

HBOS plc

Half-Year Management Report

For the half-year to 30 June 2014

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

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

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FINANCIAL REVIEW

Principal activities

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

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

Review of results

The Group recorded a profit before tax of £1,627 million for the half-year to 30 June 2014, a reduction of £797 million, or 33 per cent, compared to the profit before tax of £2,424 million for the half-year to 30 June 2013. The results in both periods have been significantly affected by one-off items, as described below. Adjusting for these items there was a modest increase in profitability.

Total income, net of insurance claims, decreased by £1,952 million, or 34 per cent, to £3,712 million for the half-year to 30 June 2014 from £5,664 million in the half-year to 30 June 2013.

During the first half of 2013 the Group recognised a gain of £563 million following the sale of part of its shareholding in St James's Place plc. Adjusting for this total income, net of insurance claims, was £1,389 million lower at £3,712 million in the half-year to 30 June 2014 compared to £5,101 million in the half-year to 30 June 2013.

Net interest income increased by £270 million, to £3,160 million in the half-year to 30 June 2014 compared to £2,890 million in the same period in 2013. This increase reflected the absence of a charge within net interest income for amounts allocated to unit holders in Open-Ended Investment Companies, there had been a charge of £636 million in the half-year to 30 June 2013 prior to the sale of the Group's shareholding in St James's Place plc. Excluding this charge, net interest income was £366 million, or 10 per cent, lower at £3,160 million in the half-year to 30 June 2014 compared to £3,526 million in the same period in 2013. There was an overall reduction in average interest-earning assets reflecting the rationalisation of the Group's balance sheet, more than offsetting the benefit of continued improvement in the net interest margin. The net interest margin increase was driven by improved deposit pricing and lower funding costs, partly offset by continued pressure on asset prices, principally in the mortgages business.

After adjusting for the gain on sale of shares in St James's Place plc, other income net of insurance claims decreased by £1,659 million, or 75 per cent, to £552 million in the half-year to 30 June 2014, compared to £2,211 million in the same period in 2013. This principally reflects the impact on fee and other income of the sale of the Group's majority investment in St James's Place plc in 2013 and other business disposals.

Total operating expenses decreased by £134 million, or 8 per cent, to £1,511 million in the half-year to 30 June 2014 compared to £1,645 million in the half-year to 30 June 2013. On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £342 million with a corresponding curtailment gain recognised in the income statement. Excluding regulatory provisions and the curtailment gain, total operating expenses increased by £46 million, or 3 per cent, to £1,639 million in the half-year to 30 June 2014 compared to £1,593 million in the half-year to 30 June 2013. Costs have been reduced as a result of savings from Simplification initiatives and the reduction in the portfolio of assets which are outside of the Group's risk appetite; although these factors were offset by increased investment in the business.

FINANCIAL REVIEW (continued)

The Group charged a total of £214 million in respect of regulatory provisions in the half-year to 30 June 2014, compared to £42 million in the same period in 2013. The Group increased the provision for expected PPI costs by a further £100 million in the half-year to 30 June 2014. This brings the total amount provided to £2,845 million, including anticipated administrative expenses.

A further provision of £25 million has been made relating to the past sale of interest rate hedging products to certain small and medium-sized businesses.

In the course of its business, the Group is engaged in discussions with regulators and governmental authorities on a range of matters. Provisions are held against the costs expected to be incurred in respect of these discussions and other regulatory investigations. In the half-year to 30 June 2014, the Group made further provisions of £89 million in respect of a limited number of matters affecting the retail business.

Impairment losses decreased by £1,021 million, or 64 per cent, to £574 million in the half-year to 30 June 2014 compared to £1,595 million in the half-year to 30 June 2013. There were lower charges across all the main lending portfolios and in the portfolio of assets which are outside of the Group's risk appetite. The reduction reflects the Group's effective portfolio management, prudent credit risk appetite, the improving economic conditions and the continued low interest rate environment.

The tax charge for the half-year to 30 June 2014 was £294 million (half-year to 30 June 2013: £613 million), reflecting a lower effective tax rate than the UK corporation tax rate as a result of tax exempt gains on sales of businesses.

On the balance sheet, total assets were £161,152 million, lower at £396,543 million at 30 June 2014, compared to £557,695 million at 31 December 2013. Loans and advances to customers decreased by £8,159 million, or 3 per cent, from £283,638 million at 31 December 2013 to £275,479 million at 30 June 2014, reflecting growth in the key customer segments being more than offset by the reduction in the portfolio of assets outside of the Group's risk appetite. Customer deposits decreased by £339 million, to £206,229 million at 30 June 2014 compared to £206,568 million at 31 December 2013. Amounts due from fellow Lloyds Banking Group undertakings were £138,301 million lower at £55,573 million at 30 June 2014 compared to £193,874 million at 31 December 2013 and amounts due to fellow Lloyds Banking Group undertakings were £140,726 million lower at £80,012 million at 30 June 2014 compared to £220,738 million at 31 December 2013; these reductions reflect a rationalisation of intercompany indebtedness across the Lloyds Banking Group. Shareholders' equity increased by £1,024 million, or 5 per cent, from £21,835 million at 31 December 2013 to £22,859 million at 30 June 2014 as a result of the profit attributable to equity shareholders.

The Group's common equity tier 1 capital ratio was 17.7 per cent at the end of June 2014, compared to a core tier 1 capital ratio of 18.0 per cent at the end of December 2013 (not restated for the implementation of CRD IV on 1 January 2014), principally driven by increased deductions and additional risk-weighted assets following the implementation of CRD IV partially offset by the retained profit for the period and an overall reduction in risk-weighted assets. The total capital ratio was 24.2 per cent compared to 24.0 per cent at 31 December 2013 (not restated for the implementation of CRD IV on 1 January 2014).

FINANCIAL REVIEW (continued)**Capital ratios**

| | At 30 June 2014 £m | At 31 Dec 2013¹ £m |
|--|---------------------------------------|--|
| Capital resources | | |
| Common equity/core tier 1 | | |
| Shareholders' equity | 22,859 | 21,835 |
| Regulatory filters: | | |
| Unrealised reserve on available-for-sale securities | (61) | (38) |
| Cash flow hedging reserve | (642) | (908) |
| Other adjustments | (103) | - |
| | 22,053 | 20,889 |
| Less: deductions from common equity/core tier 1 | | |
| Goodwill and other intangible assets | (432) | (429) |
| Excess of expected losses over impairment provisions and value adjustments | (430) | (152) |
| Removal of defined benefit pension surplus | (129) | (31) |
| Securitisation deductions | (94) | (48) |
| Deferred tax assets | (2,449) | - |
| Common equity/core tier 1 capital | 18,519 | 20,229 |
| Additional tier 1 | | |
| Additional tier 1 instruments | 2,378 | 3,182 |
| Less: deductions from tier 1 | | |
| Significant investments | - | (41) |
| Total tier 1 capital | 20,897 | 23,370 |
| Tier 2 | | |
| Tier 2 instruments | 3,958 | 5,987 |
| Unrealised gains on available-for-sale equity investments | - | 84 |
| Eligible provisions | 439 | 355 |
| Less: deductions from tier 2 | | |
| Excess of expected losses over impairment provisions and value adjustments | - | (152) |
| Securitisation deductions | - | (48) |
| Significant investments | - | (41) |
| Total tier 2 capital | 4,397 | 6,185 |
| Supervisory deductions | | |
| Connected lending of a capital nature | - | (2,640) |
| Total supervisory deductions | - | (2,640) |
| Total capital resources | 25,294 | 26,915 |
| Risk-weighted assets | 104,620 | 112,177 |
| Common equity/core tier 1 capital ratio | 17.7% | 18.0% |
| Tier 1 capital ratio | 20.0% | 20.8% |
| Total capital ratio | 24.2% | 24.0% |

¹ Calculated in line with the rules prevailing at 31 December 2013 and not restated for the implementation of CRD IV on 1 January 2014.

PRINCIPAL RISKS AND UNCERTAINTIES

The most significant risks faced by the Group which could impact the success of delivering against the Group's long-term strategic objectives together with key mitigating actions are outlined below.

Credit risk

Principal risks

As a provider of credit facilities to personal and commercial customers, together with financial institutions and Sovereigns, any adverse changes in the economic and market environment we operate in, or the credit quality and/or behaviour of our borrowers and counterparties would reduce the value of our assets and increase our write-downs and allowances for impairment losses, adversely impacting profitability.

Mitigating actions

- Credit policy incorporating prudent lending criteria aligned with the Lloyds Banking Group Board approved risk appetite to effectively manage credit risk.
- Clearly defined levels of authority ensure we lend appropriately and responsibly with separation of origination and sanctioning activities.
- Robust credit processes and controls including well-established committees to ensure distressed and impaired loans are identified early, considered and controlled with independent credit risk assurance.

Conduct risk

Principal risks

As a major financial services provider we face significant conduct risk, including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customer expectations; and exhibiting behaviours which do not meet market or regulatory standards.

Mitigating actions

- Customer focused conduct strategy implemented to ensure customers are at the heart of everything we do.
- Product approval, review process and outcome testing supported by conduct management information.
- Clearer customer accountabilities for colleagues, including rewards with customer-centric metrics.
- Learn from past mistakes including root cause analysis.

Market risk

Principal risks

We face a number of key market risks including credit spreads and interest rate risk across the Banking and Insurance businesses. However, our most significant market risk is from the Defined Benefit Pension Schemes where asset and liability movements impact on our capital position.

Mitigating actions

- A rates hedging programme is in place to reduce liability risk.
- Lloyds Banking Group Board approved pensions risk appetite covering interest rate, credit spreads and equity risks.
- Credit assets and alternative assets are being purchased by the schemes as the equities are sold.
- Stress and scenario testing.

Operational risk

Principal risks

We face a number of key operational risks including fraud losses and failings in our customer processes. The availability, resilience and security of our core IT systems is the most significant.

Mitigating actions

- Regularly review IT system architecture to ensure systems are resilient, readily available for our customers and secure from cyber attack.
- Continue to implement actions from IT resilience review conducted in 2013 to reflect enhanced demands on IT both in terms of customer and regulator expectations.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)**Funding and liquidity***Principal risks*

Our funding and liquidity position is supported by a significant and stable customer deposit base. However, a deterioration in either our or the UK's credit rating affecting the Lloyds Banking Group's wholesale funding capacity or a sudden and significant withdrawal of customer deposits could adversely impact our funding and liquidity position.

Mitigating actions

- Hold a large pool of unencumbered primary liquid assets and maintains a further large pool of secondary assets that can be used to access Central Bank liquidity facilities.
- Carry out daily monitoring against a number of market and Lloyds Banking Group specific early warning indicators and regularly stress tests its liquidity position against a range of scenarios.
- Lloyds Banking Group has a contingency funding plan embedded within the liquidity policy which is designed to identify emerging liquidity concerns at an early stage.

Capital risk*Principal risks*

Our future capital position is potentially at risk from adverse financial performance and the introduction of higher capital requirements for distinct risks, sectors or as a consequence of specific UK regulatory requirements.

Mitigating actions

- Close monitoring of actual capital ratios to ensure that we comply with current regulatory capital requirements and are well positioned to meet future requirements.
- Internal stress testing results to evidence sufficient levels of capital adequacy for Lloyds Banking Group under various scenarios.
- Lloyds Banking Group can accumulate additional capital in a variety of ways including raising equity via a rights issue or debt exchange and by raising tier 1 and tier 2 capital.

Regulatory risk*Principal risks*

Due to the nature of the industry we operate in we have to comply with a complex and demanding regulatory change agenda. Regulatory initiatives we have been working on in the first six months of 2014 include CRD IV, the new FCA Consumer Credit regime and the Dodd-Frank and Foreign Account Tax Compliance Act 2010. The sanctions for failing to comply far outweigh the costs of implementation. We also face the implications of the Banking Reform Act and potential outcomes of the proposed CMA review of Retail current accounts and SME Banking.

Mitigating actions

- The Lloyds Banking Group Legal, Regulatory and Mandatory Change Committee ensures we drive forward activity to develop plans for regulatory changes and tracks progress against those plans.
- Continued investment in our people, processes and IT systems is enabling us to meet our regulatory commitments.
- Engagement with the regulatory authorities on forthcoming regulatory changes and market review.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)**State aid***Principal risks*

HM Treasury currently holds 24.9 per cent of the Lloyds Banking Group's share capital. We continue to operate without government interference in the day-to-day management decisions, however there is a risk that a change in government priorities could result in the current framework agreement being replaced, leading to interference in the operations of the Group. Failure to meet the EU State aid commitments arising from this government support could lead to sanctions.

Mitigating actions

- Most EU State aid commitments now met with the completion of the divestment of TSB Bank outstanding.
- Divestment of the TSB business through the Initial Public Offering (IPO) in June 2014 and subsequent sales of its residual holding by the divestment deadline of end December 2015. There is provision for a further date extension to the divestment deadline, depending on market conditions.
- 38.5 per cent of the existing Ordinary Shares in TSB Bank have been sold to date, with an initial 35.0 per cent sold on 20 June 2014 and the over-allotment option of a further 3.5 per cent taken up on 18 July 2014.

Scottish Independence*Principal risks*

The impact of a 'Yes' vote in favour of Scottish Independence is uncertain. The outcome could have a significant impact on the legal, regulatory, currency and tax regime to which Lloyds Banking Group are currently subject and could also result in the Group becoming subject to a new regulatory, currency and tax regime in Scotland. The effect of this could be to increase compliance, operational and funding costs for the Group in addition to any transition costs.

Mitigating actions

- Monitoring and assessment of the potential impact on customers and the Group's business of a vote in favour of Scottish Independence with appropriate contingency planning.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

| | Note | Half-year to 30 June 2014 £ million | Half-year to 30 June 2013 £ million |
|--|------|--|--|
| Interest and similar income | | 5,811 | 7,090 |
| Interest and similar expense | | (2,651) | (4,200) |
| Net interest income | | 3,160 | 2,890 |
| Fee and commission income | | 393 | 806 |
| Fee and commission expense | | (157) | (231) |
| Net fee and commission income | | 236 | 575 |
| Net trading income | | 195 | 5,106 |
| Insurance premium income | | - | 9 |
| Other operating income | | 121 | 1,129 |
| Other income | 2 | 552 | 6,819 |
| Total income | | 3,712 | 9,709 |
| Insurance claims | | - | (4,045) |
| Total income, net of insurance claims | | 3,712 | 5,664 |
| Regulatory provisions | 17 | (214) | (52) |
| Other operating expenses | | (1,297) | (1,593) |
| Total operating expenses | 3 | (1,511) | (1,645) |
| Trading surplus | | 2,201 | 4,019 |
| Impairment | 4 | (574) | (1,595) |
| Profit before tax | | 1,627 | 2,424 |
| Taxation | 5 | (294) | (613) |
| Profit for the period | | 1,333 | 1,811 |
| Profit attributable to non-controlling interests | | - | 7 |
| Profit attributable to equity shareholders | | 1,333 | 1,804 |
| Profit for the period | | 1,333 | 1,811 |

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

| | Half-year to 30 June 2014 £ million | Half-year to 30 June 2013 £ million |
|---|--|--|
| Profit for the period | 1,333 | 1,811 |
| Other comprehensive income | | |
| Items that will not subsequently be reclassified to profit or loss: | | |
| Post-retirement defined benefit scheme remeasurements (note 13): | | |
| Remeasurements before taxation | (150) | 14 |
| Taxation | 30 | (3) |
| | (120) | 11 |
| Items that may subsequently be reclassified to profit or loss: | | |
| Movements in revaluation reserve in respect of available-for-sale financial assets: | | |
| Change in fair value | 104 | 211 |
| Income statement transfers in respect of disposals | (90) | (28) |
| Income statement transfers in respect of impairment | 4 | 23 |
| Taxation | 5 | (48) |
| | 23 | 158 |
| Movements in cash flow hedging reserve: | | |
| Effective portion of changes in fair value | (114) | 62 |
| Net income statement transfers | (218) | (214) |
| Taxation | 67 | 35 |
| | (265) | (117) |
| Currency translation differences (tax: nil) | (1) | (26) |
| Other comprehensive income for the period, net of tax | (363) | 26 |
| Total comprehensive income for the period | 970 | 1,837 |
| Total comprehensive income attributable to non-controlling interests | - | 7 |
| Total comprehensive income attributable to equity shareholders | 970 | 1,830 |
| Total comprehensive income for the period | 970 | 1,837 |

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

| | | At 30 June 2014 £ million | At 31 Dec 2013 £ million |
|---|----|--|-----------------------------------|
| Assets | | | |
| Cash and balances at central banks | | 4,775 | 7,369 |
| Items in course of collection from banks | | 454 | 217 |
| Trading and other financial assets at fair value through profit or loss | 6 | 28,157 | 37,317 |
| Derivative financial instruments | | 18,997 | 20,891 |
| Loans and receivables: | | | |
| Loans and advances to banks | | 1,705 | 2,100 |
| Loans and advances to customers | 7 | 275,479 | 283,638 |
| Debt securities | | 471 | 529 |
| Due from fellow Lloyds Banking Group undertakings | | 55,573 | 193,874 |
| | | 333,228 | 480,141 |
| Available-for-sale financial assets | | 4,870 | 3,333 |
| Investment properties | | 411 | 626 |
| Goodwill | | 334 | 334 |
| Other intangible assets | | 100 | 95 |
| Tangible fixed assets | | 1,380 | 1,415 |
| Current tax recoverable | | 3 | 2 |
| Deferred tax assets | | 2,610 | 2,748 |
| Retirement benefit assets | 13 | 161 | 39 |
| Other assets | 10 | 1,063 | 3,168 |
| Total assets | | 396,543 | 557,695 |

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

| | | At 30 June 2014 £ million | At 31 Dec 2013 £ million |
|--|----|------------------------------------|-----------------------------------|
| Equity and liabilities | | | |
| Liabilities | | | |
| Deposits from banks | | 2,382 | 3,175 |
| Customer deposits | | 206,229 | 206,568 |
| Due to fellow Lloyds Banking Group undertakings | | 80,012 | 220,738 |
| Items in course of transmission to banks | | 586 | 262 |
| Trading and other financial liabilities at fair value through profit or loss | | 27,882 | 36,624 |
| Derivative financial instruments | | 17,040 | 19,137 |
| Notes in circulation | | 1,096 | 1,176 |
| Debt securities in issue | 11 | 24,197 | 29,462 |
| Other liabilities | 12 | 1,992 | 5,241 |
| Retirement benefit obligations | 13 | 194 | 280 |
| Current tax liabilities | | 904 | 766 |
| Other provisions | | 1,225 | 1,404 |
| Subordinated liabilities | 14 | 9,896 | 10,978 |
| Total liabilities | | 373,635 | 535,811 |
| Equity | | | |
| Share capital | 15 | 3,763 | 3,763 |
| Share premium account | 16 | 18,655 | 18,655 |
| Other reserves | 16 | 10,796 | 11,039 |
| Retained profits | 16 | (10,355) | (11,622) |
| Shareholders' equity | | 22,859 | 21,835 |
| Non-controlling interests | | 49 | 49 |
| Total equity | | 22,908 | 21,884 |
| Total equity and liabilities | | 396,543 | 557,695 |

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

| | 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 2014 | 22,418 | 11,039 | (11,622) | 21,835 | 49 | 21,884 |
| Comprehensive income | | | | | | |
| Profit for the period | – | – | 1,333 | 1,333 | – | 1,333 |
| <i>Other comprehensive income</i> | | | | | | |
| Post-retirement defined benefit scheme remeasurements, net of tax | – | – | (120) | (120) | – | (120) |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | – | 23 | – | 23 | – | 23 |
| Movements in cash flow hedging reserve, net of tax | – | (265) | – | (265) | – | (265) |
| Currency translation differences (tax: nil) | – | (1) | – | (1) | – | (1) |
| Total other comprehensive income | – | (243) | (120) | (363) | – | (363) |
| Total comprehensive income | – | (243) | 1,213 | 970 | – | 970 |
| Transactions with owners | | | | | | |
| Capital contribution received | – | – | 54 | 54 | – | 54 |
| Balance at 30 June 2014 | 22,418 | 10,796 | (10,355) | 22,859 | 49 | 22,908 |

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

| | Attributable to equity shareholders | | | | | Total £ million |
|--|---|--------------------------------|----------------------------------|--------------------|---|--------------------|
| | Share capital and premium £ million | Other reserves £ million | Retained profits £ million | Total £ million | Non- controlling interests £ million | |
| Balance at 1 January 2013 | 22,418 | 11,321 | (9,209) | 24,530 | 400 | 24,930 |
| Comprehensive income | | | | | | |
| Profit for the period | – | – | 1,804 | 1,804 | 7 | 1,811 |
| <i>Other comprehensive income</i> | | | | | | |
| Post-retirement defined benefit scheme remeasurements, net of tax | – | – | 11 | 11 | – | 11 |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | – | 158 | – | 158 | – | 158 |
| Movements in cash flow hedging reserve, net of tax | – | (117) | – | (117) | – | (117) |
| Currency translation differences (tax: nil) | – | (26) | – | (26) | – | (26) |
| Total other comprehensive income | – | 15 | 11 | 26 | – | 26 |
| Total comprehensive income | – | 15 | 1,815 | 1,830 | 7 | 1,837 |
| Transactions with owners | | | | | | |
| Dividends paid | – | – | (2,900) | (2,900) | – | (2,900) |
| Change in non-controlling interests | – | – | – | – | (358) | (358) |
| Total transactions with owners | – | – | (2,900) | (2,900) | (358) | (3,258) |
| Balance at 30 June 2013 | 22,418 | 11,336 | (10,294) | 23,460 | 49 | 23,509 |
| Comprehensive income | | | | | | |
| Profit for the period | – | – | (202) | (202) | – | (202) |
| <i>Other comprehensive income</i> | | | | | | |
| Post-retirement defined benefit scheme remeasurements, net of tax | – | – | (676) | (676) | – | (676) |
| Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax | – | 5 | – | 5 | – | 5 |
| Movements in cash flow hedging reserve, net of tax | – | (213) | – | (213) | – | (213) |
| Currency translation differences (tax: nil) | – | (89) | – | (89) | – | (89) |
| Total other comprehensive income | – | (297) | (676) | (973) | – | (973) |
| Total comprehensive income | – | (297) | (878) | (1,175) | – | (1,175) |
| Transactions with owners | | | | | | |
| Dividends paid | – | – | (593) | (593) | – | (593) |
| Capital contribution received | – | – | 143 | 143 | – | 143 |
| Total transactions with owners | – | – | (450) | (450) | – | (450) |
| Balance at 31 December 2013 | 22,418 | 11,039 | (11,622) | 21,835 | 49 | 21,884 |

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

| | Half-year to 30 June 2014 £ million | Half-year 30 June 2013 £ million |
|--|--|---|
| Profit before tax | 1,627 | 2,424 |
| Adjustments for: | | |
| Change in operating assets | 161,035 | (8,978) |
| Change in operating liabilities | (160,972) | 11,573 |
| Non-cash and other items | (1,661) | (3,112) |
| Tax received | 106 | 356 |
| Net cash provided by operating activities | 135 | 2,263 |
| Cash flows from investing activities | | |
| Purchase of available-for-sale financial assets | (2,622) | (816) |
| Proceeds from sale and maturity of available-for-sale financial assets | 1,067 | 2,805 |
| Purchase of fixed assets | (80) | (560) |
| Proceeds from sale of fixed assets | 227 | 887 |
| Acquisition of businesses, net of cash acquired | (1) | (1) |
| Disposal of businesses, net of cash disposed | 17 | (583) |
| Net cash (used in) provided by investing activities | (1,392) | 1,732 |
| Cash flows from financing activities | | |
| Dividends paid to equity shareholders | – | (2,900) |
| Interest paid on subordinated liabilities | (334) | (360) |
| Repayment of subordinated liabilities | (817) | (951) |
| Net cash used in financing activities | (1,151) | (4,211) |
| Change in cash and cash equivalents | (2,408) | (216) |
| Cash and cash equivalents at beginning of period | 7,947 | 9,357 |
| Cash and cash equivalents at end of period | 5,539 | 9,141 |

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

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1. Accounting policies, presentation and estimates

These condensed consolidated half-year financial statements as at and for the period to 30 June 2014 have been prepared in accordance with the Disclosure Rules and Transparency Rules of the Financial Conduct Authority (FCA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union and comprise the results of HBOS plc (the Company) together with its subsidiaries (the Group). They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2013 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2013 Annual report and Accounts are available on the Group's website and are available upon request from Investor Relations, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the condensed consolidated half-year financial statements. In reaching this assessment, the directors have considered projections for the Group's capital and funding position and have had regard to the factors set out in Principal risks and uncertainties: Funding and Liquidity on page 5.

The accounting policies are consistent with those applied by the Group in its 2013 Annual Report and Accounts except as described below.

On 1 January 2014 the Group adopted the following amendments to standards and interpretations:

Amendments to IAS 32 Financial Instruments: Presentation – Offsetting Financial Assets and Financial Liabilities

The amendments to IAS 32 clarify the requirements for offsetting financial instruments and address inconsistencies identified in applying the offsetting criteria used in the standard.

IFRIC 21 Levies

This interpretation clarifies that the obligating event that gives rise to a liability to pay a government levy is the activity that triggers the payment of the levy as set out in the relevant legislation and that operating in a future period, irrespective of the difficulties involved in exiting a market, does not create a constructive obligation to pay a levy.

These changes have not had a significant impact on the Group.

Future accounting developments

Details of those IFRS pronouncements which will be relevant to the Group but which will not be effective at 31 December 2014 and which have not been applied in preparing these condensed consolidated half-year financial statements are set out in note 21.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may include amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. There have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2013.

2. Other income

| | Half-year to 30 June 2014 £m | Half-year to 30 June 2013 £m |
|-------------------------------------|---|---------------------------------------|
| Fee and commission income: | | |
| Current account fees | 137 | 138 |
| Credit and debit card fees | 139 | 134 |
| Other fees and commissions | 117 | 534 |
| | 393 | 806 |
| Fee and commission expense | (157) | (231) |
| Net fee and commission income | 236 | 575 |
| Net trading income | 195 | 5,106 |
| Insurance premium income | – | 9 |
| Other operating income ¹ | 121 | 1,129 |
| Total other income | 552 | 6,819 |

¹ On 15 March 2013 the Group completed the sale of 102 million shares in St James's Place plc, reducing the Group's holding in that company to approximately 37 per cent. The Group realised a gain of £524 million on the sale of those shares and the fair valuation of the Group's residual stake. On 29 May 2013 the Group completed the sale of a further 77 million shares, generating a profit of £39 million and further reducing the Group's holding to approximately 21 per cent.

3. Operating expenses

| | Half-year to 30 June 2014 £m | Half-year to 30 June 2013 £m |
|---|---|---------------------------------------|
| Administrative expenses: | | |
| Staff costs excluding past service pensions credit | 812 | 881 |
| Past service pensions credit ¹ | (341) | – |
| Total staff costs | 471 | 881 |
| Premises and equipment | 171 | 194 |
| Other expenses | 565 | 386 |
| | 1,207 | 1,461 |
| Depreciation and amortisation | 90 | 132 |
| Total operating expenses, excluding payment protection insurance provision | 1,297 | 1,593 |
| Regulatory provisions: | | |
| Payment protection insurance provision (note 17) | 100 | 52 |
| Other regulatory provisions (note 17) | 114 | – |
| | 214 | 52 |
| Total operating expenses | 1,511 | 1,645 |

¹ On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £342 million with a corresponding curtailment gain recognised in the income statement.

4. Impairment

| | Half-year to 30 June 2014 £m | Half-year to 30 June 2013 £m |
|--|---|---------------------------------------|
| Impairment losses on loans and receivables: | | |
| Loans and advances to customers | 572 | 1,617 |
| Debt securities classified as loans and receivables | - | (24) |
| Impairment losses on loans and receivables (note 8) | 572 | 1,593 |
| Impairment of available-for-sale financial assets | 2 | 2 |
| Total impairment charged to the income statement | 574 | 1,595 |

5. Taxation

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

| | Half-year to 30 June 2014 £m | Half-year to 30 June 2013 £m |
|--|---|---------------------------------------|
| Profit before tax | <u>1,627</u> | <u>2,424</u> |
| Tax charge thereon at UK corporation tax rate of 21.5 per cent (2013: 23.25 per cent) | (350) | (564) |
| Factors affecting tax (charge) credit: | | |
| UK corporation tax rate change | - | - |
| Disallowed items | (6) | (97) |
| Non-taxable items | 24 | 100 |
| Overseas tax rate differences | (3) | 97 |
| Gains exempted or covered by capital losses | 33 | 139 |
| Policyholder tax | - | (189) |
| Tax losses where no deferred tax recognised | - | - |
| Deferred tax on losses not previously recognised | - | 43 |
| Adjustments in respect of previous years | (2) | (144) |
| Effect of results in joint ventures and associates | - | 2 |
| Other items | 10 | - |
| Tax charge | <u>(294)</u> | <u>(613)</u> |

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2014 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period.

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

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--|---------------------------------------|----------------------------|
| Trading assets | 27,877 | 37,084 |
| Other financial assets at fair value through profit or loss: | | |
| Loans and advances to customers | 20 | 21 |
| Equity shares | 260 | 212 |
| | 280 | 233 |
| Total trading and other financial assets at fair value through profit or loss | 28,157 | 37,317 |

7. Loans and advances to customers

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--|---------------------------------------|----------------------------|
| Agriculture, forestry and fishing | 658 | 562 |
| Energy and water supply | 309 | 361 |
| Manufacturing | 1,223 | 1,177 |
| Construction | 3,296 | 2,605 |
| Transport, distribution and hotels | 8,361 | 9,649 |
| Postal and communications | 164 | 142 |
| Property companies | 14,952 | 19,340 |
| Financial, business and other services | 7,265 | 10,601 |
| Personal: | | |
| Mortgages | 240,018 | 240,996 |
| Other | 9,037 | 9,543 |
| Lease financing | 1,274 | 1,480 |
| Hire purchase | 55 | 56 |
| | 286,612 | 296,512 |
| Allowance for impairment losses on loans and advances (note 8) | (11,133) | (12,874) |
| Total loans and advances to customers | 275,479 | 283,638 |

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

8. Allowance for impairment losses on loans and receivables

| | Half-year to 30 June 2014 £m | Year ended 31 Dec 2013 £m |
|--|---|------------------------------------|
| At 1 January | 13,005 | 18,869 |
| Exchange and other adjustments | (263) | 323 |
| Adjustment on disposal of business | - | (61) |
| Advances written off | (2,047) | (8,404) |
| Recoveries of advances written off in previous years | 50 | 106 |
| Unwinding of discount | (54) | (228) |
| Charge for the half-year to 30 June (note 4) | 572 | 1,593 |
| Charge for the half-year to 31 December | - | 807 |
| Charge to the income statement | 572 | 2,400 |
| At end of period | 11,263 | 13,005 |
| In respect of: | | |
| Loans and advances to customers (note 7) | 11,133 | 12,874 |
| Debt securities | 130 | 131 |
| At end of period | 11,263 | 13,005 |

9. Securitisations and covered bonds

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

| | 30 June 2014 | | 31 December 2013 | |
|---|--|----------------------------------|--|-------------------------|
| | Loans and advances securitised £m | Notes in issue £m | Loans and advances securitised £m | Notes in issue £m |
| <i>Securitisation programmes¹</i> | | | | |
| UK residential mortgages | 35,055 | 24,428 | 38,096 | 28,536 |
| Credit card receivables | 6,344 | 4,174 | 6,332 | 3,992 |
| Dutch residential mortgages | 4,105 | 4,239 | 4,385 | 4,516 |
| Commercial loans | 295 | 295 | 524 | 524 |
| | 45,799 | 33,136 | 49,337 | 37,568 |
| Less held by the Group | | (23,603) | | (24,975) |
| Total securitisation programmes (note 11) | | 9,533 | | 12,593 |
| <i>Covered bond programmes</i> | | | | |
| Residential mortgage-backed | 24,759 | 17,383 | 30,467 | 19,622 |
| Social housing loan-backed | 2,439 | 1,800 | 2,536 | 1,800 |
| | 27,198 | 19,183 | 33,003 | 21,422 |
| Less held by the Group | | (7,024) | | (7,606) |
| Total covered bond programmes (note 11) | | 12,159 | | 13,816 |
| Total securitisation and covered bond programmes | | 21,692 | | 26,409 |

¹ Includes securitisations utilising a combination of external funding and credit default swaps.

9. Securitisations and covered bonds (continued)**Securitisation programmes**

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue (note 11).

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security to issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue (note 11).

Cash deposits of £7,479 million (31 December 2013: £9,881 million) held by the Group are restricted in use to repayment of the debt securities issued by the structured entities, the term advances relating to covered bonds and other legal obligations.

10. Other assets

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--|---------------------------------------|--------------------------------------|
| Settlement balances | 87 | 1,935 |
| Investments in joint ventures and associates | 65 | 76 |
| Assets of disposal groups | – | 169 |
| Other assets and prepayments | <u>911</u> | <u>988</u> |
| Total other assets | <u>1,063</u> | <u>3,168</u> |

11. Debt securities in issue

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|---|---------------------------------------|--------------------------------------|
| Medium-term notes issued | 2,285 | 2,810 |
| Covered bonds (note 9) | 12,159 | 13,816 |
| Securitisation notes (note 9) | <u>9,533</u> | <u>12,593</u> |
| | 23,977 | 29,219 |
| Amounts due to fellow Lloyds Banking Group undertakings | <u>220</u> | <u>243</u> |
| | <u>24,197</u> | <u>29,462</u> |

12. Other liabilities

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--------------------------------|------------------------------------|----------------------------|
| Settlement balances | 14 | 2,348 |
| Other creditors and accruals | <u>2,432</u> | <u>2,893</u> |
| Total other liabilities | <u>2,446</u> | <u>5,241</u> |

13. Post-retirement defined benefit schemes

The Group's post-retirement defined benefit scheme obligations are comprised as follows:

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|---|------------------------------------|----------------------------|
| Defined benefit pension schemes: | | |
| - Fair value of scheme assets | 11,294 | 10,777 |
| - Present value of funded obligations | <u>(11,248)</u> | <u>(10,939)</u> |
| Net pension scheme liability | 46 | (162) |
| Other post-retirement schemes | <u>(79)</u> | <u>(79)</u> |
| Net retirement benefit liability | <u>(33)</u> | <u>(241)</u> |
| Recognised on the balance sheet as: | | |
| Retirement benefit assets | 161 | 39 |
| Retirement benefit obligations | <u>(194)</u> | <u>(280)</u> |
| Net retirement benefit liability | <u>(33)</u> | <u>(241)</u> |

The movement in the Group's net post-retirement defined benefit scheme liability during the period was as follows:

| | £m |
|--------------------------------|--------------------|
| At 1 January 2014 | (241) |
| Exchange and other adjustments | 1 |
| Income statement charge: | |
| Regular cost | (72) |
| Curtailments (see below) | <u>341</u> |
| | 269 |
| Employer contributions | 88 |
| Remeasurement | <u>(150)</u> |
| At 30 June 2014 | <u>(33)</u> |

Included within curtailments is a credit of £342 million following the Group's decision to reduce the cap on pensionable pay (see note 3).

13. Post-retirement defined benefit schemes (continued)

The principal assumptions used in the valuations of the defined benefit pension scheme were as follows:

| | At 30 June 2014 % | At 31 Dec 2013 % |
|---|--------------------------------------|---------------------------|
| Discount rate | 4.32 | 4.60 |
| Rate of inflation: | | |
| Retail Prices Index | 3.23 | 3.30 |
| Consumer Price Index | 2.23 | 2.30 |
| Rate of salary increases | 0.00 | 2.00 |
| Weighted-average rate of increase for pensions in payment | 2.74 | 2.80 |

The application of the revised assumptions as at 30 June 2014 to the Group's principal post-retirement defined benefit schemes has resulted in a remeasurement of £150 million which has been recognised in other comprehensive income, net of deferred tax of £30 million.

14. Subordinated liabilities

The Group's subordinated liabilities are comprised as follows:

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|---------------------------------------|---------------------------------------|----------------------------|
| Preferred securities | 2,725 | 3,178 |
| Undated subordinated liabilities | 425 | 611 |
| Dated subordinated liabilities | 6,746 | 7,189 |
| Total subordinated liabilities | 9,896 | 10,978 |

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

| | Half-year to 30 June 2014 £m | Year ended 31 Dec 2013 £m |
|---|---|------------------------------------|
| Opening balance | 10,978 | 12,491 |
| Repurchases and redemptions during the period | (817) | (960) |
| Foreign exchange and other movements | (265) | (553) |
| At end of period | 9,896 | 10,978 |

15. Share capital

Ordinary share capital in issue was as follows:

| | Number of shares (million) | £m |
|---|---|--------------|
| Ordinary shares of 25 pence each | | |
| At 1 January and 30 June 2014 | 15,053 | 3,763 |

16. Reserves

| | Share premium £m | Other reserves | | | Total £m | Retained profits £m |
|--|---------------------|--------------------------|-------------------------|------------------------|---------------|------------------------|
| | | Available-for-sale £m | Cash flow hedging £m | Merger and other £m | | |
| At 1 January 2014 | 18,655 | 38 | 907 | 10,094 | 11,039 | (11,622) |
| Profit for the period | – | – | – | – | – | 1,333 |
| Post-retirement defined benefit scheme remeasurements (net of tax) | – | – | – | – | – | (120) |
| Capital contribution received | – | – | – | – | – | 54 |
| Change in fair value of available-for-sale assets (net of tax) | – | 100 | – | – | 100 | – |
| Change in fair value of hedging derivatives (net of tax) | – | – | (91) | – | (91) | – |
| Transfers to income statement (net of tax) | – | (77) | (174) | – | (251) | – |
| Exchange and other | – | – | – | (1) | (1) | – |
| At 30 June 2014 | 18,655 | 61 | 642 | 10,093 | 10,796 | (10,355) |

17. Provisions for liabilities and charges***Payment protection insurance***

Following the unsuccessful legal challenge by the BBA against the Financial Services Authority (FSA) and the Financial Ombudsman Service (FOS), the Group made provisions totalling £2,745 million between 2011 and 2013 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

During 2014 quarterly customer initiated complaints have continued to fall, albeit slightly slower than expected. Significant progress has also been made in the planned proactive mailings. There have been some adverse trends in core assumptions, and a further £100 million has been added to the provision. This brings the total amount provided to £2,845 million, including anticipated administrative expenses.

The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, in particular complaint volumes, uphold rates, average redress paid, the scope and cost of proactive mailings and remediation. The cost of these factors could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key sensitivities are as follows:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision for redress costs by £65 million;
- average uphold rate per policy: an increase of one percentage point in this assumption would increase the provision by £6 million;
- average redress paid per upheld policy: an increase of £100 in this assumption would increase the provision by £40 million.

17. Provisions for liabilities and charges (continued)

Other regulatory provisions

Interest rate hedging products

In June 2012, a number of banks, including the Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. The Group continues to review those cases within the scope of the agreement with the FCA.

During the first half of 2014, the Group has charged a further £25 million in respect of estimated redress costs, increasing the total amount provided for redress and related administration costs to £164 million (31 December 2013: £139 million). As at 30 June 2014, the Group has utilised £69 million (31 December 2013: £10 million), with £95 million (31 December 2013: £129 million) of the provision remaining. No provision has been recognised in relation to claims from customers which are not covered by the agreement with the FCA, or incremental claims from customers within the scope of the review. These will be monitored and future provisions will be recognised to the extent that an obligation resulting in a probable outflow is identified.

Other regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and governmental authorities in relation to a range of matters; a provision is held against the costs expected to be incurred as a result of the conclusions reached. In the first half of 2014 the provision was increased by a further £89 million, in respect of a limited number of matters affecting the Group's retail business, including potential remediation in relation to legacy sales of investment and protection products and historic systems and controls governing legacy incentive schemes. This brings the total amount charged to £199 million of which £17 million had been utilised at 30 June 2014. This increase reflected the Group's assessment of a limited number of matters under discussion, none of which currently is individually considered financially material in the context of the Group.

18. Contingent liabilities and commitments

Interchange fees

On 24 May 2012, the General Court of the European Union (the General Court) upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback multilateral interchange fee (MIF) 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 September 2014.

In parallel:

- the European Commission has proposed legislation to regulate interchange fees which continues through the EU legislative process. The legislation is expected to be adopted in the first quarter of 2015, and is expected to come in to force in 2016;
- the European Commission has adopted commitments proposed by VISA to settle an investigation into 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. VISA has agreed inter alia to reduce the level of interchange fees on cross-border credit card transactions to the interim level (30 basis points). VISA has previously reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange fees for cross-border debit card transactions to the interim levels agreed by MasterCard;
- the new UK payments regulator may exercise its powers, when these come in to force (in April 2015), to regulate domestic interchange fees. The Competition and Markets Authority may also seek to restart an investigation of domestic MIFs. In addition, the FCA has announced that it will carry out a market study in relation to the UK credit cards market in the third quarter of 2014.

18. Contingent liabilities and commitments (continued)

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

LIBOR and other trading rates

On 28 July 2014, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies' submissions to the British Bankers' Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The settlements in relation to LIBOR are part of an industry-wide investigation into the setting of interbank offered rates across a range of currencies.

The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the European and Swiss Competition Commissions, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar and Japanese Yen LIBOR. The claims have been asserted by plaintiffs claiming to have had an interest in various types of financial instruments linked to US Dollar and Japanese Yen LIBOR. The allegations in these cases, the majority of which have been coordinated for pre-trial purposes in two sets of multi-district litigation proceedings (MDL) in the US District Court for the Southern District of New York (the 'District Court'), are substantially similar to each other. The lawsuits allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Commodity Exchange Act (CEA), as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims have been dismissed by the District Court, and many of these cases have been stayed by order of the District Court.

The Lloyds Banking Group is also reviewing its activities in relation to the setting of certain foreign exchange daily benchmark rates and related matters, following the FCA's publicised initiation of an investigation into other financial institutions in relation to this activity. The Lloyds Banking Group is co-operating with the FCA and other regulators and is providing information about the Lloyds Banking Group's review to those regulators. In addition, the Lloyds Banking Group, together with a number of other banks, was named as a defendant in several actions filed in the District Court between late 2013 and February 2014, in which the plaintiffs alleged that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. On 31 March 2014, plaintiffs effectively withdrew their claims against the Lloyds Banking Group (but not against all defendants) by filing a superseding consolidated and amended pleading against a number of other defendants without naming any Lloyds Banking Group entity as a defendant.

It is currently not possible to predict the scope and ultimate outcome on the Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Group's contractual arrangements, including their timing and scale.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. 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.

18. Contingent liabilities and commitments (continued)

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. Although the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

Investigation into Bank of Scotland and report on HBOS

The FSA's enforcement investigation into Bank of Scotland plc's Corporate division between 2006 and 2008 concluded with the publication of a Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. On 12 September 2012 the FSA confirmed it was starting work on a public interest report on HBOS. That report is currently expected to be published in 2014.

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law which might lead to additional tax. The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Lloyds Banking Group's deferred tax asset of approximately £400 million (overall impact on the Group of approximately £400 million). The Lloyds Banking Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

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 (including class or group action claims brought on behalf of customers, shareholders or other third parties), and regulatory challenges, investigations and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the 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.

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

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--|-----------------------------|----------------------------|
| Contingent liabilities | | |
| Acceptances and endorsements | 1 | 2 |
| Other: | | |
| Other items serving as direct credit substitutes | 30 | 23 |
| Performance bonds and other transaction-related contingencies | 255 | 267 |
| | 285 | 290 |
| Total contingent liabilities | 286 | 292 |
| Commitments | | |
| Documentary credits and other short-term trade-related transactions | 2 | 4 |
| Undrawn formal standby facilities, credit lines and other commitments to lend: | | |
| Less than 1 year original maturity: | | |
| Mortgage offers made | 9,242 | 8,214 |
| Other commitments | 19,980 | 19,756 |
| | 29,222 | 27,970 |
| 1 year or over original maturity | 4,899 | 3,962 |
| Total commitments | 34,123 | 31,936 |

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £12,148 million (31 December 2013: £13,537 million) was irrevocable.

19. Fair values of financial assets and liabilities

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine those 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.

19. Fair values of financial assets and liabilities (continued)**Valuation control framework**

Key elements of the valuation control framework, which covers processes for all levels in the fair value hierarchy including level 3 portfolios, include model validation (incorporating pre-trade and post-trade testing), product implementation review and independent price verification. Formal committees meet quarterly to discuss and approve valuations in more judgemental areas.

Transfers into and out of level 3 portfolios

Transfers out of level 3 portfolios arise when inputs that could have a significant impact on the instrument's valuation become market observable; conversely, transfers into the portfolios arise when consistent sources of data cease to be available.

Valuation methodology

For level 2 and level 3 portfolios, there is no significant change to what was disclosed in the Group's 2013 Annual Report and Accounts in respect of the valuation methodology (techniques and inputs) applied to such portfolios.

The table below 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.

| | 30 June 2014 | | 31 December 2013 | |
|--|----------------------|------------------|----------------------|------------------|
| | Carrying value £m | Fair value £m | Carrying value £m | Fair value £m |
| Financial assets | | | | |
| Trading and other financial assets at fair value through profit or loss | 28,157 | 28,157 | 37,317 | 37,317 |
| Derivative financial instruments | 18,997 | 18,997 | 20,891 | 20,891 |
| Loans and receivables: | | | | |
| Loans and advances to banks | 1,705 | 1,699 | 2,100 | 2,100 |
| Loans and advances to customers | 275,479 | 272,424 | 283,638 | 277,575 |
| Debt securities | 471 | 441 | 529 | 528 |
| Due from fellow Lloyds Banking Group undertakings | 55,573 | 55,573 | 193,874 | 193,874 |
| Available-for-sale financial instruments | 4,870 | 4,870 | 3,333 | 3,333 |
| Financial liabilities | | | | |
| Deposits from banks | 2,382 | 2,400 | 3,175 | 3,204 |
| Customer deposits | 206,229 | 206,235 | 206,568 | 208,050 |
| Due to fellow Lloyds Banking Group undertakings | 80,012 | 80,012 | 220,738 | 220,738 |
| Trading and other financial liabilities at fair value through profit or loss | 27,882 | 27,882 | 36,624 | 36,624 |
| Derivative financial instruments | 17,040 | 17,040 | 19,137 | 19,137 |
| Debt securities in issue | 24,197 | 23,534 | 29,462 | 28,684 |
| Financial guarantees | 16 | 16 | 17 | 17 |
| Subordinated liabilities | 9,896 | 9,684 | 10,978 | 9,971 |

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

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

19. Fair values of financial assets and liabilities (continued)

The following table 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 30 June 2014 | | | | |
| Trading and other financial assets at fair value through profit or loss: | | | | |
| Loans and advances to customers | – | 25,683 | – | 25,683 |
| Loans and advances to banks | – | 531 | – | 531 |
| Debt securities: | | | | |
| Government securities | 51 | – | – | 51 |
| Bank and building society certificates of deposit | – | 1,568 | – | 1,568 |
| Corporate and other debt securities | – | 49 | – | 49 |
| | 51 | 1,617 | – | 1,668 |
| Equity shares | 74 | – | 186 | 260 |
| Treasury and other bills | 15 | – | – | 15 |
| Total trading and other financial assets at fair value through profit or loss | 140 | 27,831 | 186 | 28,157 |
| Available-for-sale financial assets: | | | | |
| Debt securities: | | | | |
| Government securities | 88 | 28 | – | 116 |
| Bank and building society certificates of deposit | – | 15 | – | 15 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 732 | – | 732 |
| Other asset-backed securities | – | 436 | – | 436 |
| Corporate and other debt securities | 20 | 3,181 | – | 3,201 |
| | 108 | 4,392 | – | 4,500 |
| Equity shares | 3 | 38 | 329 | 370 |
| Total available-for-sale financial assets | 111 | 4,430 | 329 | 4,870 |
| Derivative financial instruments | – | 18,593 | 404 | 18,997 |
| Total financial assets carried at fair value | 251 | 50,854 | 919 | 52,024 |
| Trading and other financial liabilities at fair value through profit or loss | | | | |
| Liabilities held at fair value through profit or loss | – | – | 12 | 12 |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 26,042 | – | 26,042 |
| Short positions in securities | 1,828 | – | – | 1,828 |
| Other | – | – | – | – |
| | 1,828 | 26,042 | – | 27,870 |
| Total trading and other financial liabilities at fair value through profit or loss | 1,828 | 26,042 | 12 | 27,882 |
| Derivative financial instruments | – | 16,988 | 52 | 17,040 |
| Financial guarantees | – | – | 16 | 16 |
| Total financial liabilities carried at fair value | 1,828 | 43,030 | 80 | 44,938 |

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

19. Fair values of financial assets and liabilities (continued)

| Valuation hierarchy | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|--|---------------|---------------|---------------|-------------|
| At 31 December 2013 | | | | |
| Trading and other financial assets at fair value through profit or loss: | | | | |
| Loans and advances to customers | – | 32,448 | – | 32,448 |
| Loans and advances to banks | – | 2,556 | – | 2,556 |
| Debt securities: | | | | |
| Government securities | 115 | – | – | 115 |
| Bank and building society certificates of deposit | – | 1,458 | – | 1,458 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | – | – | – |
| Other asset-backed securities | – | 4 | – | 4 |
| Corporate and other debt securities | – | 518 | – | 518 |
| | 115 | 1,980 | – | 2,095 |
| Equity shares | 82 | – | 130 | 212 |
| Treasury and other bills | 6 | – | – | 6 |
| Total trading and other financial assets at fair value through profit or loss | 203 | 36,984 | 130 | 37,317 |
| Available-for-sale financial assets: | | | | |
| Debt securities: | | | | |
| Government securities | 85 | 28 | – | 113 |
| Bank and building society certificates of deposit | – | 15 | – | 15 |
| Asset-backed securities: | | | | |
| Mortgage-backed securities | – | 749 | – | 749 |
| Other asset-backed securities | – | 518 | – | 518 |
| Corporate and other debt securities | 21 | 1,504 | – | 1,525 |
| | 106 | 2,814 | – | 2,920 |
| Equity shares | – | 38 | 375 | 413 |
| Total available-for-sale financial assets | 106 | 2,852 | 375 | 3,333 |
| Derivative financial instruments | – | 20,451 | 440 | 20,891 |
| Total financial assets carried at fair value | 309 | 60,287 | 945 | 61,541 |
| Trading and other financial liabilities at fair value through profit or loss | | | | |
| Liabilities held at fair value through profit or loss | – | – | 39 | 39 |
| Trading liabilities: | | | | |
| Liabilities in respect of securities sold under repurchase agreements | – | 31,562 | – | 31,562 |
| Short positions in securities | 5,023 | – | – | 5,023 |
| | 5,023 | 31,562 | – | 36,585 |
| Total trading and other financial liabilities at fair value through profit or loss | 5,023 | 31,562 | 39 | 36,624 |
| Derivative financial instruments | – | 19,091 | 46 | 19,137 |
| Financial guarantees | – | – | 17 | 17 |
| Total financial liabilities carried at fair value | 5,023 | 50,653 | 102 | 55,778 |

19. Fair values of financial assets and liabilities (continued)**Movements in level 3 portfolio**

The tables below analyse movements in the level 3 financial assets portfolio.

| | Trading and other financial assets at fair value through profit or loss £m | Available- for-sale financial assets £m | Derivative assets £m | Total financial assets carried at fair value £m |
|---|--|---|----------------------------|--|
| At 1 January 2014 | 130 | 375 | 440 | 945 |
| Exchange and other adjustments | 2 | (8) | (6) | (12) |
| Gains recognised in the income statement within other income | 18 | (78) | 24 | (36) |
| Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | 15 | – | 15 |
| Purchases | 55 | 199 | – | 254 |
| Sales | (19) | (173) | (1) | (193) |
| Transfers out of the level 3 portfolio | – | (1) | (53) | (54) |
| At 30 June 2014 | 186 | 329 | 404 | 919 |
| Gains recognised in the income statement within other income relating to those assets held at 30 June 2014 | (11) | – | 24 | 13 |
| | Trading and other financial assets at fair value through profit or loss £m | Available- for-sale financial assets £m | Derivative assets £m | Total financial assets carried at fair value £m |
| At 1 January 2013 | 163 | 428 | 172 | 763 |
| Exchange and other adjustments | 1 | 16 | – | 17 |
| Gains (losses) recognised in the income statement within other income | 26 | (1) | 87 | 112 |
| Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets | – | 31 | – | 31 |
| Purchases | 6 | 27 | 1 | 34 |
| Sales | (5) | (114) | (5) | (124) |
| Transfers into the level 3 portfolio | – | 1 | 187 | 188 |
| Transfers out of the level 3 portfolio | – | (21) | (6) | (27) |
| At 30 June 2013 | 191 | 367 | 436 | 994 |
| Gains recognised in the income statement within other income relating to those assets held at 30 June 2013 | 11 | – | 84 | 95 |

19. Fair values of financial assets and liabilities (continued)**Movements in level 3 portfolio**

The tables below analyse movements in the level 3 financial liabilities portfolio.

| | Trading and other financial liabilities at fair value through profit or loss £m | Derivative liabilities £m | Financial guarantees £m | Total financial liabilities carried at fair value £m |
|---|--|--|--|---|
| At 1 January 2014 | 39 | 46 | 17 | 102 |
| Exchange and other adjustments | – | (2) | – | (2) |
| (Gains) losses recognised in the income statement within other income | (2) | 9 | (1) | 6 |
| Redemptions | (25) | (1) | – | (26) |
| At 30 June 2014 | 12 | 52 | 16 | 80 |
| Gains (losses) recognised in the income statement within other income relating to those liabilities held at 30 June 2014 | – | (9) | – | (9) |
| | | Derivative liabilities £m | Financial guarantees £m | Total financial liabilities carried at fair value £m |
| At 1 January 2013 | | 54 | 14 | 68 |
| (Gains) losses recognised in the income statement within other income | | (30) | 2 | (28) |
| Redemptions | | (17) | – | (17) |
| Transfers into the level 3 portfolio | | 49 | – | 49 |
| At 30 June 2013 | | 56 | 16 | 72 |
| Gains (losses) recognised in the income statement within other income relating to those liabilities held at 30 June 2013 | | 28 | (2) | 26 |

19. Fair values of financial assets and liabilities (continued)

| | | | | At 30 June 2014 | | |
|---|---|---|--------------------|--|--------------------------|----------------------------|
| | | | | Effect of reasonably possible alternative assumptions ² | | |
| | Valuation technique(s) | Significant unobservable inputs | Range ¹ | Carrying value £m | Favourable changes £m | Unfavourable changes £m |
| Trading and other financial assets at fair value through profit or loss | | | | | | |
| Equity and venture capital investments | Underlying asset/net asset value (incl. property prices) ³ | n/a | n/a | 186 | 36 | (18) |
| | | | | 186 | | |
| Available-for-sale financial assets | | | | | | |
| Equity and venture capital investments | Underlying asset/net asset value (incl. property prices) ³ | n/a | n/a | 329 | 21 | (16) |
| | | | | 329 | | |
| Derivative financial assets | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (bps) | 2/189 | 184 | 7 | (4) |
| | Option pricing model | Interest rate volatility | 3%/120% | 220 | 2 | (3) |
| | | | | 404 | | |
| | | | | 919 | | |
| Financial assets carried at fair value | | | | | | |
| Trading and other financial liabilities at fair value through profit or loss | | | | | | |
| | | | | 12 | – | – |
| Derivative financial liabilities | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (bps) | 2/189 | 11 | – | – |
| | Option pricing model | Interest rate volatility | 3%/120% | 41 | – | – |
| | | | | 52 | | |
| | | | | 16 | | |
| | | | | 80 | | |

¹ The range represents the highest and lowest inputs used in the level 3 valuations.

² Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

³ Underlying asset/net asset values represent fair value.

19. Fair values of financial assets and liabilities (continued)

| | | | | At 31 December 2013 | | |
|--|---|---|--------------------|---------------------|--|------|
| | | | | Carrying value | Effect of reasonably possible alternative assumptions ² | |
| Valuation technique(s) | Significant unobservable inputs | Range ¹ | Favourable changes | | Unfavourable changes | |
| | | | | £m | £m | £m |
| Trading and other financial assets at fair value through profit or loss | | | | | | |
| Equity and venture capital investments | Underlying asset/net asset value (incl. property prices) ³ | n/a | n/a | 130 | 17 | (16) |
| | | | | 130 | | |
| Available-for-sale financial assets | | | | | | |
| Equity and venture capital investments | Underlying asset/net asset value (incl. property prices) ³ | n/a | n/a | 375 | 28 | (19) |
| | | | | 375 | | |
| Derivative financial assets | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (bps) | 62/192 | 278 | 25 | (15) |
| | Option pricing model | Interest rate volatility | 3%/112% | 162 | 1 | (2) |
| | | | | 440 | | |
| | | | | 945 | | |
| Financial assets carried at fair value | | | | | | |
| Trading and other financial liabilities at fair value through profit or loss | | | | | | |
| Derivative financial liabilities | | | | | | |
| Interest rate derivatives | Discounted cash flow | Inflation swap rate – funding component (bps) | 62/194 | 8 | – | – |
| | Option pricing model | Interest rate volatility | 3%/112% | 38 | – | – |
| | | | | 46 | | |
| | | | | 17 | | |
| Financial guarantees | | | | | | |
| | | | | 102 | | |
| Financial liabilities carried at fair value | | | | | | |

¹ The range represents the highest and lowest inputs used in the level 3 valuations.

² Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

³ Underlying asset/net asset values represent fair value.

19. Fair values of financial assets and liabilities (continued)**Unobservable inputs**

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

- Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
- Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
- Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.
- Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

Debt securities

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

Derivatives

Reasonably possible alternative assumptions have been determined in respect of the Group's derivative portfolios as follows:

- (i) Uncollateralised inflation swaps are valued using appropriate discount spreads for such transactions. These spreads are not generally observable for longer maturities. The reasonably possible alternative valuations reflect flexing of the spreads for the differing maturities to alternative values.
- (ii) Swaptions are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range.

Unlisted equity, venture capital investments and investments in property partnerships

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

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

20. Related party transactions

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

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

| | At 30 June 2014 £m | At 31 Dec 2013 £m |
|--|-----------------------------|----------------------------|
| Assets | | |
| Derivative financial instruments | 10,454 | 9,867 |
| Loans and receivables: due from fellow Lloyds Banking Group undertakings | 55,573 | 193,874 |
| Available-for-sale financial assets | 134 | 76 |
| Liabilities | | |
| Due to fellow Lloyds Banking Group undertakings | 80,012 | 220,738 |
| Derivative financial instruments | 9,277 | 8,801 |
| Subordinated liabilities | 259 | 433 |
| Debt securities in issue | 220 | 243 |

During the half-year to 30 June 2014 the Group earned £349 million (half-year to 30 June 2013: £838 million) of interest income and incurred £1,057 million (half-year to 30 June 2013: £1,206 million) of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings.

UK government

In January 2009, the UK government through HM Treasury became a related party of Lloyds Banking Group plc, the Company's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 30 June 2014, HM Treasury held a 24.9 per cent interest in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of Lloyds Banking Group plc, and therefore of the Group, during the half-year to 30 June 2014.

In accordance with IAS 24, UK government-controlled entities are related parties of the Group. The Group regards the Bank of England and entities controlled by the UK government, including The Royal Bank of Scotland Group plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc, as related parties.

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

National Loan Guarantee Scheme

The Group has participated in the UK government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Group's existing lending criteria. Eligible businesses who have taken up the funding benefit from a 1 per cent discount on their funding rate for a pre-agreed 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. At 30 June 2014, the Lloyds Banking Group had invested £95 million (31 December 2013: £64 million) in the Business Growth Fund and carried the investment at a fair value of £83 million (31 December 2013: £52 million).

20. Related party transactions (continued)

Big Society Capital

In January 2012 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Lloyds Banking Group had invested £23 million in the Fund by 31 December 2013 and invested a further £4 million during the half-year to 30 June 2014.

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. In November 2013, the Lloyds Banking Group entered into extension letters with the Bank of England to take part in the extension of the Funding for Lending Scheme until the end of January 2015. The extension of the Funding for Lending Scheme focuses on providing businesses with cheaper finance to invest and grow. At 30 June 2014, the Lloyds Banking Group had drawn down £14 billion under the Funding for Lending Scheme. £4 billion of this has been drawn under the extension, out of which £2 billion was drawn in June 2014.

Enterprise Finance Guarantee

The Lloyds Banking Group participates in the Enterprise Finance Guarantee Scheme which was launched in January 2009 as a replacement for the Small Firms Loan Guarantee Scheme. The scheme is a UK government-backed loan guarantee, which supports viable businesses with access to lending where they would otherwise be refused a loan due to a lack of lending security. The Department for Business Innovation and Skills provides the lender with a guarantee of up to 75 per cent of the capital of each loan subject to the eligibility of the customer within the rules of the scheme. As at 30 June 2014, the Lloyds Banking Group had offered 6,212 loans to customers, worth a total of £508 million. The Lloyds Banking Group entities, Lloyds Bank plc, TSB Bank plc, Lloyds TSB Commercial Finance Limited and Bank of Scotland plc contracted with The Secretary of State for Business, Innovation and Skills (formerly the Secretary of State for Business, Enterprise and Regulatory Reform).

On 1 April 2014, the Group committed to the sixth tranche of the scheme, and amended and restated agreements, which have the purpose of expanding the scope of situations in which lenders will be able to use the Enterprise Finance Guarantee Scheme to facilitate lending to SME customers, including overdrafts. The annual base lending limit allocated to the Group for the financial year 1 April 2014 to 31 March 2015 is £80 million.

Help to Buy

On 7 October 2013, Bank of Scotland plc entered into an agreement with The Commissioners of Her Majesty's Treasury by which it agreed that the Halifax Division of Bank of Scotland plc would participate in the Help to Buy Scheme with effect from 11 October 2013 and that Lloyds Bank plc would participate from 3 January 2014. The Help to Buy Scheme is a scheme promoted by the government and is aimed to encourage participating lenders to make mortgage loans available to customers who require higher loan-to-value mortgages. Halifax and Lloyds are currently participating in the Scheme whereby customers borrow between 90 per cent and 95 per cent of the purchase price.

In return for the payment of a commercial fee, HM Treasury has agreed to provide a guarantee to the lender to cover a proportion of any loss made by the lender arising from a higher loan-to-value loan being made. By 30 June 2014, £969 million had been advanced by the Lloyds Banking Group under this scheme.

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.

20. Related party transactions (continued)*Other government-related entities*

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

Other related party transactions

Other related party transactions for the half-year to 30 June 2014 are similar in nature to those for the year ended 31 December 2013.

21. 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 2014 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

| Pronouncement | Nature of change | IASB effective date |
|---|--|---|
| IFRS 9 <i>Financial Instruments</i> ¹ | <p>Replaces IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.</p> <p>IFRS 9 requires financial assets to be classified into three measurement categories, fair value through profit and loss, fair value through other comprehensive income 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. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity's own credit risk is recorded in other comprehensive income. The classification and measurement change is not expected to have a significant impact on the Group.</p> <p>IFRS 9 also replaces the existing IAS 39 'incurred loss' impairment approach with an expected credit loss approach. Loan commitments and financial guarantees not measured at fair value through profit or loss are also in scope. Those changes may result in an increase in the Group's balance sheet provisions for credit losses at the initial application date (1 January 2018) depending upon the composition of the Group's amortised cost financial assets, as well as the general economic conditions and the future outlook.</p> <p>The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The general hedging change is not expected to have a significant impact on the Group.</p> | Annual periods beginning on or after 1 January 2018 |
| IFRS 15 <i>Revenue from Contracts with Customers</i> ¹ | <p>Replaces IAS 18 <i>Revenue</i> and IAS 11 <i>Construction Contracts</i>. IFRS 15 establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods and services. Financial instruments, leases and insurance contracts are out of scope and so this standard is not expected to have a significant impact on the Group.</p> | Annual periods beginning on or after 1 January 2017 |

¹ As at 30 July 2014, these pronouncements are awaiting EU endorsement.

22. Ultimate parent undertaking

HBOS plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year to 31 December 2013 and copies may be obtained from Investor Relations, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN and are available for download from www.lloydsbankinggroup.com.

23. Other information

The financial information included in these condensed consolidated interim financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2013 have been delivered to the Registrar of Companies. The auditors' report on those accounts was unqualified, did not include an emphasis of matter paragraph and did not include a statement under section 498 of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

- an indication of important events that have occurred during the six months ended 30 June 2014 and their impact on the condensed consolidated half-year financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2014 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
30 July 2014

HBOS plc board of directors:

Lord Blackwell (Chairman)
António Horta-Osório (Group Chief Executive)
George Culmer (Chief Financial Officer)
Juan Colombás (Chief Risk Officer)
Anita Frew (Deputy Chairman)
Carolyn Fairbairn
Simon Henry
Dyfrig John CBE
Nicholas Luff
Nicholas Prettejohn
Anthony Watson CBE
Sara Weller

INDEPENDENT REVIEW REPORT TO HBOS PLC

Report on the condensed consolidated half-year financial statements

Our conclusion

We have reviewed the condensed consolidated half-year financial statements, defined below, in the half-year management report of HBOS plc for the six months ended 30 June 2014. Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated half-year financial statements are not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

This conclusion is to be read in the context of what we say in the remainder of this report.

What we have reviewed

The condensed consolidated half-year financial statements, which are prepared by HBOS plc, comprise:

- the consolidated income statement for the six months ended 30 June 2014;
- the consolidated statement of comprehensive income for the six months ended 30 June 2014;
- the consolidated balance sheet as at 30 June 2014;
- the consolidated statement of changes in equity for the six months ended 30 June 2014;
- the consolidated cash flow statement for the six months ended 30 June 2014; and
- the explanatory notes to the condensed consolidated half-year financial statements.

As disclosed in note 1, the financial reporting framework that has been applied in the preparation of the full annual financial statements of the group is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

The condensed consolidated half-year financial statements included in the half-year management report have been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

What a review of condensed consolidated financial statements involves

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and, consequently, does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

We have read the other information contained in the half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed consolidated half-year financial statements.

INDEPENDENT REVIEW REPORT TO HBOS PLC (continued)**Responsibilities for the condensed consolidated half-year financial statements and the review*****Our responsibilities and those of the directors***

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

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

PricewaterhouseCoopers LLP
Chartered Accountants
30 July 2014
London

Notes:

- (a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the 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.

CONTACTS

For further information please contact:

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