Lloyds Bank Corporate Markets plc

Report and Accounts

2018

Member of Lloyds Banking Group

Lloyds Bank Corporate Markets plc

Contents

Registered office: 25 Gresham Street, London EC2V 7HN. Registered in England no 10399850.

Lloyds Bank Corporate Markets plc

Strategic report

The directors present their strategic report on Lloyds Bank Corporate Markets plc (the Bank) and its subsidiary undertakings (the Group) for the year ended 31 December 2018.

The Bank and the Group provide a wide range of banking and financial services through branches and offices in the UK and overseas, with operations across the UK, the Crown Dependencies and Gibraltar, USA, Singapore and Germany. The Bank was established in response to the Financial Services (Banking Reform) Act 2013 for the purpose of carrying on elements of the commercial banking business of Lloyds Banking Group plc (also referred to herein as LBG) along with the banking business of LBG in territories outside the EEA. The Group contributes to the financial results of the Commercial Banking Division of LBG.

Our strategic purpose as part of LBG is to Help Britain Prosper through creating a responsible business that focuses on customers' needs and delivering long-term sustainable success. Our client focussed business model provides a competitive advantage with the diversity and strength of our client franchise enabling scalable business propositions, relative cost efficiencies and resilient returns on capital deployed. We are investing in a number of technologically enabled productivity improvements that will benefit both customers and colleagues as we improve the client experience and further simplify the business model. Working with LBG teams providing services to us, we will leverage the extensive experience in delivering successful transformation programmes, contributing to the strategic priorities of providing a leading customer experience, digitising the business, maximising our capabilities and transforming ways of working.

Principal activities

Lloyds Bank Corporate Markets (LBCM) supports a diverse range of customers and provides a broad range of banking products to help them achieve their financial goals. The Group's revenue is earned through interest and fees on a range of financial services products to commercial clients including loans, deposits, trade and asset finance, debt capital markets, and derivatives; and current accounts, savings accounts, mortgages, car finance and personal loans in the Retail market in our Crown Dependencies businesses.

The target market for these products and services in the UK and internationally is made up of large corporate companies, financial institutions, and retail and commercial clients in the Crown Dependencies, and includes the following product propositions:

- Commercial lending (including fixed rates loans, revolving credit facilities, variable loans and business mortgages)
- Trade and working capital management (including trade services, trade finance, supply chain finance and asset finance)
- Bonds and structured finance (including bonds, structured lending and asset securitisation)
- Risk management (including FX, rates, credit, commodities and liabilities management)
- Retail banking services (including mortgages, personal current accounts, personal loans, investment services and motor finance) in the Crown Dependencies.

Future developments

The Group has a number of strategic investment programmes including investment in scalable infrastructure across the Crown Dependencies business to support client and colleague experiences whilst creating efficiencies in operating model; optimising the legal entity structure of LBCM to leverage efficiencies in capital and funding; and investing in new technology and capability within our Markets proposition worldwide to generate new revenue pools whilst also creating enhanced risk management and 'straight through processing'.

Financial performance

Relevant business and companies transferred from other parts of LBG during May to December 2018 as part of the Ring Fencing programme to establish LBCM as the Non Ring Fenced bank of LBG. This was a complex multi-year project which culminated in multiple migration events and the go live of the new Bank and Group. The board closely monitored the establishment of the new Bank and Group, and consider the successful go live a key measure of performance in the year.

Our focus on our Customers is key to the success of our strategy. We measure our success in meeting customer focussed objectives such as customer satisfaction and complaint levels through a range of customer insight and feedback including net promoter scores. Our ongoing commitment to treat customers fairly and consistently delivering great service is central to our ways of working. Other key performance indicators regularly monitored include business performance and profitability versus plan; and that appropriate levels of capital, funding and liquidity are in place in both the actual results and forward operating plan. Key metrics are noted below in tables 1 and 2.

The Income Statement for 2018 is not representative of a full year's income derived from the Group's activities due to the staggered nature of the transfers across the year. Neither the Bank nor the Group traded during 2017 and therefore there are no comparatives other than Cash and Share Capital.

During the year ended 31 December 2018, the Group recorded a profit before tax of £190 million. The board was satisfied with this result against the backdrop of challenging market conditions which led to lower levels of client markets activity. Total income was £455 million, comprising net interest income of £103 million, net fee and commission income of £121 million and net trading income of £231 million. Operating expenses were £273 million, predominantly consisting of management charges relating to the Intra Group Agreement (IGA) and staff costs paid to LBG. Credit quality across the portfolio is strong and a net impairment gain of £8 million was recognised as a result of the release of a provision in the Jersey lending business. In 2018, the Group recorded a tax expense of £37 million.

Total assets of the Group at 31 December 2018 were £78,471 million, predominantly represented by the business transferred from other LBG companies as referred to above, plus subsequent new lending. Within this total are financial assets at fair value through profit or loss of £17,171 million, derivative financial instruments of £15,867 million and financial assets at amortised cost of £29,992 million (including £20,684 million advances to customers).

Total liabilities of the Group were £74,479 million at 31 December 2018 including customer deposits of £26,870 million, financial liabilities at fair value through profit or loss of £14,008 million; derivative financial instruments of £14,511 million and debt securities in issue of £12,942 million. Total equity at the year end was £3,992 million.

Financial performance (continued)

Risk-weighted assets of the Group at 31 December 2018 were £19,868 million.

During the year the Group issued a further £100 million of ordinary share capital and received £2,975 million in capital contributions, recognised through retained earnings. Including other retained earnings, regulatory capital deductions and other regulatory adjustments, the Group's common equity tier 1 capital at 31 December 2018 was £2,723 million. The common equity tier 1 capital ratio was 13.7 per cent.

In addition, the Group issued other equity instruments totalling £782 million and dated subordinated liabilities totalling £725 million which qualify for recognition as additional tier 1 capital instruments and tier 2 capital instruments respectively, subject to certain regulatory adjustments (reflected below). The Group's tier 1 capital at 31 December 2018 was £3,480 million and the tier 1 capital ratio was 17.5 per cent. Total capital at 31 December 2018 was £4,152 million and the total capital ratio was 20.9 per cent.

Table 1: Capital resources (audited)

	2018 £m
Common equity tier 1	
Shareholders' equity per balance sheet	3,210
Cash flow hedging reserve	(5)
Debit valuation adjustment	(71)
Sub-total	3,134
Less: deductions from common equity tier 1	
Prudent valuation adjustment	(199)
Excess of expected losses over impairment provisions and value adjustments	(20)
Securitisation deductions	(191)
Deferred tax assets	(1)
Common equity tier 1 capital	2,723
Additional tier 1 instruments	757
Total tier 1 capital	3,480
Tier 2 instruments	672
Total capital resources	4,152
Risk-weighted assets (unaudited)	19,868
Common equity tier 1 capital ratio	13.7%
Tier 1 capital ratio	17.5%
Total capital ratio	20.9%

Table 2: Risk-weighted assets (unaudited)

	2018 £m
Foundation Internal Ratings Based (IRB) Approach	8,287
Retail IRB Approach	22
Other IRB Approach	652
IRB Approach	8,961
Standardised Approach	3,929
Total credit risk	12,890
Counterparty credit risk	3,389
Contributions to the default fund of a central counterparty	193
Credit valuation adjustment risk	397
Operational risk	1,378
Market risk	1,607
Underlying risk-weighted assets	19,854
Threshold risk-weighted assets	14
Total risk-weighted assets	19,868

Principal risks and uncertainties
The most significant risks for the Group which could impact the delivery of our long-term strategic objectives and our approach to each risk are detailed below. These principal risks and uncertainties are reviewed and reported to Board Risk Committee regularly.

There remains continued uncertainty around both the UK and global political and macroeconomic environment. The potential impacts of external factors have been considered in all principal risks to ensure any significant uncertainties continue to be monitored and are appropriately mitigated.

As part of the LBG's ongoing assessment of the potential implications of the UK leaving the European Union, LBCM Group continues to consider the impact to its customers, colleagues and products – as well as legal, regulatory, tax, financial and capital implications.

Capital risk
The risk that we have a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the LBCM Group.

Key mitigating actions
- A comprehensive capital management framework that includes setting of capital risk appetite and dividend policy
- Close monitoring of capital and leverage ratios to ensure we meet regulatory requirements and risk appetite
- Comprehensive stress testing analyses to evidence capital adequacy

Funding and liquidity risk
The risk that we do not have sufficiently stable and diverse sources of funding. Liquidity risk is the risk we have insufficient financial resources to meet our commitments as they fall due.

Key mitigating actions
- Holding liquid assets to cover potential cash and collateral outflows and to meet regulatory requirements
- Undertaking daily monitoring against a number of market and specific early warning indicators
- Maintaining a contingency funding plan detailing actions and strategies available in stressed condition

Market risk
The risk that our capital or earnings profile is affected by adverse market rates, in particular changes in interest and foreign exchange rates (and their volatilities), inflation rates, commodity prices and credit spreads through activity in the banking and markets businesses.

Key mitigating actions
- Undertaking regular monitoring of market risk positions versus limits and triggers to ensure they remain within limits
- Mitigating actions vary depending on exposure but, in general, seek to reduce risk in a cost effective manner given market liquidity
- Structural hedge programmes implemented to manage liability margins and margin compression

Operational risk: overall
Operational risks may disrupt services to customers, cause reputational damage, and result in financial loss. These include the availability, resilience and security of our core IT systems, unlawful or inappropriate use of customer data, theft of sensitive data, fraud and financial crime threats, and the potential for failings in our customer processes.

Key mitigating actions
- Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third-party assurance
- Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis
- Significant investment in compliance with General Data Protection Regulation (GDPR) and Basel Committee on Banking Supervision standards
- Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering

Operational risk: Shared Services Model (SSM)
LBG's chosen ringfencing operating model introduces residual risk for LBCM Group in the execution of that model as a Shared Service Recipient.

Key Risk areas include:
- Key reliance on the SSM increases the prominence of internal service provision risk
- Business process risk (i.e. non-adherence to key processes, including those relating to market, operational, capital, credit and funding and liquidity risk)
- Information security and cyber risk including access management, records, data protection and cyber
- IT systems risk due to reliance on shared service from LBG IT
- Operational risk around business resilience, change activity and sourcing

Key mitigating actions
LBCM Group has arrangements in place to assess, monitor and take action on risks arising from the Shared Services Model. These arrangements include:
- Service performance and reporting to ensure that management Information is provided to the LBCM Group Executive to monitor and respond to the effectiveness of the service provision
- Service agreements in the form of legally binding IGAs are in place to ensure required standard for services
- Service governance arrangements are in place to ensure that LBCM can manage, monitor and escalate service risks to relevant boards
- Service audit rights are incorporated within the IGAs, allowing LBCM to audit the services provided by LBG

Principal risks and uncertainties (continued)

Credit risk
The risk that parties with whom we have contracted, fail to meet their financial obligations.

Key mitigating actions
- Credit policy, incorporating prudent lending criteria, independently set but aligned with the LBCM board–approved risk appetites, to effectively manage risk
- Robust risk assessment and credit sanctioning to ensure we lend appropriately and responsibly
- Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight
- Effective governance processes delivered by the shared service and supported by independent credit risk assurances
- Early identification of signs of stress leading to engagement with the customer

Model risk
The risk of financial loss, regulatory censure, reputational damage or customer detriment as a result of deficiencies in the development, application and on-going operation of models and rating systems.

Key mitigating actions
A comprehensive model risk management framework including:
- Defined roles and responsibilities, with clear ownership and accountability
- Principles regarding the requirements of data integrity, development, validation, implementation and on-going maintenance
- Regular model monitoring
- Independent review of models
- Periodic validation and re-approval of models

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

Key mitigating actions
- Effective, well established compliance and legal risk management policies and procedures which ensure appropriate controls and systems are in place to comply with applicable laws, rules and regulations
- Robust framework and processes in place to monitor on-going compliance with new legislation
- Continued investment in people, processes, training and IT to assess impact and help meet our legal and regulatory commitments
- Effective engagement with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations
- Effective mechanisms in place to identify, assess and monitor risks, with appropriate oversight and escalation routes in place
- Conduct on-going horizon scanning to identify and address changes on regulatory and legal requirements

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

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

People risk
People risks include that we fail to maintain organisational skills, capability, resilience and capacity levels in response to organisational, political and external market change and evolving business needs.

Key mitigating actions
- Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues
- Managing organisational capability and capacity to ensure there are the right skills and resources to meet our customers' needs
- Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations
- Key people resources provided under the model are managed by a People Services Agreement (PSA).

Governance

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from embedding the requirements arising from the implementation of Ring-Fencing legislation in January 2019 and the continuing evolution of the Senior Manager & Certification Regime (SM&CR).

Key mitigating actions

- Effective establishment, embedding and monitoring of the governance arrangements. This includes, but is not limited to, the Corporate Governance Framework (the board and its committees and the executive committees), Shared Service and Credit Governance
- On-going evolution of risk and governance arrangements to continue to be appropriately compliant with regulatory objectives

Climate change

The emerging risks associated with climate change are physical risks arising from climate and weather-related events, and transition risks, which are the financial risks resulting from the process of adjustment towards a lower carbon economy. Both of these risks may cause the impairment of asset values and impact the creditworthiness of our clients, which could result in currently profitable business deteriorating over the term of agreed facilities. Conversely propositions currently outside of appetite may constitute an acceptable opportunity in the future. There is increased focus on these risks by key stakeholders including businesses, clients and investors, and the regulatory landscape is evolving to reflect these risks.

There is also a risk that campaign groups or other bodies could seek to take legal action (including indirect action) against the Group and/or the financial services industry for investing in or lending to organisations that they deem to be responsible for, or contributing to, climate change.

Key mitigating actions

- Sustainability is part of LBG's Helping Britain Prosper Plan
- As part of LBG, we are taking a strategic approach to align with the UK Government's Clean Growth Strategy and have committed to adopting the approach set out by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD)
- We are therefore identifying new opportunities to support customers and clients and to finance the UK's transition to a lower carbon economy
- We will embed sustainability into the way we do business and manage our own operations in a more sustainable way, identifying and managing material sustainability related risks across the Group, and disclosing these in line with the TCFD recommendations.
- We will ensure that appropriate training is provided to business and Risk colleagues to enable them to have effective sustainability conversations with their clients.

The 2018 Strategic report has been approved by the board of directors.

On behalf of the board

Mark A Grant
Director
Lloyds Bank Corporate Markets plc
23 April 2019

Directors' report

The directors present their report for the year ended 31 December 2018.

Results

The consolidated income statement on page 19 shows a statutory profit before tax from continuing operations for the year ended 31 December 2018 of £190 million (period ended 31 December 2017: £nil).

Dividends

During the year the Bank paid no dividends. The directors have not recommended a final dividend for the year ended 31 December 2018.

Post balance sheet events

Details of events since the balance sheet date are set out in note 38 on page 79.

Going concern

The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered the principal risks and uncertainties and capital position set out in the Strategic report on pages 1 to 5 and additionally have considered projections for the Bank's and the Group's capital and funding position. The directors conclude that the Bank and the Group have adequate resources to continue in operational existence for a period of at least 12 months from the date of the approval of the financial statements and therefore it is appropriate to continue to adopt the going concern basis in preparing the accounts.

Directors

The names of the current directors are shown on page 9. Changes to the composition of the board since 1 January 2018 up to the date of this report are shown in the table below:

	Joined the board	Resigned from the board
Carla A S Antunes da Silva	appointed 14 March 2018	
Jennifer L Tippin	appointed 14 March 2018	
Philip J Piers		resigned 31 January 2019
Christopher J K Edis	appointed 1 February 2019	

Appointment and retirement of directors

The appointment of directors is governed by the Bank's articles of association and the Companies Act 2006. The Bank's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

Information included in the Strategic report

The disclosures for Principal risks and uncertainties and key performance indicators that would otherwise be required to be disclosed in the Directors' report can be found in the Strategic report on pages 1 to 5.

Directors' indemnities

The directors of the Bank, including the former director who retired after the year end, have entered into individual deeds of indemnity with LBG which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the directors to the maximum extent permitted by law and remain in force. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the directors appointed in 2018 and 2019. In addition, LBG had appropriate Directors' and Officers' liability insurance cover in place throughout 2018.

LBG has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the directors of the LBG's subsidiary companies, including former directors who retire during the year, and to colleagues of the Group subject to the provisions of the Senior Managers and Certification Regime. Such deeds were in force during the financial year ended 31 December 2018 and remain in force as at the date of this report.

Directors' interests

The directors do not have any direct interest in the shares of the Bank. Lord Lupton is also a director of LBG. Lord Lupton's interest in shares of LBG is shown in the report and accounts of that company.

Conflicts of interest

The board has a comprehensive procedure for reviewing and, as permitted by the Companies Act 2006 and the Bank's articles of association, approving actual and potential conflicts of interest. Directors have a continuing duty to notify the Chairman and the Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to the commitments of all directors are reported to the board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the board to ensure the authorisation status remains appropriate.

Lord Lupton is a senior advisor to Greenhill Europe, an investment bank focused on providing financial advice on significant mergers, acquisitions, restructurings, financings and capital raising to corporations, partnerships, institutions and governments. The board has recognised that potential conflicts may arise as a result of this position. The board has authorised the potential conflicts and requires Lord Lupton to recuse himself from discussions, should the need arise.

Conflicts of interest (continued)
Andrew McIntyre is Non-Executive Director, Senior Independent Director and Chair of the Audit and Risk Committee of C. Hoare & Co., a UK regulated private bank; a member of a Financial Reporting Council ("FRC") sub-committee called the Financial Reporting Review Panel ("FRRP"); Non-Executive director and Chair of Audit Committee of National Bank of Greece S.A; and has a continuing financial relationship with EY, as a former partner of the firm, in the form of a fixed annuity. The board has recognised that potential conflicts may arise in relation to these positions, and the continuing financial relationship with EY. The board has authorised the potential conflicts and requires Andrew McIntyre to recuse himself from discussions, should the need arise.

John Cummins is Managing Director for Urban Renewal and Clean Energy, Legal & General Capital plc and in that role has been appointed as a director of two joint ventures with Legal & General plc and has been appointed director and trustee of Centre for Cities, a charitable company limited by guarantee set up as a think tank to improve the performance of UK city economies and conduct research into urban matters. In addition, John Cummins has personal investments in a Fintech company, Shieldpay, a developer and supplier of secure anti-fraud payment systems to banks and other organisations; and Auden Group Limited, a social lending company. The board has recognised that potential conflicts may arise as a result of these positions. The board has authorised the potential conflicts and requires John Cummins to recuse himself from discussions, should the need arise.

Jennifer Tippin is Group People and Productivity Director for Lloyds Banking Group and is a member of the Group Executive Committee (GEC). This role is a permitted interest under the Bank's articles of association but for the sake of good order the board has authorised the potential conflicts that may arise as a result of this role and requires Jennifer Tippin to recuse herself from discussions, should the need arise. Jennifer Tippin does not act as a representative of the Group shareholder in her role as a Non-executive director on the Bank's board.

Carla Antunes da Silva is Group Strategy, Corporate Ventures and Investor Relations Director for Lloyds Banking Group and is an attendee of the GEC. This role is a permitted interest under the Bank's articles of association but for the sake of good order the board has authorised the potential conflicts that may arise as a result of this role and requires Carla Antunes da Silva to recuse herself from discussions, should the need arise. Carla Antunes da Silva does not act as a representative of the Group shareholder in her role as a Non-executive director on the Bank's board.

Branches, future developments and financial risk management objectives and policies
The Bank provides a wide range of banking and financial services through branches and offices in the UK and overseas. Information regarding future developments and financial risk management objectives and policies of the Group in relation to the use of financial instruments that would otherwise be required to be disclosed in the Directors' report, and which is incorporated into this report by reference, can be found in the Strategic report.

Share capital
Information about share capital is shown in note 26. This information is incorporated into this report by reference.

The Bank issued ordinary share capital of £100 million on 18 January 2018 and did not repurchase any of its own shares during the year. There are no restrictions on the transfer of shares in the Bank other than set out in the articles of association and certain restrictions which may from time to time be imposed by law and regulations.

The directors manage the business of the Bank under the powers set out in the Companies Act 2006 and the Bank's articles of association; these powers include those in relation to the issue or buy back of the Bank's shares.

Change of control
The Bank is not party to any significant agreements which take effect, alter or terminate upon a change of control of the Bank following a takeover bid. There are no agreements between the Bank and its directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

Research and development activities
The Bank did not undertake any research and development activities during the year.

Employees

The Group employed an average of 624 colleagues during 2018 (2017: nil). This represents colleagues based in Singapore, USA, Gibraltar and the Crown Dependencies. UK based colleagues are employed through other LBG companies and costs recharged via the IGA. Information concerning the employees of Lloyds Banking Group is available in the annual report and accounts of LBG (see note 40 below).

Significant contracts
The Group has entered into a shared service contract with Lloyds Bank plc for the provision of services (refer to note 7).

Details of related party transactions are set out in note 30 on pages 52 to 53.

Directors' report

Statement of directors' responsibilities

The directors are responsible for preparing the Annual report and accounts in accordance with applicable law and regulation.

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

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Bank and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

Each of the current directors, who are in office as at the date of this report and whose names are shown on page 9 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position and the profit or loss of the Bank and the Group; and
- the Strategic report and the Directors' report include a fair review of the development and performance of the business and the position of the Bank and Group, together with a description of the principal risks and uncertainties that they face.

The directors consider that the Annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Bank's performance, business model and strategy. The directors have also separately reviewed and approved the Strategic report.

Independent auditors and audit information

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

A resolution will be proposed at the 2019 annual general meeting to re-appoint PricewaterhouseCoopers LLP as auditors. The Bank's Audit Committee is satisfied that the external auditors remain independent and effective.

The financial statements were approved by the board of directors and signed on its behalf by:

Christopher J K Edis
Director
23 April 2019

Lloyds Bank Corporate Markets plc
Registered in England & Wales
Company Number 10399850

Directors

John J Cummins	*Non-executive director*
Christopher J K Edis	*Executive director and Chief Financial Officer*
Mark A Grant	*Executive director and Chief Executive Officer*
Lord Lupton	*Non-executive director and Chairman*
Andrew J McIntyre	*Non-executive director*
John S W Owen	*Non-executive director*
Carla A S Antunes da Silva	*Non-executive director*
Jennifer L Tippin	*Non-executive director*

Forward looking statements

This Annual Report contains certain forward looking statements with respect to the business, strategy, plans and/or results of the Lloyds Bank Corporate Markets Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Lloyds Bank Corporate Markets Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Lloyds Bank Corporate Markets Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the Lloyds Bank Corporate Markets Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of the Lloyds Bank Corporate Markets Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from forward looking statements made by the Lloyds Bank Corporate Markets Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates, inflation, exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Lloyds Bank Corporate Markets Group's or Lloyds Banking Group plc's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, instability as a result of the exit by the UK from the European Union (EU) and the potential for other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; natural, pandemic and other disasters, adverse weather and similar contingencies outside the Lloyds Bank Corporate Markets Group's or Lloyds Banking Group plc's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the Lloyds Bank Group's or Lloyds Banking Group plc's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the US or elsewhere including the implementation and interpretation of key legislation and regulation together with any resulting impact on the future structure of the Lloyds Bank Group; the ability to attract and retain senior management and other employees and meet its diversity objectives; actions or omissions by the Lloyds Bank Group's directors, management or employees including industrial action; changes to the Lloyds Bank Group's post-retirement defined benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Lloyds Bank Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed by Lloyds Banking Group plc with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts.

Except as required by any applicable law or regulation, the forward looking statements contained in this Annual Report are made as of the date hereof, and Lloyds Bank Corporate Markets Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this Annual Report to reflect any change in the Lloyds Bank Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. The information, statements and opinions contained in this Annual Report do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

Independent auditors' report to the members of Lloyds Bank Corporate Markets plc

Report on the audit of the financial statements

Opinion

In our opinion, Lloyds Bank Corporate Markets plc's group (the "Group") financial statements and company financial statements (the "financial statements"):

- give a true and fair view of the state of the Group's and of the company's affairs as at 31 December 2018 and of the Group's profit and the Group's and the company's cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the company's financial statements, as applied in accordance with the provisions of the Companies Act 2006; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements, included within the Report and Accounts (the "Annual Report"), which comprise: the Group and company balance sheets as at 31 December 2018; the Group consolidated income statement, the Group and company statements of comprehensive income, the Group and company cash flow statements, and the Group and company statements of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the company.

Other than those disclosed in note 7 to the financial statements, we have provided no non-audit services to the Group or the company in the period from 1 January 2018 to 31 December 2018.

Our audit approach

Context

During the year, the Group and company acquired certain subsidiaries and business activities from affiliated entities in the Lloyds Banking Group, in readiness for compliance with the UK Financial Services (Banking Reform) Act 2013 ring-fencing requirements on 1 January 2019.

As at the year-end date, the Group operates across a number of territories including the UK, the Crown Dependencies and Gibraltar, Singapore and the USA. The company operates across the UK, Singapore and the USA. The Group and company receive considerable operational support through shared service arrangements with other parts of the Lloyds Banking Group.

Independent auditors' report

Overview

Materiality	· Overall Group materiality: £34 million (2017: N/A), based on 1% of capital resources. · Overall company materiality: £34 million (2017: £0.2 million), based on 1% of capital resources. · Specific materiality applied to the Group Income Statement: £17 million. · Specific materiality applied to the company income statement: £17 million
Audit scope	· The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of components and other qualitative factors (including history of misstatement through fraud or error). · We performed full scope audit procedures over components considered financially significant in the context of the Group and the company. These comprised components in the UK, Jersey and the USA. We performed other procedures including testing entity level controls, information technology general controls and analytical review procedures to mitigate the risk of material misstatement in the residual components.
Key audit matters	· Expected credit loss allowances (Group and company). · Valuation of complex financial instruments (Group and company). · Accounting for the business acquisitions made in the year and certain funding transactions (Group and company). · Privileged access to IT systems (Group and company).

The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements.

Capability of the audit in detecting irregularities, including fraud

Based on our understanding of the Group and industry, we identified that the principal risks of non-compliance with laws and regulations related to breaches of banking laws and regulations such as, but not limited to, regulations relating to consumer credit and unethical and prohibited business practices, the regulations of the Financial Conduct Authority, Prudential Regulation Authority, UK tax legislation, equivalent laws are regulations applicable to significant component teams, and those laws and regulations that have a direct impact on the financial statements such as the Companies Act 2006 and the UK Financial Services (Banking Reform) Act 2013.

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

- Discussions with management and those charged with governance including consideration of known or suspected instances of non-compliance with laws and regulation and fraud;
- Evaluation and testing of the operating effectiveness of management's entity level controls designed to prevent and detect irregularities, in particular their code of conduct and whistleblowing helpline;
- Assessment of matters reported on the Group's whistleblowing helpline and the results of management's investigation of such matters;
- Performing testing over period end adjustments;
- Incorporating unpredictability into the nature, timing and/or extent of our testing;
- Reviewing key correspondence with the PRA, FCA, Federal Reserve, Department of Financial Services for New York State, the Jersey Regulator and other regulators;
- Challenging assumptions and judgements made by management in their significant accounting estimates, in particular in relation to expected credit loss allowances and valuation of complex financial instruments (see related key audit matters below); and
- Identifying and testing journal entries, in particular any manual journal entries posted by infrequent users or senior management, posted on unusual days, posted with descriptions indicating a higher level of risk, or posted late with a favourable impact on financial performance.

There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it. Also, the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	***How our audit addressed the key audit matter***
Expected credit loss allowances **Group and company** Refer to page 29 (Accounting Policies) and page 32 to 34 (Critical Accounting Estimates and Judgements). The determination of expected credit loss allowances is subjective and judgmental. There are a number of judgements and assumptions reflected in the financial statements, including the application of forward looking economic scenarios and identification of significant increases in credit risk. *Use of economic scenarios* Management's economics team develops future economic scenarios by using a statistical model and a number of qualitative factors. Four scenarios are chosen from the model output which represent distinct economic scenarios and sensitivities of historical loss experience. These four scenarios together with relative weightings are then provided to the Group for incorporation into the Stage allocation process and the calculation of expected credit loss allowances. *Determination of the expected credit loss allowances* An expected credit loss allowance is determined on loans and advances which are not classified as being credit impaired at the reporting date (referred to as being in Stages 1 and 2) using the statistical model based on key assumptions including significant increase in credit risk criteria (which determines whether a loan is in Stage 1 or 2), probability of default and loss given default. The expected credit loss calculation model is separate to the underlying loan systems, hence the complete and accurate transfer of data into the model is an important step in ensuring the integrity of the calculation of the expected credit loss. Expected credit loss allowances relating to credit impaired loans and advances (referred to herein also as being in Stage 3) are estimated on an individual basis. Judgement is required to determine when a loan is considered to be credit impaired, and then to estimate the expected credit loss based on expected future cash flows related to that loan under multiple weighted scenario outcomes.	*Use of economic scenarios* We evaluated management's process and tested key controls relating to the generation, selection and weighting applied to economic scenarios. We found these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit. We engaged our internal economic experts as well as actuarial modelling specialists to assist us as we considered: - The identification and use of appropriate external economic data; - The operation of the management's internally developed statistical model; - The approach to selection of economic scenarios representing an upside, downside and severe downside in addition to the base case scenario used for internal planning; and - The review, challenge and approval of the scenarios adopted through the governance process. We critically assessed the assumptions adopted in the base case economic scenario and compared this both to our independent view of the economic outlook as well as market consensus, and investigated economic variables outside of our thresholds. We assessed the risk of bias in the forecasts, as well as the existence of contrary evidence. We considered the political uncertainties that existed at the year-end and how these might impact on the economic scenarios selected. We also independently ran the model and performed testing to evaluate the level of non-linearity reflected in the expected credit loss allowances. Based on the evidence obtained, we consider that the economic scenarios adopted and the associated weightings reflect an unbiased, probability weighted view that appropriately captures the impact of non-linearity. *Expected losses on Stage 1 and 2 positions* We understood management's process and tested key controls around the determination of expected credit loss allowances, including controls relating to: - Appropriateness of modelling methodologies and monitoring of model performance; - Periodic model review, validation and approval; - The identification of credit impairment events; and - The review, challenge and approval of the expected credit loss allowances, including the impairment model outputs and key management judgements.

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We found these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on these key controls for the purposes of our audit.
We understood and assessed the appropriateness of the impairment models developed and used by management. This included assessing and challenging the appropriateness of key modelling judgements (including, for example, the criteria used to determine significant increase in credit risk) and quantifying the impact of the use of proxies and simplifications, assessing whether these were appropriate.
We tested the completeness and accuracy of key data inputs, sourced from underlying systems that are applied in the calculation. We tested the reconciliation of loans and advances between underlying source systems and the expected credit loss models.
We tested the formulae applied within the calculation files.
We used credit risk modelling specialists to support the audit team in the performance of these audit procedures.
Expected losses on Stage 3 positions
We performed the following procedures to test the completeness of credit impaired assets requiring a Stage 3 expected credit loss allowance:
- We critically assessed the criteria for determining whether a credit impairment event had occurred;
- We haphazardly tested a sample of Stage 1 and 2 loans. For each sample, we independently assessed whether they had indicators of a credit impairment event (e.g. a customer experiencing financial difficulty or in breach of covenant) and therefore whether they were appropriately categorised.
For a sample of stage 3 credit impaired loans, we:
- Evaluated the basis on which the allowance was determined, and the evidence supporting the analysis performed by management;
- We independently challenged whether the key assumptions used, such as the recovery strategies, collateral rights and ranges of potential outcomes, were appropriate, given the borrower's circumstances; and
- Re-performed management's allowance calculation, testing key inputs including expected future cash flows, discount rates, valuations of collateral held and the weightings applied to scenario outcomes.
Based on the evidence obtained, we concluded that the methodologies, modelled assumptions, management judgements and data used within the allowance assessment to be appropriate and compliant with the requirements of IFRS 9.
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Valuation of complex financial instruments
Group and company
Refer to pages 27 (Accounting Policies), page 56 (Note 32) and page 32 (Critical Accounting Estimates and Judgements).
The Group and company hold a portfolio of fair value assets and liabilities classified as level 3 instruments as valuations are subjective and determined using bespoke models which rely on a range of unobservable inputs.
The Group and company also apply credit, debit and funding valuation adjustments to uncollateralised derivative positions. Certain unobservable inputs are used to calculate these adjustments.
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We understood and tested the key controls around the valuation processes including the independent price verification and valuation governance controls.
Our testing indicated that these key controls were designed, implemented and operated effectively, and we therefore determined that we could place reliance on these key controls for the purposes of our audit.
With the support of valuation specialists in the audit team, we performed the following testing:
- Tested the completeness of the level 3 population through review and testing of the methodology to identify level 3 products;
- Tested the completeness of the uncollateralised derivatives population used for the valuation adjustments by reconciling to the source systems;
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	- Evaluated the appropriateness of the valuation methodologies and tested their application; - Evaluated key inputs and assumptions, with reference to matters including historic performance and market information and perspectives; and - Assessed the appropriateness of the methodology used in calculating credit, debit and funding valuation adjustments and tested their application. Based on the evidence obtained, we determined that the methodologies, inputs and assumptions are appropriate.
Accounting for the business acquisitions made in the year and certain funding transactions **Group and company** Refer to page 32 (Critical accounting estimates and judgements). During the year, the Group and company acquired certain subsidiaries and business activities from affiliated companies within the Lloyds Banking Group. *Accounting judgement* Accounting for the transactions requires the application of judgement, notably with regard to the determination of the nature of the transactions and accounting for any deferred valuation reserves on the acquired activities (i.e. the Fair Value through Other Comprehensive Income and Foreign Currency Translation Reserves). Judgement was also required to determine the appropriate accounting for the initial capital contributed to the company, of £2,975m. *Operational complexity* There was operational complexity in effecting the transfers which increased the risk of error in the accounting.	*Accounting judgements* We evaluated the following accounting judgements with support from our internal accounting specialists: - Whether the transferred activities met the definition of a business under accounting standards; - The treatment of the Fair Value through Other Comprehensive Income and Foreign Currency Translation Reserves, being that the Group and company recognise any amounts that the transferor had previously accumulated in respect of the transferred activities, with a corresponding adjustment to retained earnings; and - Whether the capital contributions recorded by the company had been appropriately recognised. We tested that the accounting treatments determined were appropriately applied in the financial statements. *Operational complexity* We evaluated and tested the key controls around the transfer of the activities, including the reconciliation controls supporting the completeness and accuracy of the transfers, impairment and valuation controls supporting the values at which positions were transferred and the reconciliation controls over the cash settlements. Our testing indicated that these key controls were designed, implemented and operated effectively, and therefore determined that we could place reliance on them for the purposes of our audit. We performed the following procedures over the transferred activities: - Tested the valuation of positions at transfer date to assess whether they were consistent with predecessor values; - Tested relevant cash and transfer reconciliations; - Tested whether the cash consideration paid for the transfers was equivalent to book value; and - Tested the journals to recognise the transferred activities. Based on the evidence obtained, we found that the transferred activities are appropriately reported in the financial statements.
Privileged access to IT systems **Group and company** The Group's financial reporting processes are reliant on automated processes, controls and data managed by IT systems. These processes, and associated controls, are largely provided and operated by the Lloyds Banking Group as part of the shared service arrangement. As part of our audit work we identified control matters in relation to the management of IT privileged access to IT platforms supporting applications in-scope for financial reporting. While there is an ongoing programme of activities to address such	With the support of IT audit specialists in the audit team, we evaluated and tested the design and operating effectiveness of the key controls, which are provided through the shared service arrangement, that are used to manage IT privileged access across the in-scope IT platforms relevant to the Group. We tested controls over: - The completeness and accuracy of the Access Controls Lists (ACLs) from IT platforms that are used by downstream IT security processes; - The on boarding and management of IT privileged accounts through the privileged access restriction tool (including static IT privileged accounts);

control matters, the fact that these were open during the period meant there was a risk that automated functionality, reports and data from the systems were not reliable.	- The monitoring of security events on IT platforms by the Security Operations Centre; and - The approval, recertification and timely removal of access from IT systems. This work identified a number of IT privileged accounts that had not been on boarded to the privileged access restriction tool as at 31 December 2018. Consequently, we performed an assessment of each of the areas within our audit approach where we seek to place reliance on automated functionality and data within relevant IT systems. In each case we identified a combination of mitigating controls, performed additional audit procedures and assessed other mitigating factors in order to respond to the impact on our overall audit approach.

How we tailored the audit scope

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

The Group and company operate in a number of territories as described in the Context. The Group and company receive considerable operational support through shared service arrangements with other parts of the Lloyds Banking Group.

Any components which were considered individually financially significant in the context of the Group's consolidated financial statements (defined as components that represent more than or equal to 10% of the total assets of the consolidated Group) were considered full scope components. This included the commercial lending and financial markets businesses in the UK, the company's US branch and Lloyds Bank International Limited (a wholly owned subsidiary incorporated in Jersey).

In establishing the overall approach to the Group audit, we determined the type of work that is required to be performed over the components by us, as the Group and company engagement team, or auditors within PwC UK and from other PwC network firms operating under our instruction ('component auditors').

Where the work was performed by component auditors, we determined the level of involvement we needed to have in their audit work to be able to conclude whether sufficient appropriate audit evidence has been obtained as a basis for our opinion on the consolidated financial statements as a whole. This included regular communication with the component auditors throughout the audit, the issuance of instructions, a review of the results of their work on the key audit matters, site visits and attendance at formal clearance meetings.

We considered the individual financial significance of other components in relation to primary statement account balances. We considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any component which was not already included as a full scope audit component but was identified as being individually financially significant in respect of one of more account balances was subject to specific audit procedures over those account balances. Inconsequential components (defined as components which, in our judgement, did not represent a reasonable possibility of a risk of material misstatement either individually or in aggregate) were eliminated from further consideration for specific audit procedures although they were subject to Group and company level analytical review procedures.

All remaining components which were neither inconsequential nor individually financially significant were subject to procedures which mitigated the risk of material misstatement including testing of entity level controls, information technology general controls and Group and component level analytical review procedures.

Certain account balances were audited centrally by the Group and company engagement team. In addition, we performed testing over certain activities and controls operating in the shared service centres across the Lloyds Banking Group.

Components within the scope of our audit contributed 98% of Group total assets and 92% of Group total income.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	***Company financial statements***
Overall materiality	£34 million (2017: N/A).	£34 million (2017: £0.2 million).
How we determined it	1% of capital resources.	1% of capital resources.
Rationale for benchmark applied	Capital resources is used as a benchmark as it is a primary focus for the users of the financial statements. Specific materiality for the Group Income Statement is £17 million, determined with reference to Overall materiality (as above) and the point during the year at which the acquisitions of business, including the subsidiaries, took place.	Capital resources is used as a benchmark as it is a primary focus for the users of the financial statements. Specific materiality for the company income statement is £17 million, determined with reference to Overall materiality (as above) and the point during the year at which the acquisitions of business took place.

For each component in the scope of our Group and company audits, we allocated a materiality that is less than our overall Group materiality. The range of materiality allocated across components was between £25 million and £34 million. Specific materiality allocated for the income statement was between £12.5 million and £17 million. Certain components were audited to a local statutory audit materiality that was also less than the allocated materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £1.7 million (Group) (2017: N/A) and £1.7 million (Company) (2017: £10,000) as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Conclusions relating to going concern

ISAs (UK) require us to report to you when:

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

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

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and company's ability to continue as a going concern. For example, the terms on which the United Kingdom may withdraw from the European Union are not clear, and it is difficult to evaluate all of the potential implications on the Group's and company's trade, customers, suppliers and the wider economy.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, ISAs (UK) require us also to report certain opinions and matters as described below.

Strategic Report and Directors' report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' report for the year ended 31 December 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements.

In light of the knowledge and understanding of the Group and company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' report.

Independent auditors' report

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of directors' responsibilities set out on page 8, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting

Companies Act 2006 exception reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion:

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

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the Audit Committee, we were appointed by the directors on 28 September 2016 to audit the financial statements for the year ended 31 December 2017 and subsequent financial periods. The period of total uninterrupted engagement is 2 years, covering the years ended 31 December 2017 to 31 December 2018.

Darren Meek (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
24 April 2019

Lloyds Bank Corporate Markets plc

Consolidated income statement

For the year ended 31 December 2018

	Note	2018 £m
Interest and similar income		**354**
Interest and similar expense		**(251)**
Net interest income	4	**103**
Fee and commission income		**148**
Fee and commission expense		**(27)**
Net fee and commission income	5	**121**
Net trading income	6	**231**
Other income		**352**
Total income		**455**
Operating expenses	7	**(273)**
Trading surplus		**182**
Impairment credit	8	**8**
Profit before tax		**190**
Tax expense	10	**(37)**
Profit for the year		**153**

Profit attributable to ordinary shareholders	**135**
Profit attributable to other equity holders	**18**
Profit for the year	**153**

No comparative information is presented as the Group did not trade in the prior period.

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

Lloyds Bank Corporate Markets plc

Statements of comprehensive income

For the year ended 31 December 2018

	Note	The Group 2018 £m	The Bank 2018 £m
Profit for the year		**153**	**106**
Other comprehensive income			
Items that may subsequently be reclassified to profit or loss:			
Movements in revaluation reserve in respect of fair value through other comprehensive income assets (debt securities):			
Change in fair value		**(11)**	**(11)**
Tax		**4**	**4**
		(7)	**(7)**
Movements in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income		**6**	**6**
Net income statement transfers		**-**	**-**
Tax		**(1)**	**(1)**
		5	**5**
Movements in foreign currency translation :			
Currency translation differences, (tax: nil)		**2**	**-**
Other comprehensive income for the year, net of tax		**-**	**(2)**
Total comprehensive income for the year		**153**	**104**
Total comprehensive income attributable to ordinary shareholders		**135**	**86**
Total comprehensive income attributable to other equity holders		**18**	**18**
Total comprehensive income for the year		**153**	**104**

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

No comparatives are presented as neither the Group or Bank traded in the prior period

Lloyds Bank Corporate Markets plc

Balance sheets

As at 31 December 2018

	Note	The Group 2018 £m	The Bank 2018 £m	The Bank 2017 £m
Assets				
Cash and balances at central banks	11	**14,448**	**14,441**	20
Items in the course of collection from banks		**2**	**-**	-
Financial assets at fair value through profit or loss	12	**17,171**	**17,092**	-
Derivative financial instruments	13	**15,867**	**15,921**	-
Loans and advances to banks	14	**2,583**	**2,561**	-
Loans and advances to customers	14	**20,684**	**17,036**	-
Debt securities	14	**132**	**132**	-
Due from fellow Lloyds Banking Group undertakings	14	**6,593**	**1,388**	-
Financial assets at amortised cost	14	**29,992**	**21,117**	-
Financial assets at fair value through other comprehensive income	17	**412**	**412**	-
Property, plant and equipment	18	**15**	**6**	-
Deferred tax asset	21	**6**	**4**	-
Investment in subsidiary undertakings of the Bank	19	**-**	**908**	-
Other assets	20	**558**	**533**	-
Total assets		**78,471**	**70,434**	20

Equity and liabilities	Note	The Group 2018 £m	The Bank 2018 £m	The Bank 2017 £m
Liabilities				
Deposits from banks		**3,177**	**3,176**	-
Customer deposits		**26,870**	**14,180**	-
Due to fellow Lloyds Banking Group undertakings		**1,794**	**6,501**	-
Financial liabilities at fair value through profit or loss	22	**14,008**	**14,008**	-
Derivative financial instruments	13	**14,511**	**14,510**	-
Debt securities in issue	23	**12,942**	**12,942**	-
Current tax liability		**23**	**19**	-
Other liabilities	24	**429**	**401**	-
Subordinated liabilities	25	**725**	**725**	-
Total liabilities		**74,479**	**66,462**	-
Equity				
Share capital	26	**120**	**120**	20
Other reserves	27	**(15)**	**(17)**	-
Retained earnings	28	**3,105**	**3,087**	-
Shareholders' equity		**3,210**	**3,190**	20
Other equity instruments	29	**782**	**782**	-
Total equity		**3,992**	**3,972**	20
Total equity and liabilities		**78,471**	**70,434**	20

The Group did not trade in the prior period.

The Group has elected to take the exemption under section 408 of the Companies Act 2006 not to present the Bank's income statement. The Bank recorded a profit after tax for the year of £106 million.

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

The financial statements were approved by the board of directors and were signed on its behalf by:

Mark A Grant
Director
23 April 2019

Christopher J K Edis
Director

Lloyds Bank Corporate Markets plc

Statements of changes in equity

For the year ended 31 December 2018

The Group	Share capital £m	Other reserves £m	Retained earnings £m	Total equity £m
As at 28 September 2016	-	-	-	-
Result for the period	-	-	-	-
Total comprehensive income	-	-	-	-
Transactions with owners				
Issue of share capital	20	-	-	20
Total transactions with owners	20	-	-	20
Total equity at 31 December 2017	20	-	-	20
Comprehensive income				
Profit for the year	**-**	**-**	**153**	**153**
Other comprehensive income for the year				
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income, net of tax:				
Debt securities	**-**	**(7)**	**-**	**(7)**
Movements in cash flow hedging reserve, net of tax	**-**	**5**	**-**	**5**
Currency translation differences (tax: nil)	**-**	**2**	**-**	**2**
Total other comprehensive income	**-**	**-**	**-**	**-**
Total comprehensive income/(expense)	**-**	**-**	**153**	**153**
Transactions with owners				
Distributions on other equity instruments, net of tax	**-**	**-**	**(18)**	**(18)**
Issue of ordinary shares	**100**	**-**	**-**	**100**
Establishment of foreign currency translation opening reserve	-	**(15)**	**15**	**-**
Opening reserves adjustment in respect of other transfers	-	-	**(20)**	**(20)**
Capital contribution received	**-**	**-**	**2,975**	**2,975**
Total transactions with owners	**100**	**(15)**	**2,952**	**3,037**
Shareholders equity at 31 December 2018	**120**	**(15)**	**3,105**	**3,210**
Issue of other equity instruments				**782**
Total equity at 31 December 2018				**3,992**

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

Lloyds Bank Corporate Markets plc

Statements of changes in equity

For the year ended 31 December 2018

The Bank	Share capital £m	Other reserves £m	Retained earnings £m	Total equity £m
As at 28 September 2016	-	-	-	-
Result for the period	-	-	-	-
Total comprehensive income	-	-	-	-
Transactions with owners				
Issue of share capital	20	-	-	20
Total transactions with owners	20	-	-	20
Total equity at 31 December 2017	20	-	-	20
Comprehensive income				
Profit for the year	**-**	**-**	**106**	**106**
Other comprehensive income for the year				
Movements in revaluation reserve in respect of financial assets held at fair value through other comprehensive income, net of tax:				
Debt securities	**-**	**(7)**	**-**	**(7)**
Movements in cash flow hedging reserve, net of tax	**-**	**5**	**-**	**5**
Currency translation differences (tax: nil)	**-**	**-**	**-**	**-**
Total other comprehensive expense	**-**	**(2)**	**-**	**(2)**
Total comprehensive income	**-**	**(2)**	**106**	**104**
Transactions with owners				
Distributions on other equity instruments, net of tax	**-**	**-**	**(18)**	**(18)**
Issue of ordinary shares	**100**	**-**	**-**	**100**
Establishment of foreign currency translation opening reserve	**-**	**(15)**	**15**	**-**
Opening reserves adjustment in respect of other transfers	**-**	**-**	**9**	**9**
Capital contribution received	**-**	**-**	**2,975**	**2,975**
Total transactions with owners	**100**	**(15)**	**2,981**	**3,066**
Shareholders equity at 31 December 2018	**120**	**(17)**	**3,087**	**3,190**
Issue of other equity instruments				**782**
Total equity at 31 December 2018				**3,972**

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

Lloyds Bank Corporate Markets plc

Cash flow statements

For the year ended 31 December 2018

	Note	The Group 2018 £m	The Bank 2018 £m	The Bank 2017 £m
Profit before tax		**190**	**135**	-
Adjustments for:				
Change in operating assets	37a	**(10,834)**	**(18,123)**	-
Change in operating liabilities	37b	**34,635**	**41,916**	-
Non-cash and other items	37c	**(13)**	**(5)**	-
Net cash generated from operating activities		**23,978**	**23,923**	-
Cash flows from investing activities				
Purchase of fixed assets		**(47)**	**(8)**	-
Proceeds from sale and maturity of fixed assets		**4**	**-**	-
Acquisition of businesses		**(13,049)**	**(13,049)**	-
Cash acquired on acquisition of businesses		**7**	**-**	-
Net cash used in investing activities		**(13,085)**	**(13,057)**	-
Cash flows generated from financing activities				
Distributions on other equity instruments		**(18)**	**(18)**	-
Receipt of capital contribution from parent company		**2,975**	**2,975**	-
Issue of subordinated liabilities		**725**	**725**	-
Issue of other equity instruments (AT1)		**782**	**782**	-
Issue of ordinary share capital		**100**	**100**	20
Net cash generated by financing activities		**4,564**	**4,564**	20
Effect of exchange rate changes on cash and cash equivalents		**1**	**-**	-
Change in Cash and cash equivalents		**15,458**	**15,430**	20
Cash and cash equivalents at beginning of year		**20**	**20**	-
Cash and cash equivalents at end of year	37d	**15,478**	**15,450**	20

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

1 Basis of preparation

The financial statements of Lloyds Bank Corporate Markets plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body. As noted below, in adopting IFRS 9, the Group has elected to continue applying hedge accounting under IAS 39. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of financial assets measured at fair value through other comprehensive income, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

To improve transparency and ease of reference, the capital resources disclosure required under IFRS has been included within the Strategic report on page 1. This disclosure is covered by the Audit opinion (included from page 11) and referenced as audited.

The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the Principal risks and uncertainties section under Funding and liquidity on page 3 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements. The Bank relies on its holding company for issuance of equity and subordinated debt.

The Group has adopted IFRS 9 and IFRS 15 with effect from 1 January 2018. No comparatives have required adjustment.

(i) IFRS 9 *Financial Instruments*

IFRS 9 replaces IAS 39 and addresses classification, measurement and derecognition of financial assets and liabilities, the impairment of financial assets measured at amortised cost or fair value through other comprehensive income and general hedge accounting.

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

Classification and measurement: IFRS 9 requires financial assets to be classified into one of the following measurement categories: fair value through profit or loss, fair value through other comprehensive income and amortised cost. Classification is made on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The requirements for derecognition are broadly unchanged from IAS 39.

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

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

IFRS 15 has replaced IAS 18 Revenue and IAS 11 Construction Contracts. The core principle of IFRS 15 is that revenue reflects the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled. The recognition of such revenue is in accordance with five steps to: identify the contract; identify the performance obligations; determine the transaction price; allocate the transaction price to the performance obligations; and recognise revenue when the performance obligations are satisfied. The application of these pronouncements has not had any impact for amounts recognised in these financial statements.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2018 and which have not been applied in preparing these financial statements are given in Note 39.

2 Accounting policies

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

a Consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Details of the Bank's subsidiaries are given in note 41.

2 Accounting policies (continued)

Subsidiaries

Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

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

Predecessor accounting has been applied to the business transfers in 2018 as described in note 3. Although not required to be utilised in 2018, the acquisition method of accounting will be used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see note 2c(5)) or share capital (see note 2l). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

b Revenue recognition

(1) Net interest income

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument to the gross carrying amount of the financial asset (before adjusting for expected credit losses) or to the amortised cost of the financial liability, including redemption fees, and related penalties, and premiums and discounts that are an integral part of the overall return.

Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account. Interest income from non-credit impaired financial assets is recognised by applying the effective interest rate to the gross carrying amount of the asset; for credit impaired financial assets, the effective interest rate is applied to the net carrying amount after deducting the allowance for expected credit losses. Impairment policies are set out in note 2f below.

(2) Fee and commission income and expense

Fees and commissions receivable which are not an integral part of the effective interest rate are recognised as income as the Group fulfils its performance obligations. The Group receives certain fees in respect of its asset finance business where the performance obligations are typically fulfilled towards the end of the customer contract; these fees are recognised in income on this basis. Where it is unlikely that the loan commitments will be drawn, loan commitment fees are recognised in fee and commission income over the life of the facility, rather than as an adjustment to the effective interest rate for loans expected to be drawn. Incremental costs incurred to generate fee and commission income are charged to fees and commissions expense as they are incurred.

(3) Other

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

Revenue recognition policies specific to trading income are set out in c(3) below; those relating to leases are set out in h(2) below.

c Financial assets and liabilities

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

Equity investments are measured at fair value through profit or loss unless the Group elects at initial recognition to account for the instruments at fair value through other comprehensive income. For these instruments, dividends are recognised in profit or loss but fair value gains and losses are not subsequently reclassified to profit or loss following derecognition of the investment.

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

2 Accounting policies (continued)

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

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

(1) Financial instruments measured at amortised cost

Financial assets that are held to collect contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost. A basic lending arrangement results in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Where the contractual cash flows introduce exposure to risks or volatility unrelated to a basic lending arrangement such as changes in equity prices or commodity prices, the payments do not comprise solely principal and interest. Financial assets measured at amortised cost are predominantly loans and advances to customers and banks together with certain debt securities. Interest income is accounted for using the effective interest method (see note 2b above).

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

(2) Financial assets measured at fair value through other comprehensive income

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

(3) Financial instruments measured at fair value through profit or loss

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

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

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

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. The fair values of derivative financial instruments are adjusted where appropriate to reflect credit risk (via credit valuation adjustments (CVAs), debit valuation adjustments (DVAs) and funding valuation adjustments (FVAs)), market liquidity and other risks.

(4) Borrowings

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

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

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

2 Accounting policies (continued)

(5) Sale and repurchase agreements (including securities lending and borrowing)

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

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and advance measured at amortised cost or customer deposit.

d Derivative financial instruments and hedge accounting

As permitted by IFRS 9, the Group continues to apply the requirements of IAS 39 to its hedging relationships. All derivatives are recognised at their fair value. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 32(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of all derivative instruments, other than those in effective cash flow and net investment hedging relationships, are recognised immediately in the income statement. As noted in (2) and (3) below, the change in fair value of a derivative in an effective cash flow or net investment hedging relationship is allocated between the income statement and other comprehensive income.

Derivatives embedded in a financial asset are not considered separately; the financial asset is considered in its entirety when determining whether its cash flows are solely payments of principal and interest. Derivatives embedded in financial liabilities are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item, the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective, or forecast to be highly effective, in achieving its documented objective, hedge accounting is discontinued. Note 13 provides details of the types of derivatives held by the Group and presents separately those designated in hedge relationships. Further information on hedge accounting is set out below.

(1) Fair value hedges

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

(2) Cash flow hedges

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

(3) Net investment hedges

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

2 Accounting policies (continued)

e Offset

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

f Impairment of financial assets

The impairment charge in the income statement includes the change in expected credit losses and certain fraud costs. Expected credit losses are recognised for loans and advances to customers and banks, other financial assets held at amortised cost, financial assets measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. Expected credit losses are calculated by using an appropriate probability of default, adjusted to take into account a range of possible future economic scenarios, and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held or other mitigants of loss and including the impact of discounting using the effective interest rate.

At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is made for expected credit losses resulting from default events that are possible within the next 12 months (12-month expected credit losses). In the event of a significant increase in credit risk, allowance (or provision) is made for expected credit losses resulting from all possible default events over the expected life of the financial instrument (lifetime expected credit losses). Financial assets where 12-month expected credit losses are recognised are considered to be Stage 1; financial assets which are considered to have experienced a significant increase in credit risk are in Stage 2; and financial assets which have defaulted or are otherwise considered to be credit impaired are allocated to Stage 3. Predecessor accounting has been applied to the business transfers in 2018 as described in note 3 and impairment allowances for financial assets were brought in to the financial statements at the predecessor carrying values.

An assessment takes place of whether credit risk has increased significantly within the period since the assets were acquired through a common control transaction which had existing impairment provisions (refer note 3). It considers the change in the risk of default occurring over the remaining expected life of the financial instrument. The assessment is unbiased, probability-weighted and uses forward-looking information consistent with that used in the measurement of expected credit losses. In determining whether there has been a significant increase in credit risk, the Group uses quantitative tests based on relative and absolute probability of default (PD) movements linked to internal credit ratings together with qualitative indicators such as watchlists and other indicators of historic delinquency. However, unless identified at an earlier stage, the credit risk of financial assets is deemed to have increased significantly when more than 30 days past due. Where the credit risk subsequently improves such that it no longer represents a significant increase in credit risk since origination, the asset is transferred back to Stage 1.

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

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

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

g Property, plant and equipment

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

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

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

2 Accounting policies (continued)

h Leases

(1) As lessee

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

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

(2) As lessor

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

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

i Taxation

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it.

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are re-measured as required to reflect current information.

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

2 Accounting policies (continued)

j Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The principal functional currency of the Group and the Bank is sterling. Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges.

Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on non-monetary financial assets measured at fair value through other comprehensive income are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see note 2d(3) above). On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

k Provisions and contingent liabilities

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

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

Provision is made for expected credit losses in respect of irrevocable undrawn loan commitments and financial guarantee contracts (see note 2f above).

l Share capital

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

m Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

n Investment in subsidiaries of the bank

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

3 Critical accounting estimates and judgements

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

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

3 Critical accounting estimates and judgements (continued)

Fair value of financial instruments (estimate)

At 31 December 2018, the carrying value of the Group's financial instrument assets held at fair value was £17,171 million, and its financial instrument liabilities held at fair value was £14,008 million. Included within these balances are derivative assets of £15,867 million and derivative liabilities of £14,511 million. The Group's accounting policy for its financial instruments is set out in notes 2c and 2d.

In accordance with IFRS 13 Fair Value Measurement, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. The valuation techniques for level 2 and particularly level 3 financial instruments involve management judgements and estimates, the extent of which depends on the complexity of the instrument and the availability of market observable information. For example, a judgement is made that the position is level 1, 2 or 3 or in selecting a valuation methodology. An example of an estimate would be quantitative inputs to level 3.

In addition, in line with market practice, the Group applies credit, debit and funding valuation adjustments in determining the fair value of its uncollateralised derivative positions. A description of these adjustments is set out in note 32. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are also set out in note 32.

Business Transfers and use of Predecessor Accounting (judgement)

A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities. It was judged that the assets, liabilities and subsidiaries which transferred from LBG entities during the year met this definition and therefore constitutes the transfer of a business.

IFRS does not prescribe the specific treatment for business combinations in these circumstances. The Group's accounting policy for such transfers of business is to apply predecessor accounting. This means that the transferred assets and liabilities were not restated to their fair values in the consolidated accounts of LBCM and no goodwill was recognised. Instead, they were brought into the LBCM financial statements at the predecessor carrying values which, for loans, include any existing impairment provisions, the origination PDs and staging. The Group and Bank also recognise any amounts that the transfeor had previously accumulated on transferred assets and liabilities in relation to fair value through other comprehensive income and foreign currency translation reserves. Predecessor accounting is only adopted on a prospective basis and therefore the comparative period information is not presented for the transferred businesses. LBCM paid consideration equivalent to predecessor carrying value.

Allowance for Impairment Losses (estimate)

The calculation of the expected credit loss (ECL) allowances and provisions against loans commitments and guarantees under IFRS 9 requires a number of judgements, assumptions and estimates. The most significant are set out below:

Probability of default

The probability of default (PD) of an exposure, both over a 12 month period and over its lifetime, is a key input to the measurement of the ECL allowance. The definition of default involves judgement – for example default may be deemed to have occurred when there is evidence that a customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due. The definition of default adopted by the Group is described in note 2f Impairment of financial assets.

Lifetime of an exposure

The PD of a financial asset is dependent on its expected life. A range of approaches, segmented by product type, has been adopted by the Group to estimate a product's expected life. These include using the full contractual life and taking into account behavioural factors such as early repayments and refinancing. Changes to the assumed expected lives of the Group's assets could have a material effect on the ECL allowance recognised by the Group.

Significant increase in credit risk

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

The Group uses a quantitative test together with qualitative indicators to determine whether there has been a SICR for an asset. For Commercial a doubling of PD with a minimum increase in PD of 1 per cent and a resulting change in the underlying grade is treated as a SICR. All financial assets are assumed to have suffered a SICR if they are more than 30 days past due.

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

Origination PDs

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

3 Critical accounting estimates and judgements (continued)

Post-model adjustments
Limitations in the Group's impairment models may be identified through its on-going assessment of the models. In these circumstances, management judgement is used to make appropriate adjustments to the Group's allowance for impairment losses.

Forward looking information
The measurement of expected credit losses is required to reflect an unbiased probability-weighted range of possible future outcomes. In order to do this, the Group has developed an economic model to project sixteen key impairment drivers using information derived mainly from external sources. These drivers include factors such as the unemployment rate, the house price index, commercial property prices and corporate credit spreads. The model-generated economic scenarios for the six years beyond 2018 are mapped to industry-wide historical loss data by portfolio. Combined losses across portfolios are used to rank the scenarios by severity of loss. Four scenarios from specified points along the loss distribution are selected to reflect the range of outcomes; the central scenario reflects the Group's base case assumptions used for medium-term planning purposes, an upside and a downside scenario are also selected together with a severe downside scenario. Rare occurrences of adverse economic events can lead to relatively large credit losses which means that typically the most likely outcome is less than the probability-weighted outcome of the range of possible future

To allow for this a relatively unlikely severe downside scenario is therefore included. At 1 January and 31 December 2018, the base case, upside and downside scenarios each carry a 30 per cent weighting; the severe downside scenario is weighted at 10 per cent. The choice of alternative scenarios and scenario weights is a combination of quantitative analysis and judgemental assessment to ensure that the full range of possible outcomes and material non-linearity of losses are captured. A committee under the chairmanship of the Chief Economist meets quarterly, to review and, if appropriate, recommend changes to the economic scenarios to the Chief Financial Officer and Chief Risk Officer. Findings dealing with all aspects of the expected credit loss calculation are presented to the Group Audit Committee.

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

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

UK economic assumptions	Base case %	Upside %	Downside %	Severe downside %
At 31 December 2018				
Interest rate	**1.25**	**2.34**	**1.30**	**0.71**
Unemployment rate	**4.5**	**3.9**	**5.3**	**6.9**
House price growth	**2.5**	**6.1**	**(4.8)**	**(7.5)**
Commercial real estate price growth	**0.4**	**5.3**	**(4.7)**	**(6.4)**

UK economic assumptions	Base case %	Upside %	Downside %	Severe downside %
At 1 January 2018				
Interest rate	1.18	2.44	0.84	0.01
Unemployment rate	5.0	4.0	6.1	7.1
House price growth	2.7	7.0	(2.4)	(8.2)
Commercial real estate price growth	0.0	3.0	(2.5)	(5.4)

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

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

3 Critical accounting estimates and judgements (continued)

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

Post-model adjustments
Limitations in the Group's impairment models or input data may be identified through the on-going assessment and validation of the output of the models. In these circumstances, management make appropriate adjustments to the Group's allowance for impairment losses. These adjustments are generally modelled taking into account the particular attributes of the exposure which have not been adequately captured by the primary impairment models. At 31 December 2018, post-model adjustments were of negligible impact on the Group's ECL and not individually significant.

Sensitivity analysis
The total of the Stage 1 and 2 provision as at 31 December 2018 is £13 million for the Group and £9 million for the Bank. It is considered that sensitivities on these amounts are not material. It is estimated that the downside scenario weighted at 100 per cent compared to the base scenario would result in an increase in ECL in the range of 10 per cent to 20 per cent in both the Group and Bank.

Other equity instruments (judgement)
Details of the Additional Tier 1 securities issued are included below in note 29. The judgement was made to account for these instruments as part of equity.

4 Net interest income

	2018 £m
Interest and similar income:	
Loans and advances to customers	**246**
Loans and advances to banks	**106**
Interest receivable on financial assets held at amortised cost	**352**
Financial assets at fair value through other comprehensive income	**2**
Total interest and similar income	**354**
Interest and similar expense:	
Deposits from banks, excluding liabilities under sale and repurchase agreements	**(4)**
Customer deposits, excluding liabilities under sale and repurchase agreements	**(207)**
Debt securities in issue	**(20)**
Subordinated liabilities	**(20)**
Total interest and similar expense	**(251)**
Net interest income	**103**

Included within Interest income is £nil in respect of credit impaired financial assets.

5 Net fee and commission income

	2018 £m
Fee and commission income:	
Commercial banking and treasury fees	**137**
Current accounts	**3**
Private banking and asset management	**2**
Credit and debit card fees	**2**
Other fees and commissions	**4**
Total fee and commission income	**148**
Fee and commission expense	**(27)**
Net fee and commission income	**121**

Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 6.

6 Net trading income

	2018 £m
Foreign exchange translation gains	**53**
Gains on foreign exchange trading transactions	**345**
Total foreign exchange	**398**
Securities and other losses (see below)	**(167)**
Net trading income	**231**

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

	2018 £m
Net income arising on assets and liabilities mandatorily held at fair value through profit or loss:	
Financial instruments held for trading	**(176)**
Other financial instruments mandatorily held at fair value through profit or loss:	
Debt securities, loans and advances	**3**
Net income arising on liabilities held at fair value through profit or loss – debt securities in issue	**6**
Securities and other losses	**(167)**

7 Operating expenses

	2018 £m
Staff costs	**78**
Management charges payable	**180**
Other operating expenses	**15**
Total other operating expense	**273**

Services are received by the Group from other parts of LBG via a shared service provision model. This is governed via Internal Group Agreement (IGA) Contracts and includes the provision of services supporting the business, operations and support functions. Management charges payable were paid to Lloyds Bank plc in respect of these services. UK based colleagues are employed through other LBG companies and costs recharged via the IGA. The terms of the contract are negotiated and renewable to ensure market rate expense for services provided.

The Group had an average of 624 colleagues during the year based in Singapore, USA, Gibraltar and the Crown Dependencies.

Fees payable to the Bank's auditors

	2018 £m	2017 £m
Fees payable for the audit of the Bank's current year annual report	**1.8**	-
Audit of the Bank's subsidiaries pursuant to legislation	**0.7**	-
Other services provided pursuant to legislation	**0.1**	-
Other services – audit related services	**0.3**	
Total fees payable to the Bank's auditors	**2.9**	-

Fees payable to the auditors for the audit of the 2017 financial statements was £37,500 and for non-audit services £10,000. These costs were borne by a fellow group company and not recharged.

8 Impairment credit

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Year ended 31 December 2018				
Changes in credit quality	**(2)**	**-**	**3**	**1**
Additions/(repayments)	**1**	**(2)**	**8**	**7**
Total impairment	**(1)**	**(2)**	**11**	**8**
In respect of:				
Financial assets at amortised cost				
Loans and advances to customers	**-**	**(2)**	**11**	**9**
Loan commitments and financial guarantees	**(1)**	**-**	**-**	**(1)**
Total impairment	**(1)**	**(2)**	**11**	**8**

8 Impairment credit (continued)

The Group's impairment credit comprises the following items:

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

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

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

Movements in the Group's impairment allowances are shown in note 16.

9 Directors' emoluments

The directors' emoluments payable for services provided to the Bank are set out below:

	2018 £'000	2017 £'000
Executive directors	**1,468**	202
Non-executive directors	**690**	213
	2,158	415
Highest paid director:	**1,171**	105

All amounts in the comparative period were paid by other companies within Lloyds Banking Group and have not been charged to the Bank.

10 Taxation

	2018 £m
a) Analysis of charge for the year	
UK corporation tax:	
− Current tax on taxable profit for the year	**26**
− Adjustments in respect of prior years	**(2)**
Current tax charge	**24**
Foreign tax:	
− Current tax on taxable profit for the year	**11**
− Adjustments in respect of prior years	**-**
Current tax charge	**35**
UK deferred tax:	
− Current year	**-**
− Adjustments in respect of prior years	**2**
Deferred tax charge (see note 21)	**2**
Tax charge	**37**

UK corporation tax is calculated at a rate of 19 per cent of the taxable profit for the year.

10 Taxation (continued)

b) Factors affecting the tax charge for the year

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

	2018 £m
Profit before tax	**190**
Tax charge thereon at UK corporation tax rate of 19%	**(36)**
Factors affecting credit:	
− Impact of surcharge on banking profits	**(8)**
− Non-deductible costs	**(7)**
− Non-taxable income and other deductions	**12**
− Losses on which deferred tax not recognised	**(2)**
− Derecognition of losses that arose in previous years	**(2)**
− Differences in overseas tax rates	**6**
Tax charge on profit on ordinary activities	**(37)**
Effective rate	**19.47%**

11 Cash and balances at central banks

Cash and cash equivalents for the purposes of the Cash flow statement include the following:

The Group	**2018 £m**	2017 £m
Cash balances at central banks	**14,441**	20
On demand deposits	**7**	-
	14,448	20

The Bank	**2018 £m**	2017 £m
Cash balances at central banks	**14,441**	20
On demand deposits	**-**	-
	14,441	20

12 Financial assets at fair value through profit or loss

	The Group 2018 £m	The Bank 2018 £m
Trading assets	**17,089**	**17,089**
Other financial assets at fair value through profit or loss	**82**	**3**
Total	**17,171**	**17,092**

These assets are comprised as follows:

	The Group		The Bank	
	Trading assets 2018 £m	Other financial assets at fair value through profit or loss 2018 £m	Trading assets 2018 £m	Other financial assets at fair value through profit or loss 2018 £m
Loans and advances to customers	**11,295**	**3**	**11,295**	**3**
Loans and advances to banks	**612**	**-**	**612**	**-**
Debt securities:				
Government securities	**4,898**	**59**	**4,898**	**-**
Asset-backed securities:				
Mortgage-backed securities	**10**	**-**	**10**	**-**
Other asset-backed securities	**43**	**-**	**43**	**-**
Corporate and other debt securities	**231**	**-**	**231**	**-**
	5,182	**59**	**5,182**	**-**
Treasury bills and other bills	**-**	**20**	**-**	**-**
Total	**17,089**	**82**	**17,089**	**3**

At 31 December 2018 £4,773 million of trading and other financial assets at fair value through profit or loss of the Group and £4,791 million of the Bank had a contractual residual maturity of greater than one year.

Included in financial assets at fair value through profit or loss are reverse repurchase agreements treated as collateralised loans with a carrying value of £11,669 million.

For amounts included above which are subject to repurchase and reverse repurchase agreements see note 32.

During the year the Group and Bank acquired financial assets at fair value through profit or loss of £75 million.

13 Derivative financial instruments

The Group	Contract/ notional amount 2018 £m	Fair value assets 2018 £m	Fair value liabilities 2018 £m
Trading			
Exchange rate contracts:			
Spot, forwards and futures	29,359	907	731
Currency swaps	227,530	2,979	3,096
Options purchased	9,056	485	-
Options written	9,947	-	496
	275,892	4,371	4,323
Interest rate contracts:			
Interest rate swaps	2,554,455	9,419	7,970
Forward rate agreements	412,453	4	4
Options purchased	27,903	1,802	-
Options written	21,853	-	1,883
Futures	126,805	4	-
	3,143,469	11,229	9,857
Credit derivatives	10,383	81	153
Equity and other contracts	2,370	186	178
Total derivative assets/liabilities held for trading	3,432,114	15,867	14,511
Hedging			
Derivatives designated as fair value hedges:			
Interest rate swaps	5,366	-	-
Derivatives designated as cash flow hedges:			
Interest rate swaps	1,998	-	-
Total derivative assets/liabilities held for hedging	7,364	-	-
Total derivative assets/liabilities held for trading and hedging	3,439,478	15,867	14,511

The Bank	Contract/ notional amount 2018 £m	Fair value assets 2018 £m	Fair value liabilities 2018 £m
Trading			
Exchange rate contracts:			
Spot, forwards and futures	29,359	907	732
Currency swaps	227,530	2,980	3,096
Options purchased	9,056	485	-
Options written	9,947	-	496
	275,892	4,372	4,324
Interest rate contracts:			
Interest rate swaps	2,554,451	9,475	7,968
Forward rate agreements	412,453	4	4
Options purchased	27,903	1,802	-
Options written	21,853	-	1,883
Futures	126,805	4	-
	3,143,465	11,285	9,855
Credit derivatives	10,383	81	153
Equity and other contracts	2,370	183	178
Total derivative assets/liabilities held for trading	3,432,110	15,921	14,510
Hedging			
Derivatives designated as fair value hedges:			
Interest rate swaps	5,366	-	-
Derivatives designated as cash flow hedges:			
Interest rate swaps	1,998	-	-
Total derivative assets/liabilities held for hedging	7,364	-	-
Total derivative assets/liabilities held for trading and hedging	3,439,474	15,921	14,510

13 Derivative financial instruments (continued)

During the year the Group acquired derivative assets of £23,065 million, with Bank acquiring £22,984 million and the Group and Bank acquired derrivative liabilities of £23,327 million.

The amounts for the derivative assets and liabilities in the above tables include the amounts offset in note 34.

The Group holds derivatives as part of the following strategies:
- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 35.

The principal derivatives used by the Group are as follows:
- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

The notional amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default.

To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 35 Credit risk.

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

	Maturity				
The Group - 31 December 2018	**Less than 1 month**	**1 - 3 months**	**3 months - 1 year**	**1 - 5 years**	**More than 5 years**
Fair value hedges					
Interest rate					
Interest rate swap					
Notional	-	-	-	**4,153**	**1,213**
Average fixed interest rate	-	-	-	**1.15%**	**2.65%**
Cash flow hedges					
Interest rate					
Interest rate swap					
Notional	-	-	**170**	**978**	**850**
Average fixed interest rate	-	-	**0.01%**	**1.16%**	**1.38%**

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

		Carrying amount		
The Group - 31 December 2018	**Contract/ notional amount £m**	**Assets £m**	**Liabilities £m**	**Changes in fair value used for calculating hedge ineffectiveness (YTD) £m**
Fair value hedges				
Interest rate				
Interest rate swaps	**5,366**	-	-	**50**
Cash flow hedges				
Interest rate				
Interest rate swaps	**1,998**	-	-	**6**

All amounts are held within derivative financial instruments.

13 Derivative financial instruments (continued)

The Group's hedged items are as follows:

The Group - 31 December 2018	Carrying amount of the hedged item		Accumulated amount of fair value adjustment on the hedge item		Change in fair value of hedged item for ineffectiveness assessment (YTD)
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	£m
Fair value hedges					
Interest rate					
Fixed rate issuance[1]	-	5,448	-	45	(45)

	Change in fair value of hedged item for ineffectiveness assessment (YTD)	Cash flow hedge/ currency translation reserve	
	£m	Continuing hedges £m	Discontinued hedges £m
Cash flow hedges			
Interest rate			
Customer loans[2]	(6)	6	-

1 Included within debt securities in issue.

2 Included within loans and advances to customers.

The cash flow hedge/currency translation reserve in the above table is calculated on a pre-deferred tax basis.

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

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

The Group - 31 December 2018	Gain (loss) recognised in other comprehensive income £m	Hedge ineffectiveness recognised in the income statement 1	Amounts reclassified from reserves to income statement as: Hedged item affected income statement £m	Amounts reclassified from reserves to income statement as: Income statement line item that includes reclassified amount
Fair value hedges				
Interest rate				
Fixed rate issuance	n/a	5	n/a	n/a
Cash flow hedges				
Interest rate				
Customer loans	6		-	Interest income

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

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

14 Financial assets at amortised cost

1) The Group

A. Loans and advances to customers

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	13,389	29	319	13,737
Advances/ (repayments)	7,074	(10)	(16)	7,048
Transfers between stages	(4)	4	-	-
At 31 December 2018	20,459	23	303	20,785
Allowance for impairment losses	(9)	(2)	(90)	(101)
Total loans and advances to customers	20,450	21	213	20,684

14 Financial assets at amortised cost (continued)

B. Loans and advances to banks

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	1,970	8	-	1,978
Advances/ (repayments)	615	(8)	-	607
At 31 December 2018	2,585	-	-	2,585
Allowance for impairment losses	(2)	-	-	(2)
Total loans and advances to banks	2,583	-	-	2,583

C. Debt securities

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	160	-	-	160
Net increase (decrease) in debt securities	(28)	-	-	(28)
At 31 December 2018	132	-	-	132
Allowance for impairment losses	-	-	-	-
Total debt securities	132	-	-	132

Due from fellow Lloyds Banking Group undertakings	6,593	-	-	6,593

Total financial assets at amortised cost	29,758	21	213	29,992

2) The Bank

A. Loans and advances to customers

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	11,521	-	277	11,798
Advances/ (repayments)	5,328	-	-	5,328
At 31 December 2018	16,849	-	277	17,126
Allowance for impairment losses	(8)	-	(82)	(90)
Total loans and advances to customers	16,841	-	195	17,036

B. Loans and advances to banks

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	1,911	-	-	1,911
Advances/ (repayments)	651	-	-	651
At 31 December 2018	2,562	-	-	2,562
Allowance for impairment losses	(1)	-	-	(1)
Total loans and advances to banks	2,561	-	-	2,561

14 Financial assets at amortised cost (continued)

C. Debt securities

	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
Balance at 1 January 2018	-	-	-	-
Acquisitions	160	-	-	160
Net increase (decrease) in debt securities	(28)	-	-	(28)
At 31 December 2018	132	-	-	132
Allowance for impairment losses	-	-	-	-
Total debt securities	132	-	-	132
Due from fellow Lloyds Banking Group undertakings	1,388	-	-	1,388
Total financial assets at amortised cost	20,922	-	195	21,117

Transfers of assets between stages are deemed to take place at the start of the year. All other movements in the value of the asset are deemed to take place within the Stage under which that asset is reported at the end of the year.

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

At 31 December 2018 £7,846 million of loans and advances to customers of the Group and £5,772 million of the Bank had a contractual residual maturity of greater than one year.

15 Finance lease receivables

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

	2018 £m
Gross investment in finance leases, receivable:	
Not later than 1 year	6
Later than 1 year and not later than 5 years	27
Later than 5 years	196
	229
Unearned future finance income on finance leases	(91)
Rentals received in advance	(2)
Net investment in finance leases	136

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

	2018 £m
Not later than 1 year	(3)
Later than 1 year and not later than 5 years	3
Later than 5 years	136
Net investment in finance leases	136

Equipment leased to customers under finance leases primarily relates to structured financing transactions in connection with infrastructure assets. During 2018 no contingent rentals in respect of finance leases were recognised in the income statement. There was no allowance for uncollectable finance lease receivables included in the allowance for impairment losses.

All balances were acquired in the period.

16 Allowance for impairment losses

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

The Group	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of drawn balances				
Balance at 1 January 2018	-	-	-	-
Acquisitions	8	-	105	113
Transfers to Stage 1	-	-	-	-
Transfers to Stage 2	-	-	-	-
Transfers to Stage 3	-	-	-	-
Impact of transfers between stages	-	-	-	-
	-	-	-	-
Items charged/(credited) to the Income Statement	-	2	(11)	(9)
Total charge	-	2	(11)	(9)
Recoveries of advances written off in previous years	-	-	1	1
Discount unwind	-	-	(5)	(5)
At 31 December 2018	8	2	90	100
In respect of undrawn balances				
Balance at 1 January 2018	-	-	-	-
Acquisitions	2	-	-	2
Transfers to Stage 1	-	-	-	-
Transfers to Stage 2	-	-	-	-
Transfers to Stage 3	-	-	-	-
Impact of transfers between stages	-	-	-	-
	-	-	-	-
Items charged to the Income Statement	1	-	-	1
Total charge	1	-	-	1
At 31 December 2018	3	-	-	3
Total	11	2	90	103
In respect of:				
Loans and advances to banks	2	-	-	2
Loans and advances to customers	9	2	90	101
Debt securities	-	-	-	-
Financial assets at amortised cost	11	2	90	103
Other assets	-	-	-	-
Provisions in relation to loan commitments and financial guarantees	-	-	-	-
Total	11	2	90	103

The Bank	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of drawn balances				
Balance at 1 January 2018	-	-	-	-
Acquisitions	5	-	89	94
Transfers to Stage 1	-	-	-	-
Transfers to Stage 2	-	-	-	-
Transfers to Stage 3	-	-	-	-
Impact of transfers between stages	-	-	-	-
	-	-	-	-
Items charged/(credited) to the Income Statement	1	-	(2)	(1)
Total charge	1	-	(2)	(1)
Recoveries of advances written off in previous years	-	-	-	-
Discount unwind	-	-	(5)	(5)
At 31 December 2018	6	-	82	88

16 Allowance for impairment losses (continued)

The Bank (continued)	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
In respect of undrawn balances				
Balance at 1 January 2018	-	-	-	-
Acquisitions	3	-	-	3
Transfers to Stage 1	-	-	-	-
Transfers to Stage 2	-	-	-	-
Transfers to Stage 3	-	-	-	-
Impact of transfers between stages	-	-	-	-
	-	-	-	-
Items charged to the Income Statement	-	-	-	-
Total charge	-	-	-	-
At 31 December 2018	3	-	-	3
Total	9	-	82	91
In respect of:				
Loans and advances to banks	1	-	-	1
Loans and advances to customers	8	-	82	90
Debt securities	-	-	-	-
Financial assets at amortised cost	9	-	82	91
Other assets	-	-	-	-
Provisions in relation to loan commitments and financial guarantees	-	-	-	-
Total	9	-	82	91

Transfers between stages are deemed to have taken place at the start of the reporting period, with all other movements shown in the stage in which the asset is held at 31 December 2018.

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

17 Financial assets at fair value through other comprehensive income

	The Group 2018 £m	The Bank 2018 £m
Debt securities:		
Government securities	-	-
Bank and building society certificates of deposit	136	136
Asset-backed securities:		
Mortgage-backed securities	-	-
Other asset-backed securities	121	121
Corporate and other debt securities	73	73
	330	330
Treasury and other bills	82	82
Total financial assets at fair value through other comprehensive income	412	412

At 31 December 2018 £195 million of financial assets at fair value through other comprehensive income of the Group and the Bank had a contractual residual maturity of greater than one year.

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

During the year the Group and Bank aquired financial assets at fair value through other comprehensive income of £194 million.

Notes to the financial statements

18 Property, plant and equipment

The Group	Premises £m	Equipment £m	Operating Lease assets £m	Total £m
Cost or valuation:				
At 1 January 2018	-	-	-	-
Acquisition of businesses	10	34	2	46
Additions	-	1	-	1
Disposals	-	(2)	(2)	(4)
At 31 December 2018	10	33	-	43
Accumulated depreciation and impairment				
At 1 January 2018	-	-	-	-
Acquisition of businesses	6	24	1	31
Charge for the year	-	2	-	2
Disposals	(1)	(3)	(1)	(5)
At 31 December 2018	5	23	-	28
Balance sheet amount at 31 December 2018	5	10	-	15
Balance sheet amount at 31 December 2017	-	-	-	-

The Bank	Premises £m	Equipment £m	Operating Lease assets £m	Total £m
Cost or valuation:				
At 1 January 2018	-	-	-	-
Acquisition of businesses	-	6	-	6
Additions	-	2	-	2
Disposals	-	-	-	-
At 31 December 2018	-	8	-	8
Accumulated depreciation and impairment				
At 1 January 2018	-	-	-	-
Acquisition of businesses	-	2	-	2
Charge for the year	-	-	-	-
Disposals	-	-	-	-
At 31 December 2018	-	2	-	2
Balance sheet amount at 31 December 2018	-	6	-	6
Balance sheet amount at 31 December 2017	-	-	-	-

During the year £17 million of plant, property and equipment (£46 million cost with depreciation and impairment of £31 million) was acquired by the Group and £4 million (£6 million cost with depreciation and impairment of £2 million) aquired by Bank.

19 Investment in subsidiary undertakings of the Bank

	2018 £m
At 1 January	-
Additions	908
Disposals	-
Impairment	-
At 31 December	908

Investment in subsidiary undertakings is stated at cost less impairment.

All subsidiary entities were acquired during the current reporting period as part of the LBG strategy to create a ring-fenced bank.

The Bank's interest in each of these entities is in the form of ordinary share capital.

Details of the subsidiaries and related undertakings are given on page 80 and are incorporated by reference.

20 Other assets

	The Group 2018 £m	The Bank 2018 £m
Settlement balances	474	474
Other assets and prepayments	84	60
	558	533

During the year, the Bank acquired Other assets of £28 million,

21 Deferred tax asset

The movement in the Deferred tax asset is as follows:

	The Group 2018 £m	The Bank 2018 £m
Brought forward	-	-
Charge for the year (see note 10)	(2)	1
Transfers from other group undertakings	5	-
	3	1
Amount charged to equity		
− Cash flow hedges	(1)	(1)
− Fair value through other comprehensive income	4	4
− Other	-	-
At 31 December	6	4

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

	2018 £m	2018 £m
Accelerated capital allowances	2	-
Tax losses carried forward	1	(1)
Other temporary differences	(1)	-
	2	(1)

The Deferred tax asset comprises:

	The Group 2018 £m	The Bank 2018 £m
Accelerated capital allowances	(9)	-
Tax losses carried forward	1	1
Subsidiary pension scheme	2	-
Cash flow hedges	7	(1)
Fair value through other comprehensive income	4	4
Other temporary differences	1	-
At 31 December	6	4

As a result of legislation enacted in 2016, the UK corporation tax rate will reduce from 19 per cent to 17 per cent on 1 April 2020. The Group measures its deferred tax assets and liabilities at the value expected to be recoverable or payable in future periods, and re-measures them at each reporting date based on the most recent estimates of utilisation or settlement, including the impact of bank surcharge where appropriate.

The effect of these rate reductions on the Group's and the Bank’s deferred tax balances is estimated to be not significant.

22 Financial liabilities at fair value through profit or loss

The Group and the Bank	2018 £m
Liabilities designated at fair value through profit or loss: Debt securities in issue	1,062
Trading liabilities:	
Liabilities in respect of securities sold under repurchase agreements	11,440
Other deposits	10
Short positions in securities	1,496
	12,946
Financial liabilities at fair value through profit or loss	**14,008**

At 31 December 2018, the Group and the Bank had £1,308 million of trading and other liabilities at fair value through profit or loss with a contractual residual maturity of greater than one year.

Liabilities designated at fair value through profit or loss primarily represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

For the fair value of collateral pledged in respect of repurchase agreements see note 32.

23 Debt securities in issue

The Group and the Bank	2018 £m
Medium-term notes issued	45
Certificates of deposit issued	5,353
Commercial paper	1,162
Amounts due to fellow Group undertakings	6,382
Total debt securities in issue	**12,942**

At 31 December 2018 £7,316 million of debt securities in issue of the Group and of the Bank had a contractual residual maturity of greater than one year.

24 Other liabilities

	The Group 2018 £m	The Bank 2018 £m
Settlement balances	342	342
Other creditors and accruals	87	59
	429	401

25 Subordinated liabilities

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

The Group and the Bank	Dated subordinated 2018 £m
At 1 January 2018	-
Issued during the year	696
Repurchases and redemptions during the year	-
Foreign exchange movements	26
Other movements (all non-cash)	3
At 31 December 2018	**725**

There were no repurchases during the year.

Issued during the year	**2018**
Dated Subordinated Liabilities:	**£m**
Euro Floating Rate Notes 2028 callable 2023	264
Euro Floating Rate Notes 2030 callable 2025	301
US$ Floating Rate Notes 2033 callable 2028	131

26 Share capital

The Group and the Bank	**2018 £m**	2017 £m
Allotted, issued and fully paid		
120,050,000 (2017: 20,050,000) ordinary shares of £1 each	**120**	20

Share capital and control
There are no restrictions on the transfer of shares in the Bank other than as set out in the articles of association, and certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws).

Ordinary shares
The holders of ordinary shares, who held 100 per cent of the total ordinary share capital at 31 December 2018, are entitled to receive the Bank's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares may also receive a dividend (subject to the provisions of the Bank's articles of association) and on a winding up may share in the assets of the Bank.

As permitted by the Companies Act 2006, the Bank has removed references to authorised share capital from its articles of association.

27 Other reserves

	The Group 2018 £m	**The Bank 2018 £m**
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income	**(7)**	**(7)**
Cash flow hedging reserve	**5**	**5**
Foreign currency translation reserve	**(13)**	**(15)**
At 31 December 2018	**(15)**	**(17)**

Movements in other reserves were as follows:

	The Group £m	**The Bank £m**
Revaluation reserve in respect of debt securities held at fair value through other comprehensive income		
At 1 January 2018	**-**	**-**
Change in fair value	**(1)**	**(1)**
Transfers in	**(10)**	**(10)**
Deferred Tax	**-**	**-**
Current Tax	**-**	**-**
	(11)	**(11)**
Realised gains and losses transferred to other comprehensive income		
Disposals	**-**	**-**
Deferred Tax	**4**	**4**
Current Tax	**-**	**-**
	4	**4**
At 31 December 2018	**(7)**	**(7)**

	The Group £m	**The Bank £m**
Cash flow hedging reserve		
At 1 January 2018	**-**	**-**
Change in fair value of hedging derivatives	**6**	**6**
Deferred Tax	**-**	**-**
	6	**6**
Income statement transfers	**-**	**-**
Deferred Tax	**(1)**	**(1)**
	(1)	**(1)**
At 31 December 2018	**5**	**5**

27 Other reserves (continued)

	The Group £m	The Bank £m
Foreign currency translation reserve		
At 1 January 2018	-	-
Currency translation differences arising in the year	2	-
Foreign currency (losses) gains on net investment hedges (tax: £nil)	-	-
Opening reserves adjustment in respect of foreign currency translation reserve	(15)	(15)
At 31 December 2018	**(13)**	**(15)**

28 Retained earnings

	The Group £m	The Bank £m
At 1 January 2018	-	-
Profit for the year [1]	153	106
Distributions on other equity instruments, net of tax	(18)	(18)
Opening reserves adjustment in respect of foreign currency translation reserve	15	15
Opening reserves adjustment in respect of other transfers	(19)	9
Capital contribution received [2]	2,975	2,975
At 31 December 2018	**3,105**	**3,087**

1 No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006. The profit before tax of the Bank was £135million.

2 During the period £2,975 million in capital contributions was received from a related undertaking and recognised through retained earnings.

29 Other equity instruments

During the year the Bank has in issue £782 million of Sterling, Dollar and Euro Additional Tier 1 (AT1) securities to Lloyds Banking Group plc. The AT1 securities are fixed rate resetting or floating rate Perpetual Subordinated Permanent Write-Down Securities with no fixed maturity or redemption date.

The principal terms of the AT1 securities are described below:

- The securities rank behind the claims against the Bank of unsubordinated creditors on a Winding-Up.
- The floating rate AT1 securities will be reset quarterly both prior to and following the first call date.
- Interest on the securities will be due and payable only at the sole discretion of the Bank and the Bank may at any time elect to cancel any Interest Payment (or any part thereof) which would otherwise be payable on any Interest Payment Date. There are also certain restrictions on the payment of interest as specified in the terms.
- The securities are undated and are repayable, at the option of the Bank, in whole at the first call date, or at any Interest Payment date thereafter. In addition, the AT1 securities are repayable, at the option of the Bank, in whole for certain regulatory or tax reasons.
- The securities will be subject to a Permanent Write Down should the fully Loaded Common Equity Tier 1 ratio of the Bank fall below 7.0 per cent.

30 Related party transactions

Balances and transactions with fellow Lloyds Banking Group undertakings

Balances and transactions between members of the Lloyds Bank Corporate Markets Group

In accordance with IFRS10 Consolidated financial statements, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Bank, as a result of its position as parent of a banking group, has a large number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Bank as follows:

	2018 £m
Assets, included within:	
Derivative financial instruments	**57**
Trading and other assets at fair value through profit or loss	**-**
Loans and receivables: due from fellow Lloyds Banking Corporate Markets Group undertakings	**418**
Financial assets at fair value through other comprehensive income	**-**
	475
Liabilities, included within:	
Due to fellow Lloyds Banking Corporate Markets Group undertakings	**4,951**
Trading and other financial liabilities at fair value through profit or loss	**-**
Derivative financial instruments	**-**
Debt securities in issue	**-**
Subordinated liabilities	**-**
	4,951

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2018 the Bank earned interest income on the above asset balances of £4 million and incurred interest expense on the above liability balances of £25 million.

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

	2018 £m
Assets, included within:	
Loans and receivables: due from fellow Lloyds Banking Group undertakings	**967**
Trading and other financial assets at fair value through profit or loss	**261**
Derivative financial instruments	**2,936**
	4,164
Liabilities, included within:	
Due to fellow Lloyds Banking Group undertakings	**1,550**
Financial liabilities at FVTPL	**1,065**
Derivative financial instruments	**3,496**
Debt securities in issue	**6,382**
Other equity instruments (AT1)	**782**
Subordinated liabilities	**725**
	14,000

These balances include the Group's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2018 the Bank earned £12 million interest income on the above asset balances; the Bank incurred £117 million interest expense on the above liability balances.

The Bank earned Fee and Commission Income of £100 million and incurred Fee and Commission Expense of £20 million, both in respect of transactions with the ultimate parent.

30 Related party transactions (continued)

Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Bank. Accordingly the Group and Bank's key management personnel are the members of the LBCM board. The table below represents Key management personnel emoluments.

Key management personnel emoluments

	2018	2017
	£'000	£'000
Short term employee benefits	**2,353**	198
Post employment benefits	**17**	12
	2,370	210

The amounts disclosed above relate wholly to directors of the Group.

31 Contingent liabilities and capital commitments

	The Group	**The Bank**
	2018	**2018**
Contingent liabilities	**£m**	**£m**
Acceptances and endorsements	**163**	**163**
Other:		
Other items serving as direct credit substitutes	**147**	**147**
Performance bonds and other transaction-related contingencies	**155**	**155**
	302	**302**
Total contingent liabilities	**465**	**465**

The contingent liabilities of the Group arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	The Group	**The Bank**
	2018	**2018**
Commitments	**£m**	**£m**
Less than 1 year original maturity:		
Mortgage offers made	**21**	**-**
Other commitments	**7,026**	**6,325**
	7,047	**6,325**
1 year or over original maturity - 3rd party	**9,499**	**9,041**
Total commitments	**16,546**	**15,366**

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend £16,464 million for the Group and £15,366 million for the Bank were irrevocable.

There were no contracted capital commitments at the Balance sheet date.

32 Financial instruments

(1) Measurement basis of financial assets and liabilities

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

The Group	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m
At 31 December 2018						
Financial assets						
Cash and balances at central banks	-	-	-	-	-	14,448
Items in the course of collection from banks	-	-	-	-	-	2
Financial assets at fair value through profit or loss	-	17,089	82	-	-	-
Derivative financial instruments	-	15,867	-	-	-	-
Loans and advances to banks	-	-	-	-	-	2,583
Loans and advances to customers	-	-	-	-	-	20,684
Debt securities	-	-	-	-	-	132
Due from fellow Lloyds Banking Group undertakings	-	-	-	-	-	6,593
Financial assets at amortised cost	-	-	-	-	-	29,992
Financial assets at fair value through other comprehensive income	-	-	-	-	412	-
Total financial assets	-	32,956	82	-	412	44,442

The Group (continued)	Derivatives designated as hedging instruments £m	Mandatorily held at fair value through profit or loss: Held for trading £m	Mandatorily held at fair value through profit or loss: Other £m	Designated at fair value through profit or loss £m	At fair value through other comprehensive income £m	Held at amortised cost £m
At 31 December 2018						
Financial liabilities						
Deposits from banks	-	-	-	-	-	3,177
Customer deposits	-	-	-	-	-	26,870
Due to fellow Lloyds Banking Group undertakings	-	-	-	-	-	1,794
Financial liabilities at fair value through profit or loss	-	12,946	-	1,062	-	-
Derivative financial instruments	-	14,511	-	-	-	-
Debt securities in issue	-	-	-	-	-	12,942
Subordinated liabilities	-	-	-	-	-	725
Total financial liabilities	-	27,457	-	1,062	-	45,508

32 Financial instruments (continued)

The Bank	**Derivatives designated as hedging instruments £m**	**Mandatorily held at fair value through profit or loss: Held for trading £m**	**Mandatorily held at fair value through profit or loss: Other £m**	**Designated at fair value through profit or loss £m**	**At fair value through other comprehensive income £m**	**Held at amortised cost £m**
At 31 December 2018						
Financial assets						
Cash and balances at central banks	-	-	-	-	-	14,441
Financial assets at fair value through profit or loss	-	17,089	3	-	-	-
Derivative financial instruments	-	15,921	-	-	-	-
Loans and advances to banks	-	-	-	-	-	2,561
Loans and advances to customers	-	-	-	-	-	17,036
Debt securities	-	-	-	-	-	132
Due from fellow Lloyds Banking Group undertakings	-	-	-	-	-	1,388
Financial assets at amortised cost	-	-	-	-	-	21,117
Financial assets at fair value through other comprehensive income	-	-	-	-	412	-
Total financial assets	-	33,010	3	-	412	35,558

The Bank (continued)	**Derivatives designated as hedging instruments £m**	**Mandatorily held at fair value through profit or loss: Held for trading £m**	**Mandatorily held at fair value through profit or loss: Other £m**	**Designated at fair value through profit or loss £m**	**At fair value through other comprehensive income £m**	**Held at amortised cost £m**
At 31 December 2018						
Financial liabilities						
Deposits from banks	-	-	-	-	-	3,176
Customer deposits	-	-	-	-	-	14,180
Due to fellow Lloyds Banking Group undertakings	-	-	-	-	-	6,501
Items in course of transmission to banks	-	-	-	-	-	-
Financial liabilities at fair value through profit or loss	-	12,946	-	1,062	-	-
Derivative financial instruments	-	14,510	-	-	-	-
Debt securities in issue	-	-	-	-	-	12,942
Subordinated liabilities	-	-	-	-	-	725
Total financial liabilities	-	27,456	-	1,062	-	37,524

32 Financial instruments (continued)

(2) Fair value measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

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

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

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

Fair value information is not provided for items that are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

Valuation control framework

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

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

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

Valuation of financial assets and liabilities

Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1

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

Level 2

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

Level 3

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

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

32 Financial instruments (continued)

(3) Financial assets and liabilities carried at fair value

(A) Financial assets, excluding derivatives

Valuation hierarchy

At 31 December 2018, the Group's financial assets carried at fair value, excluding derivatives, totalled £17,583 million. The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 56). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2018				
Financial assets at fair value through profit or loss				
Loans and advances to customers	-	11,295	3	11,298
Loans and advances to banks	-	612	-	612
Debt securities:				
Government securities	4,899	-	-	4,899
Other public sector securities	-	-	-	-
Bank and building society certificates of deposit	-	59	-	59
Asset-backed securities:				
Mortgage-backed securities	-	10	-	10
Other-asset-backed securities	-	43	-	43
Corporate and other debt securities	-	230	-	230
	4,899	342	-	5,241
Equity shares	-	-	-	-
Treasury and other bills	20	-	-	20
Total financial assets at fair value through profit or loss	**4,919**	**12,249**	**3**	**17,171**

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through other comprehensive income				
Debt securities:				
Government securities	-	-	-	-
Bank and building society certificates of deposit	-	136	-	136
Asset-backed securities:				-
Mortgage-backed securities	-	-	-	-
Other-asset-backed securities	-	-	121	121
Corporate and other debt securities	-	73	-	73
	-	209	121	330
Equity shares	-	-	-	-
Treasury and other bills	82	-	-	82
Total financial assets at fair value through other comprehensive income	**82**	**209**	**121**	**412**
Total financial assets carried at fair value, excluding derivatives	**5,001**	**12,458**	**124**	**17,583**

32 Financial instruments (continued)

The Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2018				
Financial assets at fair value through profit or loss				
Loans and advances to customers	-	11,295	3	11,298
Loans and advances to banks	-	612	-	612
Debt securities:				
Government securities	4,898	-	-	4,898
Other public sector securities	-	-	-	-
Bank and building society certificates of deposit	-	-	-	-
Asset-backed securities:	-	-	-	-
Mortgage-backed securities	-	10	-	10
Other-asset-backed securities	-	43	-	43
Corporate and other debt securities	-	231	-	231
	4,898	284	-	5,182
Equity shares	-	-	-	-
Treasury and other bills	-	-	-	-
Total financial assets at fair value through profit or loss	4,898	12,191	3	17,092
Financial assets at fair value through other comprehensive income				
Debt securities:				
Government securities	-	-	-	-
Bank and building society certificates of deposit	-	136	-	136
Asset-backed securities:				-
Mortgage-backed securities	-			-
Other-asset-backed securities	-		121	121
Corporate and other debt securities	-		73	73
	-	136	194	330
Equity shares	-	-	-	-
Treasury and other bills	82	-	-	82
Total financial assets at fair value through other comprehensive income	82	136	194	412
Total financial assets carried at fair value, excluding derivatives	4,980	12,327	197	17,504

Movements in level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value:

The Group and the Bank	Financial assets at fair value through profit or loss £m	At fair value through other compre-hensive income £m	Total level 3 assets carried at fair value, excluding derivatives £m
Opening balance	-	-	-
Exchange and other adjustments	1	-	1
(Losses) gains recognised in other comprehensive income within the revaluation reserve in respect of financial assets at fair value through other comprehensive income	(1)	-	(1)
Purchases	3	194	197
At 31 December 2018	3	194	197

32 Financial instruments (continued)

Valuation methodology for financial assets, excluding derivatives

Loans and advances to customers and banks

These assets are principally reverse repurchase agreements. The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security purchased under the reverse repurchase agreement.

Debt securities

Debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2018, the Group's financial liabilities carried at fair value, excluding derivatives, totalled £14,008 million. The table below analyses these financial liabilities by balance sheet classification, liability type and valuation methodology (level 1, 2 or 3, as described on page 56). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

The Group and the Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2018				
Financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss	-	1,062	-	1,062
Trading liabilities:				
Liabilities in respect of securities sold under repurchase	-	11,440	-	11,440
Short positions in securities	1,397	99	-	1,496
Other positions	-	10	-	10
Total Trading liabilities	1,397	11,549	-	12,946
Total financial liabilities carried at fair value, excluding derivatives	1,397	12,611	-	14,008

Movements in level 3 portfolio

There have been no movements in level 3 financial liabilities, excluding derivatives, carried at fair value during the year.

Valuation methodology for financial liabilities, excluding derivatives

Liabilities held at fair value through profit or loss

These principally comprise debt securities in issue which are classified as level 2 and their fair value is determined using techniques whose inputs are based on observable market data. The carrying amount of the securities is adjusted to reflect the effect of changes in own credit spreads and the resulting gain or loss is recognised in other comprehensive income.

Trading liabilities in respect of securities sold under repurchase agreements

The fair value of these liabilities is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security sold under the repurchase agreement.

(C) Derivatives

All the Group's derivative assets and liabilities are carried at fair value. At year end such assets totalled £15,867 million for the Group and £15,921 million for the Bank and liabilities totalled £14,511 million for the Group and £14,510 million for the Bank. The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 56). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

The Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2018				
Derivative assets	4	14,941	922	15,867
Derivative liabilities	-	13,804	707	14,511

The Bank	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2018				
Derivative assets	4	14,995	922	15,921
Derivative liabilities	-	13,803	707	14,510

32 Financial instruments (continued)

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

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

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

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

Certain unobservable inputs are used to calculate CVA, FVA, and own credit adjustments, but are not considered significant in determining the classification of the derivative and debt portfolios. Consequently, those inputs do not form part of the level 3 sensitivities presented.

Movements in level 3 portfolio

The table below analyses movements in level 3 derivative assets and liabilities carried at fair value.

The Group and the Bank	Derivative assets £m	Derivative liabilities £m
Opening balance	-	-
Gains recognised in the income statement within other income	-	68
Purchases	922	639
At 31 December 2018	**922**	**707**

Derivative valuation adjustments

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties

The following table summarises the movement on this valuation adjustment account for the Group during 2018.

Uncollateralised derivative valuation adjustments	2018 £m
At 1 January 2018	-
Transfers in	225
Income statement charge	85
At 31 December 2018	**310**
Represented by	**2018 £m**
Credit Valuation Adjustment (CVA)	271
Debit Valuation Adjustment (DVA)	(97)
Funding Valuation Adjustment	136
	310

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard collateral arrangements (CSAs). These adjustments reflect the level of interest rates, foreign exchange rates, expectations of counterparty creditworthiness and the Group's own credit spread respectively.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

32 Financial instruments (continued)

The CVA is sensitive to:

− the current size of the mark-to-market position on the uncollateralised asset;
− expectations of future market volatility of the underlying asset; and
− expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty becomes credit impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £47.7 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £nil of the overall CVA balance at 31 December 2018).

The DVA is sensitive to:

− the current size of the mark-to-market position on the uncollateralised liability;
− expectations of future market volatility of the underlying liability; and
− the Group’s own implied CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £21.1 million to £118.5 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates and foreign exchange rates. Due to the nature of the Group’s business and client hedging needs, CVA/DVA exposures and valuation adjustments tend to fall when interest rates rise. A one per cent rise in interest rates would lead to a £8.4 million fall in the overall valuation adjustment to £166.2 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding uncollateralised derivative positions. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £13.6 million.

(ii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group’s trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2018, the Group’s derivative trading business held mid to bid-offer valuation adjustments of £62.5 million.

32 Financial instruments (continued)

(D) Sensitivity of level 3 valuations

The Group and the Bank				**Effect of reasonably possible alternative**	
	Valuation technique(s)	**Significant unobservable inputs[1]**	**Carrying value £m**	**Favourable changes £m**	**Unfavour-able changes £m**
At 31 December 2018					
Financial Assets at fair value through profit or loss					
Loans and advances to customers	Comparable Pricing	Price	**3**	**-**	**-**
			3	**-**	**-**
Financial Assets at fair value through other comprehensive income					
Asset-backed securities	Comparable Pricing	Price	**121**	**-**	**(1)**
	Discounted cash flow	Discount margin	**-**	**-**	**-**
	Comparable Pricing	Price	**73**	**3**	**(3)**
			194	**3**	**(4)**
Derivative financial assets					
Interest rate derivatives	Option pricing model	Inflation Volatility	**311**	**3**	**(3)**
	Option pricing model	Interest Rate Volatility	**612**	**3**	**(2)**
			923	**6**	**(5)**
Level 3 financial assets carried at fair value			**1,120**	**9**	**(9)**
Derivative financial liabilities					
Interest rate derivatives	Option pricing model	Inflation Volatility	**(237)**	**-**	**-**
	Option pricing model	Interest Rate Volatility	**(470)**	**-**	**-**
			(707)	**-**	**-**
Level 3 financial liabilities carried at fair value			**(707)**	**-**	**-**

1 Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

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

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities 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.

32 Financial instruments (continued)

Reasonably possible alternative assumptions

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

Debt securities

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

Derivatives

Reasonably possible alternative assumptions have been determined in respect of swaptions in the Group's derivative portfolios which are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of 19 per cent to 80 per cent.

(4) Financial assets and liabilities carried at amortised cost

(A) Financial assets

Valuation hierarchy

The table below analyses the fair values of the financial assets of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 56). Financial assets carried at amortised cost are mainly classified as level 3 due to significant unobservable inputs used in the valuation models. Where inputs are observable, debt securities are classified as level 1 or 2.

The Group	Carrying value £m	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
As at 31 December 2018					
Loans and advances to customers	**20,684**	**20,701**	**-**	**4,604**	**16,097**
Loans and advances to banks	**2,583**	**2,583**	**-**	**-**	**2,583**
Debt securities	**132**	**127**	**-**	**127**	**-**
Due from fellow Lloyds Banking Group undertakings	**6,593**	**6,593**	**-**	**-**	**6,593**
Reverse repos included in above amounts:					
Loans and advances to customers	**4,604**	**4,604**	**-**	**4,604**	**-**
Loans and advances to banks	**-**	**-**	**-**	**-**	**-**

The Bank	Carrying value £m	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
As at 31 December 2018					
Loans and advances to customers	**17,036**	**17,051**	**-**	**4,604**	**12,447**
Loans and advances to banks	**2,561**	**2,561**	**-**	**-**	**2,561**
Debt securities	**132**	**127**	**-**	**127**	**-**
Due from fellow Lloyds Banking Group undertakings	**1,388**	**1,388**	**-**	**-**	**1,388**
Reverse repos included in above amounts:					
Loans and advances to customers	**4,604**	**4,604**	**-**	**4,604**	**-**
Loans and advances to banks	**-**	**-**	**-**	**-**	**-**

Valuation methodology

Loans and advances to customers

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates due to their short term nature. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair value of commercial loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. No adjustment is made to put it in place by the Group to manage its interest rate exposure.

32 Financial instruments (continued)

Loans and advances to banks

The carrying value of short dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

Debt securities

The fair values of debt securities are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

Reverse repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 56).

The Group	Carrying value £m	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
As at 31 December 2018					
Deposits from banks	**3,177**	**3,196**	**-**	**3,196**	**-**
Customer deposits	**26,870**	**26,910**	**-**	**26,910**	**-**
Due to fellow Lloyds Banking Group undertakings	**1,794**	**1,794**	**-**	**1,794**	**-**
Debt securities in issue	**12,942**	**12,897**	**-**	**12,897**	**-**
Subordinated liabilities	**725**	**725**	**-**	**725**	**-**
Repos included in above amounts:					
Deposits from banks	**-**	**-**	**-**	**-**	**-**
Customer deposits	**372**	**372**	**-**	**372**	**-**
Due to fellow Lloyds Banking Group undertakings	**-**	**-**	**-**	**-**	**-**

The Bank	Carrying value £m	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
As at 31 December 2018					
Deposits from banks	**3,176**	**3,195**	**-**	**3,195**	**-**
Customer deposits	**14,180**	**14,226**	**-**	**14,226**	**-**
Due to fellow Lloyds Banking Group undertakings	**6,501**	**6,501**	**-**	**6,501**	**-**
Debt securities in issue	**12,942**	**12,897**	**-**	**12,897**	**-**
Subordinated liabilities	**725**	**725**	**-**	**725**	**-**
Repos included in above amounts:					
Deposits from banks	**-**	**-**	**-**	**-**	**-**
Customer deposits	**372**	**372**	**-**	**372**	**-**
Due to fellow Lloyds Banking Group undertakings	**-**	**-**	**-**	**-**	**-**

Valuation methodology

Deposits from banks and customer deposits

The fair value of bank and customer deposits repayable on demand is assumed to be equal to their carrying value.

The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

Debt securities in issue

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

32 Financial instruments (continued)

Subordinated liabilities

The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

Repurchase agreements

The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

(5) Reclassifications of financial assets

There have been no reclassifications of financial assets in 2018.

33 Business combinations

During the year, the Group acquired 100% of the voting equity instruments and obtained control of a number of fellow Lloyds Banking Group undertakings representing the element of their commercial banking businesses required to be transferred in order to ensure compliance with the Ring-fencing legislation for a total consideration of £13 billion. The legal entities transferred during the year are those listed in note 41 below. All entities transferred have remained under common control of the ultimate parent.

Consistent with predecessor accounting (refer note 3), the consideration paid was equal to book value and hence no goodwill or discount arose on acquisition. Total consideration was paid as cash.

The Bank did not dispose of any operations of the acquiree as part of this business combination.

Predecessor accounting has been applied prospectively as described in note 3.

34 Offsetting of financial assets and liabilities

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements or collateral arrangements in place with counterparties.

				Related amounts where set off in the balance sheet not permitted [3]		
	Gross amounts of assets and liabilities [1] £m	Amounts offset in the balance sheet [2] £m	Net amounts presented in the balance sheet £m	Cash collateral received/ pledged £m	Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
At 31 December 2018						
Financial assets						
Financial assets at fair value through profit or loss:						
Excluding reverse repos	**5,264**	**-**	**5,264**	**-**	**(1,418)**	**3,846**
Reverse repos	**16,259**	**(4,352)**	**11,907**	**-**	**(11,907)**	**-**
	21,523	**(4,352)**	**17,171**	**-**	**(13,325)**	**3,846**
Derivative financial instruments	**29,191**	**(13,324)**	**15,867**	**(3,143)**	**(10,150)**	**2,574**
Loans and advances to banks:						
Excluding reverse repos	**2,583**	**-**	**2,583**	**(1,179)**	**-**	**1,404**
Reverse repos	**-**	**-**	**-**	**-**	**-**	**-**
	2,583	**-**	**2,583**	**(1,179)**	**-**	**1,404**
Loans and advances to customers:						
Excluding reverse repos	**18,723**	**(2,643)**	**16,080**	**(456)**	**-**	**15,624**
Reverse repos	**4,604**	**-**	**4,604**	**-**	**(4,604)**	**-**
	23,327	**(2,643)**	**20,684**	**(456)**	**(4,604)**	**15,624**
Debt securities	**132**	**-**	**132**	**-**	**-**	**132**
Financial assets at fair value through other comprehensive income	**412**	**-**	**412**	**-**	**-**	**412**

34 Offsetting of financial assets and liabilities (continued)

	Gross amounts of assets and liabilities [1] £m	Amounts offset in the balance sheet [2] £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted [3] Cash collateral received/ pledged £m	Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
At 31 December 2018						
Financial liabilities						
Deposits from banks:						
Excluding repos	3,177	-	3,177	(2,067)	-	1,110
Repos	-	-	-	-	-	-
	3,177	-	3,177	(2,067)	-	1,110
Customer deposits:						
Excluding repos	26,611	(113)	26,498	(1,077)	-	25,421
Repos	372	-	372	-	-	372
	26,983	(113)	26,870	(1,077)	-	25,793
Financial liabilities at fair value through profit or loss:						
Excluding repos	1,506	-	1,506	-	-	1,506
Repos	16,855	(4,353)	12,502	(3,837)	(8,665)	-
	18,361	(4,353)	14,008	(3,837)	(8,665)	1,506
Derivative financial instruments	30,366	(15,855)	14,511	(1,635)	(2,687)	10,189

1 After impairment allowance.

2 The amounts set off in the balance sheet as shown above represent derivatives and repurchase agreements with central clearing houses which meet the criteria for offsetting under IAS 32.

3 The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respective of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over-collateralisation have not been taken into account in the above table.

35 Financial risk management

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

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

(1) Credit risk

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

A. Maximum credit exposure

The maximum credit risk exposure of the Group and the Bank in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

35 Financial risk management (continued)

The Group	Maximum exposure £m	Offset [2] £m	Net exposure £m
31 December 2018			
Loans and advances to banks, net [1]	2,583	-	2,583
Loans and advances to customers, net [1]	20,684	(456)	20,228
Debt securities, net [1]	132	-	132
	23,399	(456)	22,943
Financial assets at fair value through other comprehensive income	412	-	412
Financial assets at fair value through profit or loss:			
Loans and advances	11,910	-	11,910
Debt securities, treasury and other bills	5,261	-	5,261
	17,171	-	17,171
Derivative assets	15,867	(8,343)	7,524
Off-balance sheet items:			
Acceptances and endorsements	163	-	163
Other items serving as direct credit substitutes	147	-	147
Performance bonds and other transaction related contingencies	155	-	155
Irrevocable commitments and guarantees	16,464	-	16,464
	16,929	-	16,929
	73,778	(8,799)	64,979

The Bank	Maximum exposure £m	Offset [2] £m	Net exposure £m
31 December 2018			
Loans and advances to banks, net [1]	2,561	-	2,561
Loans and advances to customers, net [1]	17,036	(456)	16,580
Debt securities, net [1]	132	-	132
	19,729	(456)	19,273
Financial assets at fair value through other comprehensive income	412	-	412
Financial assets at fair value through profit or loss:			
Loans and advances	11,910	-	11,910
Debt securities, treasury and other bills	5,182	-	5,182
	17,092	-	17,092
Derivative assets	15,867	(8,343)	7,524
Off-balance sheet items:			
Acceptances and endorsements	163	-	163
Other items serving as direct credit substitutes	147	-	147
Performance bonds and other transaction related contingencies	155	-	155
Irrevocable commitments and guarantees	15,366	-	15,366
	15,831	-	15,831
	68,931	(8,799)	60,132

1 Amounts shown net of related impairment allowances.

2 Offset items comprise deposit amounts available for offset, and amounts available for offset under master netting arrangements, that do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

B. Concentrations of exposure

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products.

At 31 December 2018 the most significant concentrations of exposure were in Financial, business and other services (comprising 78 per cent of total loans and advances to customers) and to Manufacturing (comprising 8 per cent of the total).

35 Financial risk management (continued)

Loans and advances to customers

	The Group £m	The Bank £m
31 December 2018		
Agriculture, forestry and fishing	**7**	**-**
Energy and water supply	**160**	**160**
Manufacturing	**1,564**	**1,556**
Construction	**216**	**9**
Transport, distribution and hotels	**181**	**166**
Postal and telecommunications	**316**	**311**
Property companies	**1,172**	**1,088**
Financial, business and other services	**16,160**	**13,836**
Mortgages	**707**	**-**
Other: Personal	**83**	**-**
Lease financing	**136**	**-**
Hire purchase	**81**	**-**
Total loans and advances to customers before allowance for impairment losses	**20,783**	**17,126**
Allowance for impairment losses (note 16)	**(101)**	**(90)**
Total loans and advances to customers	**20,682**	**17,036**

C. Credit quality of assets

Loans and advances

The analysis of lending has been prepared with the business segment in which the exposure is recorded reflected in the ratings system applied. The internal credit ratings systems used by the Group for commercial business reflects the characteristics of these exposures and the way that they are managed internally; these credit ratings are set out below. All probabilities of default (PDs) include forward-looking information and are based on 12 month values, with the exception of credit impaired.

	Corporate	
	Grade	IFRS 9 PD%
Good quality	**1-10**	**0.00-0.50**
Satisfactory quality	**11-14**	**0.51-3.00**
Lower quality	**15-18**	**3.01–20.00**
Below standard	**19**	**20.01–99.99**
Credit impaired	**20-23**	**100**

The Group **Gross carrying amount**	Loans and advances to banks £m	Loans and advances to customers £m
At 31 December 2018		
Stage 1		
Good quality	**2,584**	**19,594**
Satisfactory quality	**-**	**712**
Lower quality	**-**	**153**
Below standard, but not credit-impaired	**-**	**-**
	2,584	**20,459**
Stage 2		
Good quality	**-**	**-**
Satisfactory quality	**-**	**1**
Lower quality	**-**	**22**
Below standard, but not credit-impaired	**-**	**-**
	-	**23**
Stage 3		
Credit-impaired	**-**	**303**
Purchased or originated credit-impaired		
Credit-impaired	**1**	**-**
Total	**2,585**	**20,785**

35 Financial risk management (continued)

The Group **Loan commitments and financial guarantees**	**Loans and advances to customers £m**
At 31 December 2018	
Stage 1	
Good quality	**16,209**
Satisfactory quality	**281**
Lower quality	**56**
Below standard, but not credit-impaired	**-**
	16,546
Stage 2	
Good quality	**-**
Satisfactory quality	**-**
Lower quality	**-**
Below standard, but not credit-impaired	**-**
	-
Stage 3	
Credit-impaired	**-**
Purchased or originated credit-impaired	
Credit-impaired	**-**
Total	**16,546**

The Bank **Gross carrying amount**	**Loans and advances to banks £m**	**Loans and advances to customers £m**
At 31 December 2018		
Stage 1		
Good quality	**2,562**	**16,031**
Satisfactory quality	**-**	**665**
Lower quality	**-**	**153**
Below standard, but not credit-impaired	**-**	**-**
	2,562	**16,849**
Stage 2		
Good quality	**-**	**-**
Satisfactory quality	**-**	**-**
Lower quality	**-**	**-**
Below standard, but not credit-impaired	**-**	**-**
	-	**-**
Stage 3		
Credit-impaired	**-**	**277**
Purchased or originated credit-impaired		
Credit-impaired	**-**	**-**
Total	**2,562**	**17,126**

35 Financial risk management (continued)

The Bank **Loan commitments and financial guarantees**	**Loans and advances to customers** **£m**
At 31 December 2018	
Stage 1	
Good quality	**15,029**
Satisfactory quality	**281**
Lower quality	**56**
Below standard, but not credit-impaired	**-**
	15,366
Stage 2	
Good quality	**-**
Satisfactory quality	**-**
Lower quality	**-**
Below standard, but not credit-impaired	**-**
	-
Stage 3	
Credit-impaired	**-**
Purchased or originated credit-impaired	
Credit-impaired	**-**
Total	**15,366**

Loans and advances carried at fair value through profit or loss includes £11,907 million for the Group and for the Bank of trading assets of which £15,029 million for the Group and for the Bank have a good quality rating and £281 million for the Group and the Bank have a satisfactory rating. The remaining £3 million Loans and advances carried at fair value through profit or loss for the Group and for the Bank is Other assets mandatorily held at fair value through profit or loss, all of which is viewed by the business as investment grade.

Debt securities held at amortised cost

An analysis by credit rating of debt securities held at amortised cost is provided below:

The Group and the Bank	**Investment grade [1]** **£m**	**Other [2]** **£m**	**Total** **£m**
31 December 2018			
Asset-backed securities:			
Mortgage-backed securities	**-**	**-**	**-**
Other asset-backed securities	**132**	**-**	**132**
	132	**-**	**132**
Corporate and other debt securities	**-**	**-**	**-**
Gross exposure	**132**	**-**	**132**
Allowance for impairment losses			**-**
Total debt securities held at amortised cost			**132**

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

2 Other comprises sub-investment grade (2018: £nil million for the Group and £nil for the Bank) and not rated (2018: £nil million for the Group and £nil for the Bank).

Financial assets at fair value through other comprehensive income

An analysis of financial assets at fair value through other comprehensive income is included in note 17. The credit quality of financial assets at fair value through other comprehensive income (excluding equity shares) is set out below:

35 Financial risk management (continued)

The Group	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Debt securities			
Government securities	-	-	-
Bank and building society certificates of deposit	118	-	118
Asset-backed securities:			
Mortgage-backed securities	121	-	121
Other asset-backed securities	-	73	73
	121	73	194
Corporate and other debt securities	18	-	18
Total debt securities	257	73	330
Treasury and other bills	82	-	82
Total financial assets at fair value through other comprehensive income	339	73	412

1 Credit ratings equal to or better than 'BBB'.
2 Other comprises sub-investment grade (2018: £nil million) and not rated (2018: £73 million).

The Bank	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Debt securities			
Government securities	-	-	-
Bank and building society certificates of deposit	118	-	118
Asset-backed securities:			
Mortgage-backed securities	121	-	121
Other asset-backed securities	-	73	73
	121	73	194
Corporate and other debt securities	18	-	18
Total debt securities	257	73	330
Treasury and other bills	82	-	82
Total financial assets at fair value through other comprehensive income	339	73	412

1 Credit ratings equal to or better than 'BBB'.
2 Other comprises sub-investment grade (2018: £nil million) and not rated (2018: £73 million).

Debt securities, treasury and other bills held at fair value through profit or loss
An analysis of financial assets at fair value through profit or loss is included in note 12. The credit quality of debt securities, treasury and other bills held at fair value through profit or loss is set out below.

35 Financial risk management (continued)

The Group	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Trading assets			
Government securities	**4,898**	**-**	**4,898**
Bank and building society certificates of deposit	**-**	**-**	**-**
Asset-backed securities:			
Mortgage-backed securities	**10**	**-**	**10**
Other asset-backed securities	**43**	**-**	**43**
	53	**-**	**53**
Corporate and other debt securities	**205**	**26**	**231**
Total held as trading assets	**5,156**	**26**	**5,182**
Other assets mandatorily at fair value through profit or loss			
Government securities	**-**	**-**	**-**
Bank and building society certificates of deposit	**59**	**-**	**59**
Corporate and other debt securities	**-**	**-**	**-**
Total debt securities mandatorily at fair value through profit or loss	**59**	**-**	**59**
Treasury and other bills	**20**	**-**	**20**
Total other assets mandatorily at fair value through profit or loss	**79**	**-**	**79**
	5,235	**26**	**5,261**
Due from fellow Lloyds Banking Group undertakings:			
Corporate and other debt securities	**-**	**-**	**-**
Total held at fair value through profit or loss	**5,235**	**26**	**5,261**

1 Credit ratings equal to or better than 'BBB'.
2 Other comprises sub-investment grade (2018: £nil million) and not rated (2018: £26 million).

The Bank	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Trading assets			
Government securities	**4,898**	**-**	**4,898**
Bank and building society certificates of deposit	**-**	**-**	**-**
Asset-backed securities:			
Mortgage-backed securities	**10**	**-**	**10**
Other asset-backed securities	**43**	**-**	**43**
	53	**-**	**53**
Corporate and other debt securities	**205**	**26**	**231**
Total held as trading assets	**5,156**	**26**	**5,182**
Other assets mandatorily at fair value through profit or loss			
Government securities	**-**	**-**	**-**
Bank and building society certificates of deposit	**-**	**-**	**-**
Corporate and other debt securities	**-**	**-**	**-**
Total debt securities mandatorily at fair value through profit or loss	**-**	**-**	**-**
Treasury and other bills	**-**	**-**	**-**
Total other assets mandatorily at fair value through profit or loss	**-**	**-**	**-**
	5,156	**26**	**5,182**
Due from fellow Lloyds Banking Group undertakings:			
Corporate and other debt securities	**-**	**-**	**-**
Total held at fair value through profit or loss	**5,156**	**26**	**5,182**

1 Credit ratings equal to or better than 'BBB'.
2 Other comprises sub-investment grade (2018: £nil million) and not rated (2018: £26 million).

35 Financial risk management (continued)

Derivative assets

An analysis of derivative assets is given in note 13.

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net credit risk relating to derivative assets of £15,867 million for the Group, cash collateral of £3,143 million for the Group was held and a further £119 million for the Group was due from OECD banks.

The Group	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Trading and other	**12,091**	**838**	**12,929**
Hedging	**-**	**-**	**-**
	12,091	**838**	**12,929**
Due from fellow Lloyds Banking Group undertakings:			**2,938**
Total derivative financial instruments			**15,867**

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

2 Other comprises sub-investment grade (2018: £638 million) and not rated (2018: £200 million).

The Bank	Investment grade [1] £m	Other [2] £m	Total £m
31 December 2018			
Trading and other	**12,091**	**838**	**12,929**
Hedging	**-**	**-**	**-**
	12,091	**838**	**12,929**
Due from fellow Lloyds Banking Group undertakings:			**2,992**
Total derivative financial instruments			**15,921**

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

2 Other comprises sub-investment grade (2018: £638 million) and not rated (2018: £200 million).

Financial guarantees and irrevocable loan commitments

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

D. Collateral held as security for financial assets

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

Loans and receivables

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

Loans and advances to banks

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £2,583 million for the Group and the Bank, against which the Group and the Bank held collateral of £1,179 million.

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

Commercial lending

Reverse repurchase transactions

At 31 December 2018 there were reverse repurchase agreements which were accounted for as collateralised loans with a carrying value of £4,604 million for the Group and the Bank against which the Group and the Bank held collateral with a fair value of £3,143 million all of which the Group was able to repledge. No collateral in the form of cash was provided in respect of reverse repurchase agreements to the Group or the Bank. These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

35 Financial risk management (continued)

Stage 3 secured lending

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

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

Stage 1 and Stage 2 secured lending

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

Stage 1 and Stage 2 secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for Stage 3 lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured commercial lending portfolio is provided to key management personnel.

Financial assets at fair value through profit or loss (excluding equity shares)

Included in financial assets at fair value through profit or loss are reverse repurchase agreements treated as collateralised loans with a carrying value of £11,669 million for the Group and the Bank. Collateral is held with a fair value of £11,669 million for the Group and the Bank, all of which the Group is able to repledge.

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

Derivative assets, after offsetting of amounts under master netting arrangements

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £8,343 million for the Group and the Bank, cash collateral of £3,663 million for the Group and for the Bank was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2018, there were no irrevocable loan commitments or other credit-related contingencies for the Group or the Bank.

E. Collateral pledged as security

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

Repurchase transactions

Deposits from banks

Included in deposits from banks are balances arising from repurchase transactions of £nil million for the Group and £nil million for the Bank; the fair value of the collateral provided under these agreements at 31 December 2018 was £nil million for the Group and £nil million for the Bank.

Customer deposits

Included in customer deposits are balances arising from repurchase transactions of £372 million for the Group and the Bank; the fair value of the collateral provided under these agreements at 31 December 2018 was £372 million for the Group and the Bank.

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

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowing, where the secured party is permitted by contract or custom to repledge was £nil million for the Group and the Bank.

Securities lending transactions

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

	The Group and the Bank 2018 £m
Financial assets at fair value through profit or loss	**945**
Financial assets at fair value through other comprehensive income	**892**
Total	**1,837**

35 Financial risk management (continued)

(2) Market risk

Interest rate risk

Interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. The rates on the remaining deposits are contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However, a significant proportion of the Group's lending assets, for example many personal loans and mortgages, bear interest rates which are contractually fixed.

The Group's risk management policy is to optimise reward whilst managing its market risk exposures within the risk appetite defined by the board. The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates and is managed through the Group's structural hedge. The structural hedge consists of longer-term fixed rate assets or interest rate swaps and the amount and duration of the hedging activity is reviewed regularly by the Lloyds Banking Group Asset and Liability Committee.

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

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

At 31 December 2018 the aggregate notional principle of interest rate swaps designated as fair value hedges was £5,366 million for the Group and Bank with a net fair value asset of £nil and a net fair value liability of £nil. There were gains recognised on the hedging instruments of £50 million for the Group and Bank. There were losses on the hedged items attributable to the hedged risk of £46 million for the Group and Bank. The gains and losses relating to the fair value hedges are recorded in net trading income.

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the commercial business. Note 13 shows when the hedged cash flows are expected to occur and when they will affect income for the designated cash flow hedges. The notional principle of the interest rate swaps designated as cash flow hedges at 31 December 2018 was £1,998 million for the Group and Bank with a fair value asset of £nil and a fair value liability of £nil. Ineffectiveness recognised in the income statement that arises from cash flow hedges was £nil for the Group and Bank.

Currency risk

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market and liquidity risk function in London. The Group also manages foreign currency risk via cash flow hedge accounting, utilising currency swaps.

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

The Group's main overseas operations are in the USA, Europe and Singapore. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

The Group	US Dollar £m	Other non-sterling £m
31 December 2018		
Group exposure	**69**	1
Net investment hedges	**-**	-
Total structural foreign currency exposures, after net investment hedges	**69**	1

35 Financial risk management (continued)

(3) Liquidity risk

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The tables below analyse financial instrument liabilities of the Group and the Bank on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

The Group	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
31 December 2018						
Deposits from banks	1	304	143	588	2,141	3,177
Customer deposits	19,749	3,264	2,521	253	1,083	26,870
Derivative financial instruments	1,686	768	1,057	2,191	8,809	14,511
Trading and other financial liabilities at fair value through profit or loss	3,286	6,689	2,725	685	623	14,008
Debt securities in issue	1,182	1,698	2,746	5,556	1,760	12,942
Subordinated liabilities	725	-	-	-	-	725

The Bank	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
31 December 2018						
Deposits from banks	1	304	142	588	2,141	3,176
Customer deposits	8,161	2,909	1,842	184	1,084	14,180
Derivative financial instruments	1,686	768	1,056	2,191	8,809	14,510
Trading and other financial liabilities at fair value through profit or loss	3,286	6,689	2,725	685	623	14,008
Debt securities in issue	1,182	1,698	2,746	5,556	1,760	12,942
Subordinated liabilities	725	-	-	-	-	725

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

The Group	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
31 December 2018					
Acceptances and endorsements	117	46	-	-	163
Other contingent liabilities	140	48	114	-	302
Total contingent liabilities	257	94	114	-	465
Lending commitments and guarantees	21	-	-	-	21
Other commitments	1,818	5,208	9,113	386	16,525
Total commitments and guarantees	1,839	5,208	9,113	386	16,546
Total contingents and commitments	2,096	5,302	9,227	386	17,011

35 Financial risk management (continued)

The Bank	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
31 December 2018					
Acceptances and endorsements	**117**	**46**	**-**	**-**	**163**
Other contingent liabilities	**140**	**48**	**114**	**-**	**302**
Total contingent liabilities	**257**	**94**	**114**	**-**	**465**
Lending commitments and guarantees	**-**	**-**	**-**	**-**	**-**
Other commitments	**1,686**	**4,639**	**8,658**	**383**	**15,366**
Total commitments and guarantees	**1,686**	**4,639**	**8,658**	**383**	**15,366**
Total contingents and commitments	**1,943**	**4,733**	**8,772**	**383**	**15,831**

36 Capital disclosures

Capital management

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

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

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is set at 8 per cent of total risk-weighted assets calculated in respect of credit risk, counterparty credit risk, operational risk and market risk. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital.

The minimum requirement for capital is supplemented by Pillar 2 of the regulatory framework. Under Pillar 2A, additional requirements are set through the issuance of a bank specific Individual Capital Requirement (ICR), which adjusts the Pillar 1 minimum requirement for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICR process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process (ICAAP).

A range of additional bank specific regulatory capital buffers apply under CRD IV, which are required to be met with CET1 capital. These include a capital conservation buffer (1.875 per cent of risk-weighted assets during 2018, increasing to 2.5 per cent from 1 January 2019) and a time-varying countercyclical capital buffer (currently 0.5 per cent of risk-weighted assets).

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

Regulatory capital development

The regulatory framework within which the Group operates continues to be developed at a global level through the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS), at a European level mainly through the European Commission (EC) and the issuance of CRD IV technical standards and guidelines by the European Banking Authority (EBA) and within the UK by the PRA and through directions from the Financial Policy Committee (FPC).The Group continues to monitor these developments very closely, analysing potential capital impacts to ensure the Group and individual regulated entities continue to maintain a strong capital position that exceeds the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

Capital resources

Regulatory capital is divided into tiers depending on the degree of permanency and loss absorbency exhibited.

- Common equity tier 1 (CET1) capital represents the strongest form of capital consisting of shareholders' equity after a number of regulatory adjustments and deductions are applied. These include the elimination of the cash flow hedging reserve and debit valuation adjustment.
- Fully qualifying additional tier 1 (AT1) capital comprises non-cumulative perpetual securities containing specific provisions to write down the security should the CET1 ratio fall to a defined trigger limit.
- Tier 2 (T2) capital comprises certain other subordinated debt securities that do not qualify as AT1. They must have an original term of at least 5 years, cannot normally be redeemed within their first 5 years and are phased out as T2 regulatory capital in the final 5 years before maturity.

36 Capital disclosures (continued)

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

	2018 £m
Common equity tier 1 capital	2,723
Additional tier 1 capital	757
Tier 2 capital	672
Total capital	**4,152**

37 Notes to the Cash flow statement

a Change in operating assets

	The Group £m	The Bank £m
Change in financial assets held at amortised cost	(6,275)	(5,894)
Changes in amounts due from fellow Lloyds Banking Group undertakings	6,206	(1,388)
Change in derivative financial instruments and financial assets at fair value	(9,852)	(9,908)
Change in other operating assets	(913)	(933)
Change in operating assets	**(10,834)**	**(18,123)**

b Change in operating liabilities

	The Group 2018 £m	The Bank 2018 £m
Change in deposits from banks	3,177	3,176
Change in customer deposits	13,964	14,007
Changes in amounts due to fellow Lloyds Banking Group undertakings	(540)	6,501
Change in debt securities in issue	12,942	12,942
Change in derivative financial instruments and financial liabilities at fair value	5,192	5,191
Change in other operating liabilities	(100)	99
Change in operating liabilities	**34,635**	**41,916**

c Non-cash and other items

	The Group 2018 £m	The Bank 2018 £m
Depreciation and amortisation	2	2
Foreign exchange element on balance sheet [1]	2	-
Other non-cash items	(17)	(7)
Non-cash and other items	**(13)**	**(5)**

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

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

	The Group 2018 £m	The Bank 2018 £m
Cash and balances with central banks	14,448	14,441
Less: mandatory reserve deposits [1]	(12)	(12)
	14,436	14,429
Loans and advances to banks	2,583	2,561
Less: amounts with a maturity of three months or more	(1,541)	(1,540)
	1,042	1,021
Total cash and cash equivalents	**15,478**	**15,450**

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

38 Events since the balance sheet date

There are no post balance sheet events requiring disclosure in these financial statements.

39 Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2018 and have not been applied in preparing these financial statements. Save as disclosed below, the impact of these accounting changes is still being assessed by the Group and reliable estimates cannot be made at this stage.

With the exception of certain minor amendments, as at the date of signing these financial statements these pronouncements have been endorsed by the EU.

IFRS 16 Leases

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

The Group's accounting as a lessor will remain aligned to the current approach under IAS 17; however for lessee accounting there will no longer be a distinction between finance and operating leases. The transition approach adopted by the Group will result in the recognition of right of use assets and lease liabilities of approximately £73 million in respect of leased properties previously accounted for as operating leases. As permitted by the transition options under IFRS 16, comparative figures for the prior year will not be restated. Going forward, the Group will recognise a finance charge on the lease liability and a depreciation charge on the right-of-use asset, whereas previously the Group included lease rentals within operating expenses. The Group intends to take advantage of a number of exemptions within IFRS 16, including the election not to recognise a lease liability and a right-of-use asset for leases for which the underlying asset is of low value.

Minor amendments to other accounting standards

The IASB has issued a number of minor amendments to IFRSs effective 1 January 2019 and 1 January 2020 (including IAS 19 Employee Benefits, IAS 12 Income Taxes and IFRIC 23 Uncertainty over Income Tax Treatments). The Group will adopt the changes to IAS 12 Income Taxes with effect from 1 January 2019, resulting in the presentation of the tax benefit of distributions on other equity instruments in the Group's income statement; these impacts are currently recognised directly in equity. Comparative information will be restated. For the comparative year ended 31 December 2018, this will result in the reclassification of a tax credit of £7 million. These changes will have no impact on the Group's reported balance sheet or profit before tax. The amendments to other accounting standards are not expected to have a significant impact on the Group.

40 Ultimate parent undertaking and controlling party

Lloyds Bank Corporate Markets plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and overseas.

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

Notes to the financial statements

41 Subsidiaries and related undertakings

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Bank, as at 31 December 2018. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the Group. All shares held are ordinary shares unless indicated otherwise in the notes.

The Bank directly or indirectly holds 100% of the share class and a majority of voting rights in the following undertakings.

Subsidiary undertakings	Bank interest	Registered Address
Black Horse Offshore Limited	100.00%	PO Box 311, 11-12 Esplanade, St Helier, Jersey JE4 8ZU
Lloyds America Securities Corporation	100.00% [a.]	1095 Avenue of the America's, 34th Floor, New York, NY 10036, United States
Lloyds Bank (International Services) Limited (formerly Lloyds Bank (Gibraltar) Limited)	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA
Lloyds Bank Corporate Asset Finance (No.1) Limited	100.00%	25 Gresham Street, London EC2V 7HN
Lloyds Bank Corporate Markets Wertpapierhandelsbank GMBH	100.00%	Thurn-Und, Frankfurt Am Main, 60313, Germany
Lloyds Bank International Limited	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA
Lloyds Corporate Services (Jersey) Limited	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA
Lloyds Holdings (Jersey) Limited	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA
Lloyds Investment Fund Managers Limited	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA
Lloyds Merchant Bank Asia Limited	100.00% [b.]	138 Market Street #21-01, Capitagreen, 048946, Singapore
Lloyds Nominees (Guernsey) Limited	100.00%	PO Box 123, Sarnia House, Le Truchot, St. Peter Port, Guernsey, GY1 4EF
Lloyds Securities Inc.	100.00% [c.]	1095 Avenue of the America's, 34th Floor, New York, NY 10036, United States
Nominees (Jersey) Limited	100.00%	11-12 Esplanade, St Helier, Jersey JE2 3QA

Notes
a.10,000 US$ No par value
b. 2,000,000 SGD 1.00 Preferred ordinary Sg$1   13,000,000 SGD 1.00 Ordinary Sg$1
c. 10 US$ 0.1% common