillar 2 of the Basel II framework, the FSA currently sets additional minimum requirements through the issuance of Individual Capital Guidance (ICG) for each UK bank calibrated by reference to the CRR. A key input into the FSA's ICG setting process is each bank's Internal Capital Adequacy Assessment Process. The Group has been given an ICG by the FSA. The FSA has made it clear, however, that ICG remains a confidential matter between each bank and the FSA.

The Group maintains its own buffer to ensure that the regulatory minimum requirements and regulatory targets and buffers are met at all times.

During the course of the year there have been a number of significant regulatory reform developments:

Until the Basel III reforms for an enhanced global capital accord are introduced in the EU through the implementation of the new Capital Requirements Directive and Regulation (CRDIV), the regulatory capital will continue to be based upon the Basel II framework. The impact of the reforms will be gradually phased in as they are subject to a long transition period through to 2022. This allows time for the Group to further strengthen its capital position as necessary through business performance and mitigating actions.

Many of the details of the way these reforms will be integrated within the UK are still to be finalised. In the meantime the Group continues to monitor their development very closely and to analyse their potential impact whilst ensuring that the Group continues to have a strong loss absorption capacity exceeding regulatory requirements as currently formulated.

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 Cash flow statements

a Change in operating assets

	Group 2012 £m	Group 2011 £m
Change in loans and receivables	**6,512**	5,332
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(15,905)**	(3,427)
Change in other operating assets	**(1,957)**	205
Change in operating assets	**(11,350)**	2,110

b Change in operating liabilities

	Group 2012 £m	Group 2011 £m
Change in deposits from banks	**21,696**	6,905
Change in customer deposits	**469**	638
Change in debt securities in issue	**(25,848)**	(25,307)
Change in derivative financial instruments and trading liabilities	**11,163**	10,503
Change in investment contract liabilities	**6,404**	3,264
Change in other operating liabilities	**342**	(2,857)
Change in operating liabilities	**14,226**	(6,854)

c Non-cash and other items

	Group 2012 £m	Group 2011 £m
Depreciation and amortisation	**257**	355
Impairment of tangible fixed assets	**–**	65
Revaluation of investment properties	**116**	65
Allowance for loan losses	**4,269**	7,021
Write-off of allowance for loan losses	**(9,224)**	(8,584)
Impairment of available-for-sale financial assets	**397**	749
Change in insurance contract liabilities	**38**	(871)
Payment protection insurance provision	**850**	1,155
Other provision movements	**152**	(75)
Net charge (credit) in respect of defined benefit schemes	**(150)**	81
Impact of consolidation and deconsolidation of OEICs[1]	**(433)**	–
Unwind of discount on impairment allowances	**(329)**	(171)
Foreign exchange element on balance sheet[2]	**589**	236
Interest expense on subordinated liabilities	**657**	780
Loss (profit) on disposal of businesses	**7**	1,760
Other non-cash items	**(694)**	750
Total non-cash items	**(3,498)**	3,316
Contributions to defined benefit schemes	**(333)**	(321)
Payments in respect of customer goodwill payments provision	**–**	(497)
Payments in respect of payment protection insurance provision	**(879)**	(375)
Other	**13**	5
Total other items	**(1,199)**	(1,188)
Non-cash and other items	**(4,697)**	2,128

[1]These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a majority beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unit holders, and changes in funds consolidated represent a non-cash movement on the balance sheet.

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

56 Cash flow statements (continued)

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

	Group	
	2012 £m	2011 £m
Cash and balances with central banks	**6,112**	3,075
Less: mandatory reserve deposits[1]	**(259)**	(499)
	5,853	2,576
Loans and advances to banks	**140,085**	91,210
Less: amounts with a maturity of three months or more and balances due from fellow Lloyds Banking Group undertakings	**(136,581)**	(87,144)
	3,504	4,066
Total cash and cash equivalents	**9,357**	6,642

[1]Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

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

	2012 £m	2011 £m
Derivatives, trading and other financial assets at fair value through profit or loss	**–**	56,359
Loans and advances to banks	**–**	2,318
Loans and advances to customers	**15**	–
Debt securities	**–**	6
Tangible fixed assets	**–**	185
Insurance and investment contract liabilities	**–**	(52,371)
Other net assets and liabilities	**29**	(1,592)
	44	4,905
(Loss) profit on sale of businesses	**(7)**	(1,760)
Net cash inflow from disposals	**37**	3,145

57 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 the full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 *Presentation of Financial Statements – 'Presentation of Items of Other Comprehensive Income'*	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 *Financial Instruments: Disclosures – Disclosures-Offsetting Financial Assets and Financial Liabilities'*	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 *Consolidated Financial Statements*	Supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities* and establishes the principles for when the Group controls another entity and therefore is required to consolidate the other entity in the Group's financial statements. The implementation of IFRS 10 will result in the Group consolidating certain entities that were previously not consolidated, and deconsolidating certain entities which were previously consolidated. The effect of applying IFRS 10 in 2012 would have been to recognise an increase in total assets and total liabilities at 31 December 2012 of approximately £1.5 billion resulting in no change to shareholders' equity. There would have been no impact on the result for the year to 31 December 2012.	Annual periods beginning on or after 1 January 2013.
IFRS 12 *Disclosure of Interests in Other Entities*	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 *Fair Value Measurement*	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.
Amendments to IAS 19 *Employee Benefits*	Prescribes the accounting and disclosure by employers for employee benefits. The main change is that actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes are no longer permitted to be deferred using the corridor approach and must be recognised immediately in other comprehensive income. In addition, revised IAS 19 also replaces interest cost and expected return on plan assets with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset). Had the Group adopted these changes in 2012, profit after tax for the year to 31 December 2012 would have been approximately £2 million lower and other comprehensive income net of tax some £570 million lower. As at 31 December 2012, unrecognised actuarial losses of some £220 million and deferred tax assets of £50 million would have been recognised and shareholders' equity would have been £170 million lower.	Annual periods beginning on or after 1 January 2013.
Amendments to IAS 32 *Financial Instruments: Presentation – 'Offsetting Financial Assets and Financial Liabilities'*	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 *Financial Instruments*[1,2]	Replaces those parts of IAS 39 *Financial Instruments: Recognition and Measurement* 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 derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities, except for those designated at fair value through profit or loss where that part of the fair value change attributable to an entity's own credit risk is recorded in other comprehensive income.	Annual periods beginning on or after 1 January 2015.

[1]As at 1 March 2013, this pronouncement is 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.

58 Approval of financial statements and other information

The consolidated financial statements were approved by the directors of HBOS plc on 1 March 2013.

HBOS plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

HBOS plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via www.lloydsbankinggroup.com.

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