

# Lloyds TSB Bank plc

Report and Accounts  
**2012**

Member of Lloyds Banking Group



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Lloyds TSB Bank plc  
Directors' report

## Results

The consolidated income statement on page 12 shows a loss attributable to equity shareholders for the year ended 31 December 2012 of £1,271 million.

## Principal activities

Lloyds TSB Bank plc (the Bank) and its subsidiary undertakings (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

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

## Business review

For the year ended 31 December 2012, the Group recorded a loss before tax of £474 million compared with a loss before tax in 2011 of £1,531 million; the result in both years reflected significant Payment Protection Insurance provisions (2012: £3,575 million; 2011: £3,200 million).

Total income increased by £10,169 million, or 36 per cent, to £38,795 million in 2012 compared with £28,626 million in 2011, comprising a £14,270 million increase in other income only partly offset by a decrease of £4,101 million in net interest income.

Net interest income was £8,755 million in 2012; a decrease of £4,101 million, or 32 per cent compared to £12,856 million in 2011. There was an adverse impact of £1,647 million from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies included in the consolidated results of the Group. After adjusting for this, there was a reduction in net interest income of 19 per cent reflecting a decrease in average interest-earning assets across all divisions, mainly due to subdued lending demand and the disposal of assets outside of the Group's risk appetite. It was also driven by a decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds.

Other income was £14,270 million, or 90 per cent, higher at £30,040 million in 2012 compared to £15,770 million in 2011. Fee and commission income was £203 million, or 4 per cent, lower at £4,732 million compared to £4,935 million in 2011. Fee and commission expense increased by £47 million or 3 per cent to £1,438 million compared with £1,391 million in 2011. Net trading income increased by £14,642 million to £13,817 million in 2012 compared to a deficit of £825 million in 2011; this increase included an improvement of £14,024 million in gains on policyholder investments held within the insurance business, offset by a similar increase in the related claims expense. Insurance premium income was largely unchanged at £8,284 million in 2012 compared with £8,170 million in 2011; an increase of £114 million or 1 per cent. Other operating income was £236 million lower at £4,645 million in 2012 compared to £4,881 million in 2011. In 2012 there were profits on the sale of government bonds as the Group repositions its portfolio and a positive variance of £891 million in the income arising from the movement in value of in-force insurance business; this offset the impact of the non-repetition of a £2,083 million gain in 2011 which resulted from the repurchase at fair value of senior debt held by subsidiaries of Lloyds Banking Group plc by means of the issue of subordinated debt securities.

Insurance claims expense was £12,355 million higher at £18,396 million in 2012 compared to £6,041 million in 2011. The insurance claims expense in respect of life and pensions business was £12,340 million higher at £18,031 million in 2012 compared to £5,691 million in 2011; this increase in claims was matched by a similar improvement in net trading income, reflecting the improved performance of policyholder investments. Insurance claims in respect of general insurance business were £15 million, or 4 per cent, higher at £365 million compared to £350 million in 2011.

Operating expenses decreased by £298 million, or 2 per cent to £15,724 million in 2012 compared with £16,022 million in 2011. Both years included significant charges in respect of regulatory provisions (2012: £4,175 million; 2011: £3,375 million); operating expenses excluding these provisions were £1,098 million, or 9 per cent lower at £11,549 million in 2012 compared with £12,647 million in 2011. Staff costs were £717 million, or 12 per cent lower at £5,449 million in 2012 compared with £6,166 million in 2011. Excluding the past service pension credit in 2012, staff costs were £467 million, or 8 per cent lower at £5,699 million compared with £6,166 million in 2011 due to the ongoing impact of headcount reductions, more than offsetting the effect of annual pay rises. Premises and equipment costs were £102 million, or 10 per cent, lower at £949 million compared with £1,051 million in 2011. Other expenses (excluding the charges in respect of payment protection insurance and other regulatory provisions of £4,175 million from 2012 and £3,375 million from 2011) were £165 million, or 5 per cent, lower at £3,025 million in 2012 compared with £3,190 million in 2011 as increased technology-related spend was more than offset by reductions in advertising spend and in other costs. Depreciation and amortisation costs were £49 million, or 2 per cent, lower at £2,126 million in 2012 compared to £2,175 million in 2011. In 2011, there had been a charge of £65 million in relation to the impairment of tangible fixed assets; there was no such charge in 2012.

Impairment losses decreased by £2,945 million, or 36 per cent, to £5,149 million in 2012 compared with £8,094 million in 2011. Impairment losses in respect of loans and advances to customers were £2,895 million, or 36 per cent, lower at £5,125 million compared with £8,020 million in 2011. The overall performance of the portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although improving, unemployment.

The impairment charge in respect of debt securities classified as loans and receivables was £53 million better at a credit of £4 million in 2012 compared to a charge of £49 million in 2011 and the impairment charge in respect of available-for-sale financial assets was £43 million, or 54 per cent lower at £37 million in 2012 compared to £80 million in 2011. There was a release of £9 million in respect of other credit provisions compared to a release of £55 million in 2011, as a number of commitments have now been drawn down.

In 2012, the Group recorded a tax charge of £713 million compared to a tax credit of £736 million in 2011. The tax charge of £713 million in 2012 arose on a loss before tax of £474 million, an effective rate of 150 per cent. An effective rate of 150 per cent represents a greater tax burden than that implied by the UK Statutory rate. This is primarily due to a policyholder tax charge arising from the revaluation of policyholder tax credits, in light of current economic forecasts and recent changes to the taxation of life insurance companies. An additional tax charge results from the impact of the UK corporation tax rate reduction to 23 per cent with effect from 1 April 2013 on the net deferred tax asset.

The Group continues to focus on improving its risk profile and further strengthening its balance sheet, through improving the capital and funding position and making continued progress on reducing holdings of assets outside of its risk appetite, despite challenging market conditions, resulting in a reduction in such assets of £42 billion to £98 billion. There was a further strengthening of the funding position, with an improvement in the maturity profile of wholesale funding.

Total assets at 31 December 2012 were £942,794 million, £45,572 million, or 5 per cent, lower compared to £988,366 million at 31 December 2011. The decrease reflects the continuing disposal of assets which are outside of the Group's risk appetite, customer deleveraging and de-risking and subdued demand in lending markets.

Customer deposits increased by £12,485 million, or 3 per cent, to £436,862 million compared to £424,377 million at 31 December 2011, following growth in retail savings balances. Overall, however, the funding requirement declined, with deposits from banks decreasing £1,405 million from £39,810 million at

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Directors' report

31 December 2011 to £38,405 million at 31 December 2012 and a reduction of £67,687 million in debt securities in issue from £184,504 million at 31 December 2011 to £116,817 million at 31 December 2012.

Shareholders' equity decreased by £2,198 million, from £50,599 million at 31 December 2011 to £48,401 million at 31 December 2012, as a result of the loss for the year, coupled with the realisation of gains on available-for-sale financial assets.

As at 31 December 2012, the Group's capital ratios had increased with a total capital ratio of 16.5 per cent (compared to 14.8 per cent at 31 December 2011); a tier 1 capital ratio of 15.8 per cent (compared to 14.3 per cent at 31 December 2011); and a core tier 1 ratio of 13.5 per cent (compared to 12.2 per cent at 31 December 2011). During 2012 risk-weighted assets decreased by £42,042 million to £310,299 million at 31 December 2012 compared with £352,341 million at 31 December 2011; this decrease reflected risk-weighted asset reductions across all divisions driven by reductions in assets outside of the Group's risk appetite, lower lending balances and strong management of risk. Risk-weighted assets in the Retail division were £7,767 million lower, risk-weighted assets in Commercial Banking were £27,676 million lower and those in Wealth, Asset Finance and International were £7,426 million lower.

#### Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 54 on page 123. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 7 to 10. This information is incorporated into this report by reference. Additional information can be found in the annual report of Lloyds Banking Group plc, the Bank's ultimate parent, which does not form part of this report.

#### 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 a number of key dependencies as discussed in the Principal risks and uncertainties section under Liquidity and funding on page 9 and additionally have considered projections for the Group's capital and funding position. Having considered these, the Directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

#### Directors

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

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

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

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

#### Directors' interests

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

#### Directors' conflicts of interest

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

#### Directors' indemnities

The Directors of the Bank, including the former Directors who retired during the year and since the year end, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. In addition, Lloyds Banking Group plc has granted a deed of indemnity through deed poll which constituted 'third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' to the Directors of the Bank's subsidiary companies, including to former Directors who retired during the year and since the year end. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Directors who joined the Boards in 2012 and 2013. The indemnities remain in force for the duration of a Director's period of office. The deeds indemnify the Directors to the maximum extent permitted by law. Deeds for existing Directors are available for inspection at the Bank's registered office.

#### Share capital

Information about share capital and dividends is shown in notes 45 and 49 on pages 90 and 92 and is incorporated into this report by reference.

#### Employees

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

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

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

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

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

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

The Bank has signed up to the 'Prompt Payment Code' published by the Department for Business Innovation and Skills (BIS), regarding the making of payments to suppliers. Information about the 'Prompt Payment Code' may be obtained by visiting [www.promptpaymentcode.org.uk](http://www.promptpaymentcode.org.uk).

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

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 31 (2011: 33 days). This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2012 bears to the aggregate of the amounts invoiced by suppliers during the year.

#### **Essential business contracts**

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

#### **Significant contracts**

Details of related party transactions are set out in note 51 on pages 99 to 102.

#### **Research and development activities**

During the ordinary course of business the Bank develops new products and services.

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

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

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

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the 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. 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](http://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, whose names are shown on page 5 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Bank and Group and the profit or loss of the Group;
- the business review includes a fair review of the development and performance of the business and the position of the Bank and Group; and
- the principal risks and uncertainties faced by the Bank and the Group are set out on pages 7 to 10.

#### **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 2013 annual general meeting to reappoint PricewaterhouseCoopers LLP as auditors. The Bank's Audit Committee is satisfied that the external auditors remain independent and effective.

On behalf of the Board

#### **Claire A Davies**

Company Secretary  
1 March 2013

Company Number 2065

## Directors

Sir Winfried Bischoff *Chairman*

A Horta-Osório *Group Chief Executive*

M G Culmer *Group Finance Director*

Lord Blackwell

C J Fairbairn

A M Frew

D L Roberts

T T Ryan, Jr

M A Scicluna

A Watson CBE

S V Weller

## Forward looking statements

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

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

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

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



## Principal risks and uncertainties

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

### CREDIT RISK

#### Definition

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

#### Principal risks

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

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

#### Mitigating actions

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

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

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

### CONDUCT RISK

#### Definition

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

#### Principal risks

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

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

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

#### Mitigating actions

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

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

### MARKET RISK

#### Definition

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

#### Principal risks

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

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

## Principal risks and uncertainties

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

### Mitigating actions

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

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

A variety of risk measures are used such as:

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

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

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

## OPERATIONAL RISK

### Definition

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

### Principal risks

The principal operational risks currently facing the Group are:

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

### Mitigating actions

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

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

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

## PEOPLE RISK

### Definition

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

### Principal risks

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

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

- The Group's continuing structural consolidation and the sale of part of its branch network under Project Verde may disrupt its ability to lead and manage its people effectively in some areas;
- The developing and increasingly rigorous and intrusive regulatory environment may challenge the Group's people strategy, remuneration practices and retention; and
- Negative political and media attention on banking sector culture, sales practices and ethical conduct may impact colleague engagement, investor sentiment and the Group's cost base.

## Principal risks and uncertainties

### Mitigating actions

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

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

### LIQUIDITY AND FUNDING RISK

#### Definition

Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

#### Principal risks

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

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

#### Mitigating actions

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

- The Group's liquidity and funding position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term wholesale funding;
- Daily monitoring and control processes are in place to address regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group;
- The Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA on an ongoing basis. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics; and
- The Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

### INSURANCE RISK

#### Definition

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

#### Principal risks

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

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

#### Mitigating actions

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

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

Insurance risk is reported regularly to appropriate committees and boards.

### STATE FUNDING AND STATE AID

#### Principal risks

HM Treasury currently holds 39.2 per cent of Lloyds Banking Group's ordinary share capital. United Kingdom Financial Investments Limited (UKFI), as manager of HM Treasury's shareholding, continues to operate in line with the framework document between UKFI and HM Treasury, managing the investment in Lloyds Banking Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group.

In addition, Lloyds Banking Group is subject to European State Aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and remedy any distortion of competition and trade in

## Principal risks and uncertainties

the European Union (EU) arising from the State Aid given to Lloyds Banking Group. This has placed a number of requirements on Lloyds Banking Group including an asset reduction target from a defined pool of assets by the end of 2014, known as Project Atlantic, and the divestment of certain portions of its Retail business by the end of November 2013, known as Project Verde. There is a risk that if the Group does not deliver its divestment commitments by November 2013, a Divestiture Trustee would be appointed to dispose of the divestment, which could be sold at a negative price.

### Mitigating actions

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

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

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

The Group continues to work closely with the FSA, EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the restructuring plan and mitigate customer impact.

### EMERGING RISKS

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

#### Macroeconomic environment

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

#### Mitigating actions

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

#### Capital risk

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

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

#### Mitigating actions

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

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

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

#### Regulatory change

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

#### Mitigating actions

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

#### Compliance and conduct

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

#### Mitigating actions

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

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

#### Accounting standards

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

#### Mitigating actions

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

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

Lloyds TSB Bank plc  
Independent auditors' report

**INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF LLOYDS TSB BANK PLC**

We have audited the Group and the Bank financial statements (the 'financial statements') of Lloyds TSB Bank plc for the year ended 31 December 2012 which comprise the consolidated income statement, the Group and Bank statements of comprehensive income, the Group and Bank balance sheets, the Group and Bank statements of changes in equity, the Group and Bank cash flow statements and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the Bank financial statements, as applied in accordance with the provisions of the Companies Act 2006.

**Respective responsibilities of directors and auditors**

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

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

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

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Bank's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

**Opinion on financial statements**

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2012 and of the Group's loss and the Group's and Bank's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Bank financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

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

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

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

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

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

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

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

Lloyds TSB Bank plc  
**Consolidated income statement**  
for the year ended 31 December 2012

	Note	2012 £ million	2011 £ million
Interest and similar income		23,932	26,689
Interest and similar expense		(15,177)	(13,833)
<b>Net interest income</b>	5	<b>8,755</b>	12,856
Fee and commission income		4,732	4,935
Fee and commission expense		(1,438)	(1,391)
Net fee and commission income	6	3,294	3,544
Net trading income	7	13,817	(825)
Insurance premium income	8	8,284	8,170
Other operating income	9	4,645	4,881
<b>Other income</b>		<b>30,040</b>	15,770
<b>Total income</b>		<b>38,795</b>	28,626
Insurance claims	10	(18,396)	(6,041)
<b>Total income, net of insurance claims</b>		<b>20,399</b>	22,585
Regulatory provisions		(4,175)	(3,375)
Other operating expenses		(11,549)	(12,647)
<b>Total operating expenses</b>	11	<b>(15,724)</b>	(16,022)
<b>Trading surplus</b>		<b>4,675</b>	6,563
Impairment	12	(5,149)	(8,094)
<b>Loss before tax</b>		<b>(474)</b>	(1,531)
Taxation	14	(713)	736
<b>Loss for the year</b>		<b>(1,187)</b>	(795)
Profit attributable to non-controlling interests		84	73
Loss attributable to equity shareholders		(1,271)	(868)
<b>Loss for the year</b>		<b>(1,187)</b>	(795)

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

Statements of comprehensive income  
for the year ended 31 December 2012

<b>The Group</b>	<b>2012</b> £ million	2011 £ million
<b>Loss for the year</b>	<b>(1,187)</b>	(795)
<b>Other comprehensive income</b>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Adjustment on transfer from held-to-maturity portfolio	<b>1,168</b>	–
Change in fair value	<b>779</b>	2,603
Income statement transfers in respect of disposals	<b>(3,547)</b>	(343)
Income statement transfers in respect of impairment	<b>42</b>	80
Other income statement transfers	<b>290</b>	(155)
Taxation	<b>339</b>	(575)
	<b>(929)</b>	1,610
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	<b>100</b>	893
Net income statement transfers	<b>(92)</b>	70
Taxation	<b>6</b>	(262)
	<b>14</b>	701
Currency translation differences, (tax: nil)	<b>(14)</b>	(84)
<b>Other comprehensive income for the year, net of tax</b>	<b>(929)</b>	2,227
<b>Total comprehensive income for the year</b>	<b>(2,116)</b>	1,432
Total comprehensive income attributable to non-controlling interests	<b>82</b>	72
Total comprehensive income attributable to equity shareholders	<b>(2,198)</b>	1,360
<b>Total comprehensive income for the year</b>	<b>(2,116)</b>	1,432

<b>The Bank</b>	<b>2012</b> £ million	2011 £ million
<b>Profit (loss) for the year</b>	<b>(2,150)</b>	1,537
<b>Other comprehensive income:</b>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Adjustment on transfer from held-to-maturity portfolio	<b>1,168</b>	–
Change in fair value	<b>155</b>	2,708
Income statement transfers in respect of disposals	<b>(3,118)</b>	(234)
Other income statement transfers	<b>169</b>	(78)
Taxation	<b>366</b>	(603)
	<b>(1,260)</b>	1,793
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	<b>(5)</b>	(10)
Net income statement transfers	<b>–</b>	8
Taxation	<b>1</b>	–
	<b>(4)</b>	(2)
Currency translation differences (tax: nil)	<b>(21)</b>	3
<b>Other comprehensive income for the year, net of tax</b>	<b>(1,285)</b>	1,794
<b>Total comprehensive income for the year</b>	<b>(3,435)</b>	3,331

Lloyds TSB Bank plc  
**Balance sheets**  
at 31 December 2012

	Note	The Group		The Bank	
		2012 £ million	2011 £ million	2012 £ million	2011 £ million
<b>Assets</b>					
Cash and balances at central banks		<b>80,298</b>	60,722	<b>74,078</b>	57,500
Items in the course of collection from banks		<b>1,256</b>	1,408	<b>806</b>	898
Trading and other financial assets at fair value through profit or loss	15	<b>154,344</b>	139,243	<b>6,462</b>	4,665
Derivative financial instruments	16	<b>55,129</b>	64,842	<b>32,247</b>	37,517
Loans and receivables:					
Loans and advances to banks	17	<b>29,417</b>	32,606	<b>188,216</b>	167,896
Loans and advances to customers	18	<b>536,107</b>	584,237	<b>240,546</b>	249,113
Debt securities	21	<b>5,273</b>	12,470	<b>492</b>	633
		<b>570,797</b>	629,313	<b>429,254</b>	417,642
Available-for-sale financial assets	23	<b>31,374</b>	37,952	<b>31,092</b>	31,351
Held-to-maturity investments	24	–	8,098	–	8,098
Investment properties	25	<b>5,405</b>	6,122	–	–
Goodwill	26	<b>2,016</b>	2,016	–	–
Value of in-force business	27	<b>6,800</b>	6,638	–	–
Other intangible assets	28	<b>2,792</b>	3,196	<b>411</b>	329
Tangible fixed assets	29	<b>7,342</b>	7,673	<b>2,186</b>	1,731
Current tax recoverable		<b>751</b>	428	<b>1,102</b>	830
Deferred tax assets	42	<b>4,301</b>	4,565	<b>3,796</b>	3,127
Investment in subsidiary undertakings	30	–	–	<b>39,958</b>	40,289
Retirement benefit assets	41	<b>1,867</b>	1,338	<b>738</b>	736
Other assets	31	<b>18,322</b>	14,812	<b>1,547</b>	1,263
		<b>942,794</b>	988,366	<b>623,677</b>	605,976

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



Lloyds TSB Bank plc  
**Balance sheets**  
at 31 December 2012

Equity and liabilities	Note	The Group		The Bank	
		2012 £ million	2011 £ million	2012 £ million	2011 £ million
<b>Liabilities</b>					
Deposits from banks	32	<b>38,405</b>	39,810	<b>214,725</b>	154,592
Customer deposits	33	<b>436,862</b>	424,377	<b>231,773</b>	227,553
Items in course of transmission to banks		<b>996</b>	844	<b>445</b>	487
Trading and other financial liabilities at fair value through profit or loss	34	<b>35,972</b>	24,955	<b>10,841</b>	10,905
Derivative financial instruments	16	<b>48,937</b>	58,701	<b>30,616</b>	35,031
Notes in circulation		<b>1,198</b>	1,145	–	–
Debt securities in issue	35	<b>116,817</b>	184,504	<b>61,494</b>	102,237
Liabilities arising from insurance contracts and participating investment contracts	36	<b>82,968</b>	79,001	–	–
Liabilities arising from non-participating investment contracts	38	<b>54,372</b>	49,636	–	–
Unallocated surplus within insurance businesses	39	<b>267</b>	300	–	–
Other liabilities	40	<b>34,598</b>	32,525	<b>4,524</b>	4,364
Retirement benefit obligations	41	<b>300</b>	381	<b>150</b>	199
Current tax liabilities		<b>138</b>	104	<b>10</b>	24
Deferred tax liabilities	42	<b>327</b>	314	–	1
Other provisions	43	<b>3,961</b>	3,166	<b>2,371</b>	1,624
Subordinated liabilities	44	<b>37,590</b>	37,330	<b>26,249</b>	25,045
<b>Total liabilities</b>		<b>893,708</b>	937,093	<b>583,198</b>	562,062
<b>Equity</b>					
Share capital	45	<b>1,574</b>	1,574	<b>1,574</b>	1,574
Share premium account	46	<b>35,533</b>	35,533	<b>35,533</b>	35,533
Other reserves	47	<b>6,573</b>	7,500	<b>874</b>	2,159
Retained profits	48	<b>4,721</b>	5,992	<b>2,498</b>	4,648
<b>Shareholders' equity</b>		<b>48,401</b>	50,599	<b>40,479</b>	43,914
Non-controlling interests		<b>685</b>	674	–	–
<b>Total equity</b>		<b>49,086</b>	51,273	<b>40,479</b>	43,914
<b>Total equity and liabilities</b>		<b>942,794</b>	988,366	<b>623,677</b>	605,976

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

The directors approved the financial statements on 1 March 2013.

**Sir Winfried Bischoff**  
Chairman

**António Horta-Osório**  
Chief Executive

**George Culmer**  
Finance Director

Statement of changes in equity  
for the year ended 31 December 2012

The Group	Attributable to equity shareholders				Non-controlling interests £ million	Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million		
Balance at 1 January 2011	37,107	5,272	4,512	46,891	841	47,732
<b>Comprehensive income</b>						
(Loss) profit for the year	–	–	(868)	(868)	73	(795)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,611	–	1,611	(1)	1,610
Movements in cash flow hedging reserve, net of tax	–	701	–	701	–	701
Currency translation differences, net of tax	–	(84)	–	(84)	–	(84)
Total other comprehensive income	–	2,228	–	2,228	(1)	2,227
Total comprehensive income	–	2,228	(868)	1,360	72	1,432
<b>Transactions with owners</b>						
Dividends	–	–	–	–	(50)	(50)
Capital contribution	–	–	2,340	2,340	–	2,340
Value of employee services:						
Share option schemes	–	–	8	8	–	8
Change in non-controlling interests	–	–	–	–	(189)	(189)
Total transactions with owners	–	–	2,348	2,348	(239)	2,109
Balance at 31 December 2011	37,107	7,500	5,992	50,599	674	51,273
<b>Comprehensive income</b>						
(Loss) profit for the year	–	–	(1,271)	(1,271)	84	(1,187)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(927)	–	(927)	(2)	(929)
Movements in cash flow hedging reserve, net of tax	–	14	–	14	–	14
Currency translation differences, net of tax	–	(14)	–	(14)	–	(14)
Total other comprehensive income	–	(927)	–	(927)	(2)	(929)
<b>Total comprehensive income</b>	–	(927)	(1,271)	(2,198)	82	(2,116)
<b>Transactions with owners</b>						
Dividends	–	–	–	–	(56)	(56)
Change in non-controlling interests	–	–	–	–	(15)	(15)
<b>Total transactions with owners</b>	–	–	–	–	(71)	(71)
<b>Balance at 31 December 2012</b>	<b>37,107</b>	<b>6,573</b>	<b>4,721</b>	<b>48,401</b>	<b>685</b>	<b>49,086</b>

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

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

Statement of changes in equity  
for the year ended 31 December 2012

The Bank	Attributable to equity shareholders			Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	
Balance at 1 January 2011	37,107	365	771	38,243
<b>Comprehensive income</b>				
Profit for the year	–	–	1,537	1,537
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,793	–	1,793
Movements in cash flow hedging reserve, net of tax	–	(2)	–	(2)
Currency translation differences, net of tax	–	3	–	3
Total other comprehensive income	–	1,794	–	1,794
Total comprehensive income	–	1,794	1,537	3,331
<b>Transactions with owners</b>				
Capital contribution	–	–	2,340	2,340
Balance at 31 December 2011	37,107	2,159	4,648	43,914
<b>Comprehensive income</b>				
Loss for the year	–	–	(2,150)	(2,150)
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(1,260)	–	(1,260)
Movements in cash flow hedging reserve, net of tax	–	(4)	–	(4)
Currency translation differences, net of tax	–	(21)	–	(21)
Total other comprehensive income	–	(1,285)	–	(1,285)
<b>Total comprehensive income</b>	–	<b>(1,285)</b>	<b>(2,150)</b>	<b>(3,435)</b>
<b>Transactions with owners</b>				
Capital contribution	–	–	–	–
<b>Balance at 31 December 2012</b>	<b>37,107</b>	<b>874</b>	<b>2,498</b>	<b>40,479</b>

## Cash flow statements

for the year ended 31 December 2012

	Note	The Group		The Bank	
		2012 £ million	2011 £ million	2012 £ million	2011 £ million
<b>(Loss) profit before tax</b>		<b>(474)</b>	(1,531)	<b>(2,703)</b>	640
Adjustments for:					
Change in operating assets	56(a)	<b>47,688</b>	44,052	<b>(8,710)</b>	(30,262)
Change in operating liabilities	56(b)	<b>(47,243)</b>	(23,142)	<b>20,191</b>	50,140
Non-cash and other items	56(c)	<b>2,908</b>	(2,544)	<b>106</b>	2,547
Tax (paid) received		<b>(370)</b>	(287)	<b>(26)</b>	(26)
<b>Net cash provided by (used in) operating activities</b>		<b>2,509</b>	16,548	<b>8,858</b>	23,038
<b>Cash flows from investing activities</b>					
Purchase of financial assets		<b>(22,050)</b>	(28,995)	<b>(18,825)</b>	(20,062)
Proceeds from sale and maturity of financial assets		<b>38,228</b>	36,523	<b>28,490</b>	15,918
Purchase of fixed assets		<b>(3,003)</b>	(3,226)	<b>(1,042)</b>	(847)
Proceeds from sale of fixed assets		<b>2,595</b>	2,216	<b>15</b>	35
Additional capital injections to subsidiaries	56(e)	–	–	<b>(37)</b>	(159)
Acquisition of businesses, net of cash acquired	56(e)	<b>(11)</b>	(13)	–	–
Disposal of businesses, net of cash disposed	56(f)	<b>37</b>	298	<b>362</b>	4
<b>Net cash provided by (used in) investing activities</b>		<b>15,796</b>	6,803	<b>8,963</b>	(5,111)
<b>Cash flows from financing activities</b>					
Dividends paid to non-controlling interests		<b>(56)</b>	(50)	–	–
Interest paid on subordinated liabilities		<b>(2,231)</b>	(1,416)	<b>(1,442)</b>	(630)
Proceeds from issue of subordinated liabilities		–	524	–	–
Capital contribution received		–	2,340	–	2,340
Repayment of subordinated liabilities		<b>(864)</b>	(1,174)	<b>(215)</b>	(1,082)
Change in non-controlling shareholders		<b>23</b>	8	–	–
<b>Net cash provided by financing activities</b>		<b>(3,128)</b>	232	<b>(1,657)</b>	628
Effect of exchange rate changes on cash and cash equivalents		<b>(8)</b>	6	<b>(5)</b>	5
Change in cash and cash equivalents		<b>15,169</b>	23,589	<b>16,159</b>	18,560
Cash and cash equivalents at beginning of year		<b>85,889</b>	62,300	<b>58,949</b>	40,389
<b>Cash and cash equivalents at end of year</b>	56(d)	<b>101,058</b>	85,889	<b>75,108</b>	58,949

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

## Notes to the accounts

**1 Basis of preparation**

The financial statements of Lloyds TSB Bank plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB. The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The going concern of the 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 Liquidity and funding on page 9 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

The Group has reviewed its holding of government securities classified as held-to-maturity; since it is no longer the Group's intention to hold these to maturity, they have been reclassified as available-for-sale. In addition, as the Group's share of results of joint ventures and associates is no longer significant, this is now included within other operating income and the related asset reported within other assets; comparatives have been re-presented on a consistent basis.

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

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

Requires disclosures in respect of all transferred financial assets that are not derecognised in their entirety and transferred assets that are derecognised in their entirety but with which there is continuing involvement. Disclosures in connection with such transfers can be found in note 53.

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

Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis.

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

Lloyds TSB Bank plc  
Notes to the accounts

## 2 Accounting policies

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

### a Consolidation

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

#### (1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 30.

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

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

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

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

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(5)) or share capital (see 2r(1)). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

#### (2) Joint ventures and associates

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

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

### b Goodwill

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

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

### c Other intangible assets

Other intangible assets include brands, core deposit intangible, purchased credit card relationships, customer-related intangibles and both internally and externally generated capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 7 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangible	up to 8 years
Purchased credit card relationships	5 years

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

## 2 Accounting policies (continued)

### d Revenue recognition

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

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

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

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

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

### e Financial assets and liabilities

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

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

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

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

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

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

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

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

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

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

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

## Notes to the accounts

**2 Accounting policies** (continued)

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

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

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

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

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

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

*(3) Loans and receivables*

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

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

*(4) Held-to-maturity investments*

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity other than:

- those that the Group designates upon initial recognition as at fair value through profit or loss;
- those that the Group designates as available-for-sale; and
- those that meet the definition of loans and receivables.

These are initially recognised at fair value including direct and incremental transaction costs and measured subsequently at amortised cost, using the effective interest method, less any provision for impairment.

A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments to available-for-sale financial assets.

*(5) Borrowings*

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

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

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

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

*(6) Sale and repurchase agreements*

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

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



## Notes to the accounts

**2 Accounting policies** (continued)**f Derivative financial instruments and hedge accounting**

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

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

Derivatives embedded in financial instruments and insurance contracts (unless the embedded derivative is itself an insurance contract) are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. In accordance with IFRS 4 Insurance Contracts, a policyholder's option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

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

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

*(1) Fair value hedges*

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

*(2) Cash flow hedges*

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

*(3) Net investment hedges*

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

**g Offset**

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

**h Impairment of financial assets***(1) Assets accounted for at amortised cost*

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

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

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

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios in the Commercial Banking and Wealth, Asset Finance and International divisions. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios in both the Retail and Wealth, Asset Finance and International divisions that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

## 2 Accounting policies (continued)

### *Individual assessment*

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

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

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

### *Collective assessment*

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

### *Homogenous groups of loans*

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

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

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

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

### *Incurred but not yet identified impairment*

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

### *Loan renegotiations and forbearance*

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

### *Write offs*

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

### *Debt for equity exchanges*

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities held as available-for-sale. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has

## 2 Accounting policies (continued)

significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see (a) above). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

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

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

### i Investment property

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

### j Tangible fixed assets

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

Premises (excluding land):

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

Equipment:

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

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

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

### k Leases

#### (1) As lessee

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

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

#### (2) As lessor

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

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

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

### l Pensions and other post-retirement benefits

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries, or in the case of the Scottish Widows Retirement Benefits Scheme, by a

## 2 Accounting policies (continued)

qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

The Group's income statement charge includes the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

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

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

### m Share-based compensation

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

### n Taxation

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

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

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

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

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

### o Insurance

The Group undertakes both life insurance and general insurance business. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts*, which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP, including FRS 27 *Life Assurance*, and UK established practice.

## Notes to the accounts

**2 Accounting policies** (continued)

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

- Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.
- Investment contracts containing a discretionary participation feature ('participating investment contracts') – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group, within the constraints of the terms and conditions of the instrument and based upon the performance of specified assets.
- Non-participating investment contracts – these contracts do not transfer significant insurance risk or contain a discretionary participation feature.

The general insurance business issues only insurance contracts.

*(1) Life insurance business**(i) Accounting for insurance and participating investment contracts**Premiums and claims*

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

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

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

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

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

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

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

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

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

*Unallocated surplus*

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

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

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

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

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

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

*(iii) Value of in-force business*

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

## Notes to the accounts

**2 Accounting policies** (continued)

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

*(2) General insurance business*

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

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

*(3) Liability adequacy test*

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

*(4) Reinsurance*

Contracts entered into by the Group with reinsurers under which the Group is compensated for benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

*Assets arising from reinsurance contracts held – Classified as insurance contracts*

Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

*Assets arising from reinsurance contracts held – Classified as non-participating investment contracts*

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

**p Foreign currency translation**

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

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

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

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

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

**q Provisions and contingent liabilities**

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



Lloyds TSB Bank plc  
Notes to the accounts

## 2 Accounting policies (continued)

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

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

### r Share capital

#### (1) Share issue costs

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

#### (2) Dividends

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

### s Cash and cash equivalents

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

### t Investment in subsidiaries

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

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## 3 Critical accounting estimates and judgements

The preparation of the 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 accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the results and financial position, are as follows.

### Allowance for impairment losses on loans and receivables

At 31 December 2012 gross loans and receivables of the Group totalled £586,256 million (2011: £648,335 million) against which impairment allowances of £15,459 million (2011: £19,022 million) had been made and of the Bank totalled £432,492 million (2011: £421,241 million) against which impairment allowances of £3,238 million (2011: £3,599 million) had been made (see note 22). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h; this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

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

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

Given the relative size of the mortgage portfolio, a key variable is house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were ten per cent lower than those estimated at 31 December 2012, the impairment charge would increase by approximately £330 million for the Group and £50 million for the Bank in respect of UK mortgages and a further £55 million for the Group in respect of Irish mortgages.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the wholesale business, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £130 million for the Group and £42 million for the Bank (at 31 December 2011, a one month increase in the loss emergence period would have increased the collective unimpaired provision by an estimated £181 million for the Group and £46 million for the Bank).

### Unwind of HBOS acquisition fair value adjustments

The acquisition of HBOS in January 2009 required the Lloyds Banking Group to recognise the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. The overall effect was to increase the book value of HBOS's net assets by £1,241 million primarily reflecting a reduction in the value of HBOS's debt securities and subordinated liabilities of £15,439 million, partially offset by a reduction in the carrying value of HBOS's loans and receivables of £14,880 million, including loans and advances to customers of £13,512 million.

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

In the periods subsequent to the acquisition all of the fair value adjustments unwind. The fair value adjustments made to debt securities and subordinated liabilities unwind over the expected remaining life of the related securities except in the event that the liability is extinguished, in which case the remaining unamortised fair value adjustment is recognised in the income statement immediately. The timing of the unwind of the fair value adjustment relating to loans and receivables requires significant management judgement. This includes the identification of losses which were expected at the date of acquisition and assessing whether anticipated losses will still be incurred. In 2012, there was a benefit of £1,339 million (2011: £1,943 million) to the income statement either from the reversal of a fair value adjustment being credited to the income statement or through a lower impairment charge as a result of the initial HBOS acquisition fair value adjustments.

#### Fair value of financial instruments

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

Valuation techniques for level 2 financial instruments use inputs that are largely based on observable market data. Level 3 financial instruments are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Determining the appropriate assumptions to be used for level 3 financial instruments requires significant management judgement.

At 31 December 2012, the Group classified £4,810 million of financial assets and £591 million of financial liabilities as level 3 (the Bank, £850 million and £522 million respectively). Further details of the level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out in note 53.

#### Recoverability of deferred tax assets

At 31 December 2012, the Group carried deferred tax assets on its balance sheet of £4,301 million (2011: £4,565 million) and deferred tax liabilities of £327 million (2011: £314 million); the Bank carried deferred tax assets of £3,796 million (2011: £3,127 million) and deferred tax liabilities of £nil (2011: £1 million). This presentation takes into account the ability of the Group and the Bank to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 42 presents deferred tax assets and liabilities by type. The largest category of deferred tax assets relates to tax losses carried forward.

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

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

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

Total deferred tax assets include £7,026 million (2011: £5,901 million) for the Group and £2,969 million (2011: £1,956 million) for the Bank in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and Lloyds TSB Bank plc.

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

As disclosed in note 42, deferred tax assets totalling £1,311 million (2011: £1,288 million) for the Group and £26 million (2011: £169 million) for the Bank have not been recognised in respect of certain capital losses carried forward, trading losses carried forward (mainly in certain overseas companies) and unrelieved foreign tax credits as there are no predicted future capital or taxable profits against which these losses can be recognised.

#### Retirement benefit obligations

The net asset recognised in the Group's balance sheet at 31 December 2012 in respect of retirement benefit obligations was £1,567 million (2011: £957 million), comprising an asset of £1,867 million (2011: £1,338 million) and a liability of £300 million (2011: £381 million), of which an asset of £1,748 million (2011: £1,131 million) related to defined benefit pension schemes. The net asset recognised in the Bank's balance sheet at 31 December 2012 in respect of the retirement benefit obligations was £588 million (2011: £537 million), comprising an asset of £738 million (2011: £736 million) and a liability of £150 million (2011: £199 million), of which an asset of £709 million (2011: £655 million) related to defined benefit pension schemes. As explained in note 2, the Group adopts the corridor approach to the recognition of actuarial gains and losses in respect of its pension schemes and as a consequence has not recognised actuarial losses of £2,705 million (2011: £539 million) and the Bank has not recognised actuarial losses of £1,698 million (2011: £741 million). After allowing for this, the defined benefit pension schemes' net accounting deficit for the Group totalled £957 million (2011: surplus of £592 million), for the Bank there was a net accounting deficit of £989 million (2011: deficit of £86 million), representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

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

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



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

#### Valuation of assets and liabilities arising from life insurance business

At 31 December 2012, the Group recognised a value of in-force business asset of £5,488 million (2011: £5,247 million) and an acquired value of in-force business asset of £1,312 million (2011: £1,391 million). The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The acquired value of in-force business asset represents the contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 2o(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value of in-force business assets at 31 December 2012 are set out in note 27.

At 31 December 2012, the Group carried liabilities arising from insurance contracts and participating investment contracts of £82,968 million (2011: £79,001 million). The methodology used to value these liabilities is described in note 2o(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 36.

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

#### Payment protection insurance and other regulatory provisions

At 31 December 2012, the Group carried provisions of £3,366 million (2011: £2,499 million) against the cost of making redress payments to customers and the related administration costs in connection with historic regulatory breaches, principally the misselling of payment protection insurance. Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the number of future complaints, the extent to which they will be upheld and the average cost of redress. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

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

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### 4 Segmental analysis

The Lloyds TSB Bank Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

The Group Executive Committee of the Lloyds Banking Group has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. The Group Executive Committee reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

Following the transfer of HBOS to the Group on 1 January 2010, all of the trading activities of the Lloyds Banking Group are carried out within the Group and, as a result, the chief operating decision maker reviews the Group's performance by considering that of the Lloyds Banking Group. The segmental results and comparatives are presented on a management basis, the basis reviewed by the chief operating decision maker. Previously the results of the Group's segments had been reviewed on a combined businesses basis and the Group's segmental analysis was presented accordingly. Profit on the management basis is equivalent to profit before tax on a combined businesses basis. However, the effects of asset sales, volatile items and liability management are shown on a separate line in the management basis income statements whereas they were previously included in the relevant line items on a combined businesses basis; in addition the results of asset sales are now reported net of the related fair value unwind whereas this was previously included on the separate fair value unwind line.

Following a reorganisation during 2012, the Group's activities are now organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. The impact of this reorganisation was as follows:

- The Group's Wholesale and Commercial divisions have been combined to form Commercial Banking.
- The Asset Finance business unit, previously reported within Wholesale, is now reported within the Wealth, Asset Finance and International segment; the Asset Finance business recorded a management basis profit before tax of £319 million in the year ended 31 December 2012 (2011: £275 million).
- The Group's Continental European wholesale business and the wholesale Australian business have been transferred from Wealth, Asset Finance and International to Commercial Banking; during the year ended 31 December 2012 these transferred businesses recorded a management basis loss before tax of £439 million (2011: £1,050 million).

In addition, asset sales now include sales of centrally held government bonds, following an increase in activity in the first half of 2012.

Comparative figures have been restated accordingly for all of the above changes.

Retail offers a broad range of retail financial service products in the UK, including current accounts, savings, personal loans, credit cards and mortgages. It is also a major general insurer and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

Commercial Banking provides banking and related services for all UK and multinational business clients, from small and medium-sized enterprises to major corporate and financial institutions.

Wealth, Asset Finance and International gives increased focus and momentum to the Group's private banking and asset management activities, closely co-ordinates the management of its international businesses and now also encompasses the Asset Finance business in the UK and Australia. Wealth comprises the Group's private banking, wealth and asset management businesses in the UK and overseas. International comprises retail businesses, principally in Continental Europe.

## Notes to the accounts

### 4 Segmental analysis (continued)

Insurance provides long-term savings, protection and investment products distributed through the retail branch network, intermediary and direct channels in the UK. It is also a distributor of home insurance in the UK with products sold through the retail branch network, direct channels and strategic corporate partners. The business consists of Life, Pensions and Investments UK, Life, Pensions and Investments Europe, and General Insurance.

Other includes the costs of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and sourcing, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions, including hedge ineffectiveness, UK bank levy, Financial Services Compensation Scheme costs, gains on liability management, volatile items such as hedge accounting volatility managed centrally and other gains from the structural hedging of interest rate risk.

Inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the movement in the fair value of the derivative to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and leads to accounting volatility in the central group segment where it is managed.

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4 Segmental analysis (continued)

Year ended 31 December 2012	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Group Operations and Central items £m	Reported basis total £m
Net interest income	7,195	2,206	799	(78)	213	10,335
Other income (net of fee and commission expense)	1,462	2,932	2,043	2,294	(315)	8,416
Insurance claims	–	–	–	(365)	–	(365)
<b>Total underlying income, net of insurance claims</b>	<b>8,657</b>	<b>5,138</b>	<b>2,842</b>	<b>1,851</b>	<b>(102)</b>	<b>18,386</b>
Total costs	(4,199)	(2,516)	(2,291)	(744)	(332)	(10,082)
Impairment	(1,270)	(2,946)	(1,480)	–	(1)	(5,697)
<b>Underlying profit (loss)</b>	<b>3,188</b>	<b>(324)</b>	<b>(929)</b>	<b>1,107</b>	<b>(435)</b>	<b>2,607</b>
Asset sales	–	(464)	(196)	–	3,207	2,547
Volatile items	–	138	–	–	(886)	(748)
Liability management	–	–	–	–	(229)	(229)
Fair value unwind	482	888	(51)	(42)	(627)	650
<b>Management basis profit (loss)</b>	<b>3,670</b>	<b>238</b>	<b>(1,176)</b>	<b>1,065</b>	<b>1,030</b>	<b>4,827</b>
External revenue	10,951	4,070	2,835	2,497	(1,967)	18,386
Inter-segment revenue	(2,294)	1,068	7	(646)	1,865	–
<b>Segment revenue</b>	<b>8,657</b>	<b>5,138</b>	<b>2,842</b>	<b>1,851</b>	<b>(102)</b>	<b>18,386</b>
<b>Segment external assets</b>	<b>346,030</b>	<b>314,090</b>	<b>76,449</b>	<b>143,851</b>	<b>44,132</b>	<b>924,552</b>
<b>Segment customer deposits</b>	<b>260,838</b>	<b>114,115</b>	<b>51,885</b>	<b>–</b>	<b>74</b>	<b>426,912</b>
<b>Segment external liabilities</b>	<b>287,631</b>	<b>249,097</b>	<b>91,251</b>	<b>134,963</b>	<b>116,926</b>	<b>879,868</b>
Other segment items reflected in income statement above:						
Depreciation and amortisation	345	219	815	95	90	1,564
(Decrease) increase in value of in-force business	–	–	(4)	273	–	269
Defined benefit scheme charges	103	54	36	23	(148)	68
Other segment items:						
Additions to tangible fixed assets	143	67	1,732	378	683	3,003
Investments in joint ventures and associates at end of year	185	113	6	–	9	313

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**4 Segmental analysis** (continued)

Year ended 31 December 2011 <sup>1</sup>	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Group Operations and Central Items £m	Reported basis total £m
Net interest income	7,497	3,192	1,003	(67)	585	12,210
Other income (net of fee and commission expense)	1,660	2,806	2,230	2,687	(204)	9,179
Insurance claims	–	–	–	(343)	–	(343)
<b>Total underlying income, net of insurance claims</b>	<b>9,157</b>	<b>5,998</b>	<b>3,233</b>	<b>2,277</b>	<b>381</b>	<b>21,046</b>
Total costs	(4,438)	(2,600)	(2,414)	(812)	(357)	(10,621)
Impairment	(1,970)	(4,210)	(3,604)	–	(3)	(9,787)
<b>Underlying profit (loss)</b>	<b>2,749</b>	<b>(812)</b>	<b>(2,785)</b>	<b>1,465</b>	<b>21</b>	<b>638</b>
Asset sales	48	61	(21)	–	196	284
Volatile items	–	(736)	–	–	(2)	(738)
Liability management	–	–	–	–	1,295	1,295
Fair value unwind	839	1,562	122	(43)	(1,274)	1,206
<b>Management basis profit (loss)</b>	<b>3,636</b>	<b>75</b>	<b>(2,684)</b>	<b>1,422</b>	<b>236</b>	<b>2,685</b>
External revenue	12,230	3,889	3,863	2,910	(1,846)	21,046
Inter-segment revenue	(3,073)	2,109	(630)	(633)	2,227	–
<b>Segment revenue</b>	<b>9,157</b>	<b>5,998</b>	<b>3,233</b>	<b>2,277</b>	<b>381</b>	<b>21,046</b>
<b>Segment external assets</b>	<b>356,295</b>	<b>350,711</b>	<b>73,345</b>	<b>140,754</b>	<b>49,441</b>	<b>970,546</b>
<b>Segment customer deposits</b>	<b>247,088</b>	<b>123,822</b>	<b>41,661</b>	<b>–</b>	<b>1,335</b>	<b>413,906</b>
<b>Segment external liabilities</b>	<b>279,162</b>	<b>294,088</b>	<b>73,635</b>	<b>129,350</b>	<b>147,717</b>	<b>923,952</b>
Other segment items reflected in income statement above:						
Depreciation and amortisation	364	244	836	91	67	1,602
Increase (decrease) in value of in-force business	–	–	3	(625)	–	(622)
Defined benefit scheme charges	121	54	37	23	(36)	199
Other segment items:						
Additions to tangible fixed assets	189	197	1,452	451	806	3,095
Investments in joint ventures and associates at end of year	147	155	29	–	3	334

<sup>1</sup>Restated as explained on page 31.

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4 Segmental analysis (continued)

Year ended 31 December 2012	Lloyds TSB Bank Group statutory £m	Impact of other entities in the Lloyds Banking Group <sup>1</sup> £m	Acquisition related and other items <sup>2</sup> £m	Volatility arising in insurance businesses £m	Removal of:			Reported basis £m
					Insurance gross up £m	Legal and regulatory provisions <sup>3</sup> £m	Fair value unwind £m	
Net interest income	8,755	320	(199)	(8)	1,230	–	237	10,335
Other income	30,040	(209)	(1,691)	(298)	(19,433)	50	(43)	8,416
Insurance claims	(18,396)	–	–	–	18,031	–	–	(365)
<b>Total underlying income, net of insurance claims</b>	<b>20,399</b>	<b>111</b>	<b>(1,890)</b>	<b>(306)</b>	<b>(172)</b>	<b>50</b>	<b>194</b>	<b>18,386</b>
Operating expenses	(15,724)	(207)	1,478	–	172	4,175	24	(10,082)
Impairment	(5,149)	–	320	–	–	–	(868)	(5,697)
<b>Underlying profit (loss)</b>	<b>(474)</b>	<b>(96)</b>	<b>(92)</b>	<b>(306)</b>	<b>–</b>	<b>4,225</b>	<b>(650)</b>	<b>2,607</b>
Asset sales		–	2,547	–	–	–	–	2,547
Volatile items		–	(748)	–	–	–	–	(748)
Liability management		–	(229)	–	–	–	–	(229)
Fair value unwind		–	–	–	–	–	650	650
<b>(Loss) profit</b>	<b>(474)</b>	<b>(96)</b>	<b>1,478</b>	<b>(306)</b>	<b>–</b>	<b>4,225</b>	<b>–</b>	<b>4,827</b>

<sup>1</sup>This reflects the inclusion in the results reviewed by the chief operating decision maker of the Bank's fellow subsidiary undertakings and its parent undertaking, Lloyds Banking Group plc.

<sup>2</sup>Comprises the effects of asset sales (gain of £2,547 million), volatile items (loss of £748 million), liability management (loss of £229 million), Simplification costs related to severance, IT and business costs of implementation (£676 million), EC mandated retail business disposal costs (£570 million), the amortisation of purchased intangibles (£482 million) and the past service pensions credit (£250 million, see note 11).

<sup>3</sup>Comprises the payment protection insurance provision (£3,575 million) and other regulatory provisions (£650 million).

Year ended 31 December 2011	Lloyds TSB Bank Group statutory £m	Impact of other entities in the Lloyds Banking Group <sup>1</sup> £m	Acquisition related and other items <sup>2</sup> £m	Volatility arising in insurance businesses £m	Removal of:			Reported basis £m
					Insurance gross up £m	Legal and regulatory provisions <sup>3</sup> £m	Fair value unwind £m	
Net interest income	12,856	(158)	(843)	(19)	(336)	–	710	12,210
Other income	15,770	(1,625)	2	857	(5,530)	–	(295)	9,179
Insurance claims	(6,041)	–	–	–	5,698	–	–	(343)
<b>Total underlying income, net of insurance claims</b>	<b>22,585</b>	<b>(1,783)</b>	<b>(841)</b>	<b>838</b>	<b>(168)</b>	<b>–</b>	<b>415</b>	<b>21,046</b>
Operating expenses	(16,022)	(228)	2,014	–	168	3,375	72	(10,621)
Impairment	(8,094)	–	–	–	–	–	(1,693)	(9,787)
<b>Underlying profit (loss)</b>	<b>(1,531)</b>	<b>(2,011)</b>	<b>1,173</b>	<b>838</b>	<b>–</b>	<b>3,375</b>	<b>(1,206)</b>	<b>638</b>
Asset sales		–	284	–	–	–	–	284
Volatile items		–	(738)	–	–	–	–	(738)
Liability management		–	1,295	–	–	–	–	1,295
Fair value unwind		–	–	–	–	–	1,206	1,206
<b>(Loss) profit</b>	<b>(1,531)</b>	<b>(2,011)</b>	<b>2,014</b>	<b>838</b>	<b>–</b>	<b>3,375</b>	<b>–</b>	<b>2,685</b>

<sup>1</sup>This reflects the inclusion in the results reviewed by the chief operating decision maker of the Bank's fellow subsidiary undertakings and its parent undertaking, Lloyds Banking Group plc.

<sup>2</sup>Comprises the effects of asset sales (gain of £284 million), volatile items (loss of £738 million), liability management (gain of £1,295 million), integration and Simplification costs related to severance, IT and business costs of implementation (£1,282 million), EC mandated retail business disposal costs (£170 million) and the amortisation of purchased intangibles (£562 million).

<sup>3</sup>Comprises the payment protection insurance provision (£3,200 million) and other regulatory provisions (£175 million).

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**4 Segmental analysis** (continued)

**Geographical areas**

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

	2012			2011		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
<b>Total income</b>	<b>36,535</b>	<b>2,260</b>	<b>38,795</b>	26,200	2,426	28,626
<b>Total assets</b>	<b>841,906</b>	<b>100,888</b>	<b>942,794</b>	893,738	94,628	988,366

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

**5 Net interest income**

	Weighted average effective interest rate		2012 £m	2011 £m
	2012 %	2011 %		
Interest and similar income:				
Loans and advances to customers, excluding lease and hire purchase receivables	<b>3.87</b>	3.92	<b>21,307</b>	23,409
Loans and advances to banks	<b>0.53</b>	0.78	<b>590</b>	628
Debt securities held as loans and receivables	<b>4.77</b>	3.17	<b>433</b>	590
Lease and hire purchase receivables	<b>5.35</b>	5.13	<b>672</b>	742
Interest receivable on loans and receivables	<b>3.37</b>	3.56	<b>23,002</b>	25,369
Available-for-sale financial assets	<b>2.05</b>	2.98	<b>642</b>	1,058
Held-to-maturity investments	<b>2.80</b>	3.29	<b>288</b>	262
<b>Total interest and similar income</b>	<b>3.30</b>	3.53	<b>23,932</b>	26,689
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	<b>1.14</b>	0.80	<b>(324)</b>	(222)
Customer deposits, excluding liabilities under sale and repurchase agreements	<b>1.74</b>	1.79	<b>(6,968)</b>	(6,880)
Debt securities in issue	<b>2.03</b>	2.21	<b>(3,023)</b>	(5,007)
Subordinated liabilities	<b>8.99</b>	5.84	<b>(3,189)</b>	(1,608)
Liabilities under sale and repurchase agreements	<b>1.47</b>	1.39	<b>(245)</b>	(335)
Interest payable on liabilities held at amortised cost	<b>2.18</b>	2.03	<b>(13,749)</b>	(14,052)
Other	<b>7.40</b>	(1.14)	<b>(1,428)</b>	219
<b>Total interest and similar expense</b>	<b>2.34</b>	1.95	<b>(15,177)</b>	(13,833)
<b>Net interest income</b>			<b>8,755</b>	12,856

Included within interest and similar income is £1,133 million (2011: £1,405 million) in respect of impaired financial assets. Net interest income also includes a credit of £92 million (2011: a charge of £70 million) transferred from the cash flow hedging reserve (see note 47).

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**6 Net fee and commission income**

	2012 £m	2011 £m
Fee and commission income:		
Current accounts	1,008	1,053
Credit and debit card fees	941	877
Other	2,783	3,005
<b>Total fee and commission income</b>	<b>4,732</b>	<b>4,935</b>
Fee and commission expense	(1,438)	(1,391)
<b>Net fee and commission income</b>	<b>3,294</b>	<b>3,544</b>

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

**7 Net trading income**

	2012 £m	2011 £m
Foreign exchange translation (losses) gains	(225)	317
Gains on foreign exchange trading transactions	502	342
Total foreign exchange	277	659
Investment property losses (note 25)	(264)	(107)
Securities and other gains (losses) (see below)	13,804	(1,377)
<b>Net trading income (expense)</b>	<b>13,817</b>	<b>(825)</b>

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

	2012 £m	2011 £m
Net income (expense) arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	3,616	5,292
Equity shares	10,100	(4,917)
Total net income arising on assets held at fair value through profit or loss	13,716	375
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	(576)	(233)
Total net gains arising on assets and liabilities held at fair value through profit or loss	13,140	142
Net gains (losses) on financial instruments held for trading	664	(1,519)
<b>Securities and other gains (losses)</b>	<b>13,804</b>	<b>(1,377)</b>

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## 8 Insurance premium income

	2012 £m	2011 £m
<i>Life insurance</i>		
Gross premiums	7,391	7,276
Ceded reinsurance premiums	(222)	(322)
Net earned premiums	7,169	6,954
<i>Non-life insurance</i>		
Gross premiums written	1,081	1,198
Ceded reinsurance premiums	(31)	(52)
Net written premiums	1,050	1,146
Change in provision for unearned premiums (note 36)	72	70
Change in provision for ceded unearned premiums (note 36)	(7)	–
Net earned premiums	1,115	1,216
<b>Total net earned premiums</b>	<b>8,284</b>	<b>8,170</b>

Life insurance gross premiums can be further analysed as follows:

	2012 £m	2011 £m
Life and pensions	6,755	6,737
Annuities	630	529
Other	6	10
<b>Gross premiums</b>	<b>7,391</b>	<b>7,276</b>

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

	2012 £m	2011 £m
Credit protection	173	231
Home	904	963
Health	4	4
<b>Gross written premiums</b>	<b>1,081</b>	<b>1,198</b>

## 9 Other operating income

	2012 £m	2011 £m
Operating lease rental income	1,145	1,268
Rental income from investment properties (note 25)	389	388
Other rents receivable	27	34
Gains less losses on disposal of available-for-sale financial assets (note 47)	3,547	343
Movement in value of in-force business (note 27)	269	(622)
Liability management (losses) gains	(338)	2,682
Share of results of joint ventures and associates (note 13)	28	31
Other income	(422)	757
<b>Total other operating income</b>	<b>4,645</b>	<b>4,881</b>

### Liability management gains

During February 2012, the Group completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012. This exchange resulted in a gain on the extinguishment of the existing securities of £59 million being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs. Additionally, during the second half of 2012 losses totalling £397 million arose on the buy-back of other debt securities.



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**9 Other operating income** (continued)

During December 2011, the Lloyds Banking Group completed the exchange of certain subordinated debt securities which resulted in a gain on extinguishment of the existing securities of £599 million.

During 2011, the Lloyds Banking Group restructured certain securities issued by the Bank and held by fellow Lloyds Banking Group undertakings; this led to a profit of £2,083 million recognised by the Group.

**10 Insurance claims**

Insurance claims comprise:

	2012 £m	2011 £m
<b>Life insurance and participating investment contracts</b>		
Claims and surrenders:		
Gross	(8,719)	(8,622)
Reinsurers' share	185	230
	<b>(8,534)</b>	<b>(8,392)</b>
Change in insurance and participating investment contracts (note 36(1)):		
Change in gross liabilities	(4,284)	1,383
Change in assets arising from reinsurance contracts held	(186)	451
	<b>(4,470)</b>	<b>1,834</b>
Change in non-participating investment contracts:		
Change in gross liabilities	(5,058)	527
Change in assets arising from reinsurance contracts held	-	-
	<b>(5,058)</b>	<b>527</b>
Change in unallocated surplus (note 39)	31	340
<b>Total life insurance and participating investment contracts</b>	<b>(18,031)</b>	<b>(5,691)</b>
<b>Non-life insurance</b>		
Claims and claims paid:		
Gross	(439)	(528)
Reinsurers' share	1	4
	<b>(438)</b>	<b>(524)</b>
Change in liabilities (note 36(2)):		
Gross	74	186
Reinsurers' share	(1)	(12)
	<b>73</b>	<b>174</b>
Total non-life insurance	<b>(365)</b>	<b>(350)</b>
<b>Total insurance claims expense</b>	<b>(18,396)</b>	<b>(6,041)</b>

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

	2012 £m	2011 £m
Deaths	(618)	(625)
Maturities	(2,238)	(1,861)
Surrenders	(4,795)	(5,041)
Annuities	(789)	(764)
Other	(279)	(331)
<b>Total life insurance gross claims</b>	<b>(8,719)</b>	<b>(8,622)</b>

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

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**11 Operating expenses**

	2012 £m	2011 £m
Staff costs:		
Salaries	3,411	3,774
Performance-based compensation	395	371
Social security costs	383	432
Pensions and other post-retirement benefit schemes (note 41):		
Past service credit <sup>1</sup>	(250)	–
Other	547	401
	297	401
Restructuring costs	217	124
Other staff costs	746	1,064
	5,449	6,166
Premises and equipment:		
Rent and rates	488	547
Hire of equipment	17	22
Repairs and maintenance	174	188
Other	270	294
	949	1,051
Other expenses:		
Communications and data processing	1,082	954
Advertising and promotion	314	398
Professional fees	552	575
Financial services compensation scheme levy (note 52)	175	179
Other	902	1,084
	3,025	3,190
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 29)	1,431	1,434
Amortisation of acquired value of in-force non-participating investment contracts (note 27)	79	78
Amortisation of other intangible assets (note 28)	616	663
	2,126	2,175
Impairment of tangible fixed assets (note 29)	–	65
Total operating expenses, excluding payment protection insurance provision	11,549	12,647
Regulatory provisions		
Payment protection insurance provision (note 43)	3,575	3,200
Other regulatory provisions (note 43) <sup>2</sup>	600	175
	4,175	3,375
<b>Total operating expenses</b>	<b>15,724</b>	<b>16,022</b>

<sup>1</sup>Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

<sup>2</sup>In addition, regulatory provisions of £50 million (2011: £nil) have been charged against income.

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**11 Operating expenses** (continued)

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

	2012	2011
UK	<b>110,295</b>	116,371
Overseas	<b>3,322</b>	4,078
<b>Total</b>	<b>113,617</b>	120,449

**Fees payable to the Bank's auditors**

During the year the auditors earned the following fees:

	2012 £m	2011 £m
Fees payable for the audit of the Bank's current year annual report	<b>2.4</b>	4.6
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	<b>13.3</b>	12.3
Other services supplied pursuant to legislation	<b>2.0</b>	1.8
Other services – audit-related fees	<b>0.9</b>	2.1
Taxation compliance services	<b>0.2</b>	0.2
All other taxation advisory services	<b>0.6</b>	0.9
Services relating to corporate finance transactions	<b>0.2</b>	0.7
All other services	<b>2.2</b>	2.2
<b>Total fees payable to the Bank's auditors</b>	<b>21.8</b>	24.8

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

	2012 £m	2011 £m
Audits of the Group pension schemes	<b>0.4</b>	0.4
Audits of unconsolidated Open Ended Investment Companies managed by the Group	<b>0.8</b>	0.6
Reviews of the financial position of corporate and other borrowers	<b>5.4</b>	11.0
Acquisition due diligence and other work performed in respect of potential venture capital investments	<b>0.7</b>	1.0

**12 Impairment**

	2012 £m	2011 £m
Impairment losses on loans and receivables (note 22):		
Loans and advances to customers	<b>5,125</b>	8,020
Debt securities classified as loans and receivables	<b>(4)</b>	49
Total impairment losses on loans and receivables	<b>5,121</b>	8,069
Impairment of available-for-sale financial assets	<b>37</b>	80
Other credit risk provisions (note 43)	<b>(9)</b>	(55)
<b>Total impairment charged to the income statement</b>	<b>5,149</b>	8,094

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### 13 Investments in joint ventures and associates

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

	Joint ventures		Associates		Total	
	2012 £m	2011 £m	2012 £m	2011 £m	2012 £m	2011 £m
Share of income statement amounts:						
Income	278	316	63	160	341	476
Expenses	(229)	(261)	(68)	(161)	(297)	(422)
Impairment	(6)	(20)	(1)	1	(7)	(19)
Profit (loss) before tax	43	35	(6)	–	37	35
Tax	(9)	(4)	–	–	(9)	(4)
<b>Share of post-tax results</b>	<b>34</b>	<b>31</b>	<b>(6)</b>	<b>–</b>	<b>28</b>	<b>31</b>
Share of balance sheet amounts:						
Current assets	3,103	3,346	127	246	3,230	3,592
Non-current assets	1,596	2,148	581	976	2,177	3,124
Current liabilities	(729)	(714)	(128)	(293)	(857)	(1,007)
Non-current liabilities	(3,672)	(4,471)	(565)	(904)	(4,237)	(5,375)
<b>Share of net assets at 31 December</b>	<b>298</b>	<b>309</b>	<b>15</b>	<b>25</b>	<b>313</b>	<b>334</b>
Movement in investments over the year:						
At 1 January	309	326	25	103	334	429
Additional investments	10	7	1	3	11	10
Disposals	(44)	(47)	(6)	(79)	(50)	(126)
Share of post-tax results	34	31	(6)	–	28	31
Dividends paid	(13)	(5)	–	(1)	(13)	(6)
Exchange and other adjustments	2	(3)	1	(1)	3	(4)
<b>Share of net assets at 31 December</b>	<b>298</b>	<b>309</b>	<b>15</b>	<b>25</b>	<b>313</b>	<b>334</b>

During 2012, the Group recognised a net £10 million (2011: £8 million) of losses of associates not previously recognised. The Group's unrecognised share of losses of associates during 2011 was £8 million and of joint ventures is £126 million in 2012 (2011: £85 million). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £31 million (2011: £56 million) and of joint ventures is £330 million (2011: £299 million).

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

Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

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**14 Taxation**

**a Analysis of tax (charge) credit for the year**

	2012 £m	2011 £m
UK corporation tax:		
Current tax on loss for the year	(83)	(174)
Adjustments in respect of prior years	77	(152)
	(6)	(326)
Foreign tax:		
Current tax on profit for the year	(86)	(90)
Adjustments in respect of prior years	(8)	36
	(94)	(54)
Current tax charge	(100)	(380)
Deferred tax (note 42):		
Origination and reversal of temporary differences	(368)	1,646
Reduction in UK corporation tax rate	(313)	(411)
Adjustments in respect of prior years	68	(119)
	(613)	1,116
<b>Tax (charge) credit</b>	<b>(713)</b>	<b>736</b>

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

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

	2012 £m	2011 £m
Tax (charge) credit attributable to policyholders	(944)	72
Shareholder tax credit (charge)	231	664
<b>Tax (charge) credit</b>	<b>(713)</b>	<b>736</b>

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**14 Taxation** (continued)

**b Factors affecting the tax (charge) credit for the year**

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

	2012 £m	2011 £m
Loss before tax	<b>(474)</b>	(1,531)
Tax credit thereon at UK corporation tax rate of 24.5 per cent (2011: 26.5 per cent)	<b>116</b>	406
Factors affecting (charge) credit:		
UK corporation tax rate change	<b>(313)</b>	(411)
Disallowed and non-taxable items	<b>141</b>	868
Overseas tax rate differences	<b>75</b>	17
Gains exempted or covered by capital losses	<b>36</b>	14
Policyholder tax	<b>(139)</b>	160
Further factors affecting the life business <sup>1</sup> :		
Derecognition of deferred tax on policyholder tax credits	<b>(583)</b>	(146)
Taxation of certain insurance assets arising on transition to new tax regime	<b>(221)</b>	–
Changes to the taxation of pension business:		
Policyholder tax cost	<b>(182)</b>	–
Shareholder tax benefit	<b>206</b>	–
Deferred tax on losses not previously recognised	–	332
Tax losses where no deferred tax recognised	<b>(13)</b>	(261)
Adjustments in respect of previous years	<b>137</b>	(235)
Effect of profit in joint ventures and associates	<b>23</b>	8
Other items	<b>4</b>	(16)
<b>Tax (charge) credit on loss on ordinary activities</b>	<b>(713)</b>	736

<sup>1</sup>The Finance Act 2012 introduced a new UK tax regime for the taxation of life insurance companies which takes effect from 1 January 2013. The new regime, combined with current economic forecasts, has had a number of impacts on the tax charge.

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Trading assets	23,358	18,068	6,049	4,084
Other financial assets at fair value through profit or loss	130,986	121,175	413	581
<b>Total</b>	<b>154,344</b>	<b>139,243</b>	<b>6,462</b>	<b>4,665</b>

These assets are comprised as follows:

	The Group				The Bank			
	2012		2011		2012		2011	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	13,598	34	9,642	124	9	12	–	69
Loans and advances to banks	919	–	1,355	–	191	–	–	–
Debt securities:								
Government securities	3,965	16,766	2,000	21,367	3,781	–	1,008	–
Other public sector securities	–	1,056	–	1,183	–	–	–	–
Bank and building society certificates of deposit	3,166	228	2,863	385	926	–	1,479	–
Asset-backed securities:								
Mortgage-backed securities	130	708	99	612	130	–	99	–
Other asset-backed securities	21	1,802	222	1,764	17	–	19	–
Corporate and other debt securities	1,185	23,873	1,588	19,981	906	388	1,404	496
	<b>8,467</b>	<b>44,433</b>	<b>6,772</b>	<b>45,292</b>	<b>5,760</b>	<b>388</b>	<b>4,009</b>	<b>496</b>
Equity shares	–	86,463	–	75,759	–	13	–	16
Treasury bills and other bills	374	56	299	–	89	–	75	–
<b>Total</b>	<b>23,358</b>	<b>130,986</b>	<b>18,068</b>	<b>121,175</b>	<b>6,049</b>	<b>413</b>	<b>4,084</b>	<b>581</b>

At 31 December 2012 £131,073 million (2011: £119,025 million) of trading and other financial assets at fair value through profit or loss of the Group and £4,504 million (2011: £2,688 million) of the Bank had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss represent the following assets designated into that category:

- (i) financial assets backing insurance contracts and investment contracts which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise;
- (ii) certain loans and advances to customers which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and
- (iii) certain private equity investments that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2012 of the loans and advances to customers designated at fair value through profit or loss by the Bank and the Group was £34 million (2011: £124 million); the Bank and the Group do not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk; this is determined by reference to the publicly available credit ratings of the instruments involved.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £14,433 million for the Group and £2,630 million for the Bank (2011: £10,990 million for the Group and £nil for the Bank). Collateral is held with a fair value of £19,629 million for the Group and £2,629 million for the Bank (2011: £15,765 million for the Group and £nil for the Bank), all of which the Group and the Bank are able to repledge. At 31 December 2012, £15,640 million had been repledged by the Group and £1,325 million by the Bank (2011: £3,740 million by the Group and £nil by the Bank).

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

## Notes to the accounts

**16 Derivative financial instruments**

The Group holds derivatives as part of the following strategies:

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

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

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. The Group also uses credit default swaps to securitise, in combination with external funding, £2,829 million (2011: £3,436 million) of corporate and commercial banking loans.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.



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**16 Derivative financial instruments** (continued)

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

The Group	2012			2011		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	815,757	1,431	1,598	178,312	2,542	2,780
Currency swaps	107,137	1,689	1,682	97,926	3,499	2,208
Options purchased	330,844	591	–	17,725	610	–
Options written	21,757	–	605	18,654	–	616
	<b>1,275,495</b>	<b>3,711</b>	<b>3,885</b>	312,617	6,651	5,604
Interest rate contracts:						
Interest rate swaps	2,071,046	32,820	31,880	927,668	38,806	40,207
Forward rate agreements	1,836,186	494	599	238,327	586	613
Options purchased	105,919	4,463	–	62,713	3,693	–
Options written	115,780	–	4,045	58,898	–	3,517
Futures	53,529	2	2	118,921	1	2
	<b>4,182,460</b>	<b>37,779</b>	<b>36,526</b>	1,406,527	43,086	44,339
Credit derivatives	6,169	94	343	9,980	238	328
Equity and other contracts	23,690	1,974	1,311	18,209	2,018	1,184
<b>Total derivative assets/liabilities held for trading</b>	<b>5,487,814</b>	<b>43,558</b>	<b>42,065</b>	1,747,333	51,993	51,455
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Cross currency swaps	56,651	817	615	12,317	708	302
Interest rate swaps (including swap options)	136,375	6,086	1,772	110,943	6,719	1,236
Options written	68	–	–	879	–	9
Derivatives designated as cash flow hedges:						
Cross currency swaps	2,395	14	32	7,432	172	90
Interest rate swaps	86,190	4,653	4,453	207,343	5,250	5,608
Futures	49,527	1	–	103,467	–	–
Derivatives designated as net investment hedges:						
Cross currency swaps	–	–	–	49	–	1
<b>Total derivative assets/liabilities held for hedging</b>	<b>331,206</b>	<b>11,571</b>	<b>6,872</b>	442,430	12,849	7,246
<b>Total recognised derivative assets/liabilities</b>	<b>5,819,020</b>	<b>55,129</b>	<b>48,937</b>	2,189,763	64,842	58,701

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**16 Derivative financial instruments** (continued)

**Hedged cash flows**

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

<b>2012</b>	<b>0-1 years £m</b>	<b>1-2 years £m</b>	<b>2-3 years £m</b>	<b>3-4 years £m</b>	<b>4-5 years £m</b>	<b>5-10 years £m</b>	<b>10-20 years £m</b>	<b>Over 20 years £m</b>	<b>Total £m</b>
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	<b>214</b>	<b>241</b>	<b>271</b>	<b>139</b>	<b>67</b>	<b>163</b>	<b>37</b>	<b>33</b>	<b>1,165</b>
Forecast payable cash flows	<b>(168)</b>	<b>(126)</b>	<b>(36)</b>	<b>(40)</b>	<b>(148)</b>	<b>(960)</b>	<b>(1,682)</b>	<b>(442)</b>	<b>(3,602)</b>
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	<b>254</b>	<b>287</b>	<b>256</b>	<b>95</b>	<b>51</b>	<b>157</b>	<b>32</b>	<b>33</b>	<b>1,165</b>
Forecast payable cash flows	<b>(190)</b>	<b>(120)</b>	<b>(41)</b>	<b>(42)</b>	<b>(154)</b>	<b>(963)</b>	<b>(1,694)</b>	<b>(398)</b>	<b>(3,602)</b>
<hr/>									
<b>2011</b>	<b>0-1 years £m</b>	<b>1-2 years £m</b>	<b>2-3 years £m</b>	<b>3-4 years £m</b>	<b>4-5 years £m</b>	<b>5-10 years £m</b>	<b>10-20 years £m</b>	<b>Over 20 years £m</b>	<b>Total £m</b>
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	140	239	475	208	35	354	192	66	1,709
Forecast payable cash flows	(178)	(181)	(63)	(81)	(78)	(1,394)	(1,163)	(354)	(3,492)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	234	232	389	208	47	383	162	54	1,709
Forecast payable cash flows	(224)	(154)	(53)	(81)	(145)	(1,475)	(1,110)	(250)	(3,492)

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

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**16 Derivative financial instruments** (continued)

At 31 December 2012 £50,419 million of total recognised derivative assets of the Group and £44,239 million of total recognised derivative liabilities of the Group (2011: £58,269 million of assets and £52,020 million of liabilities) had a contractual residual maturity of greater than one year.

	2012			2011		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>The Bank</b>						
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	810,650	1,405	1,548	207,436	2,492	2,885
Currency swaps	159,242	1,686	1,619	105,038	2,449	1,914
Options purchased	330,786	591	–	18,214	615	–
Options written	21,827	–	654	19,051	–	619
	<b>1,322,505</b>	<b>3,682</b>	<b>3,821</b>	349,739	5,556	5,418
Interest rate contracts:						
Interest rate swaps	2,129,032	21,614	19,795	1,401,283	25,124	24,483
Forward rate agreements	1,846,083	494	592	62,196	514	546
Options purchased	97,182	3,764	–	59,448	3,026	–
Options written	109,231	–	3,620	59,378	–	2,952
Futures	8,918	2	1	5,630	1	1
	<b>4,190,446</b>	<b>25,874</b>	<b>24,008</b>	1,587,935	28,665	27,982
Credit derivatives	6,032	94	287	10,105	228	254
Equity and other contracts	11,207	691	616	11,842	473	472
<b>Total derivative assets/liabilities held for trading</b>	<b>5,530,190</b>	<b>30,341</b>	<b>28,732</b>	1,959,621	34,922	34,126
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Cross currency swaps	33,365	450	366	29	216	186
Interest rate swaps (including swap options)	93,989	1,454	1,463	53,808	2,379	692
Options written	75	–	–	657	–	9
Derivatives designated as cash flow hedges:						
Interest rate swaps	78,763	2	55	1,075	–	18
<b>Total derivative assets/liabilities held for hedging</b>	<b>206,192</b>	<b>1,906</b>	<b>1,884</b>	55,569	2,595	905
<b>Total recognised derivative assets/liabilities</b>	<b>5,736,382</b>	<b>32,247</b>	<b>30,616</b>	2,015,190	37,517	35,031

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**16 Derivative financial instruments** (continued)

**Hedged cash flows**

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

<b>2012</b>	<b>0-1 years £m</b>	<b>1-2 years £m</b>	<b>2-3 years £m</b>	<b>3-4 years £m</b>	<b>4-5 years £m</b>	<b>5-10 years £m</b>	<b>10-20 years £m</b>	<b>Over 20 years £m</b>	<b>Total £m</b>
Hedged forecast cash flows expected to occur:	<b>49</b>	<b>36</b>	<b>14</b>	<b>3</b>	<b>2</b>	<b>3</b>	–	–	<b>107</b>
Forecast payable cash flows	<b>(66)</b>	<b>(47)</b>	<b>(17)</b>	<b>(5)</b>	<b>(3)</b>	<b>(7)</b>	–	–	<b>(145)</b>
Hedged forecast cash flows affect profit or loss:	<b>49</b>	<b>36</b>	<b>14</b>	<b>3</b>	<b>2</b>	<b>3</b>	–	–	<b>107</b>
Forecast payable cash flows	<b>(66)</b>	<b>(47)</b>	<b>(17)</b>	<b>(5)</b>	<b>(3)</b>	<b>(7)</b>	–	–	<b>(145)</b>

  

<b>2011</b>	<b>0-1 years £m</b>	<b>1-2 years £m</b>	<b>2-3 years £m</b>	<b>3-4 years £m</b>	<b>4-5 years £m</b>	<b>5-10 years £m</b>	<b>10-20 years £m</b>	<b>Over 20 years £m</b>	<b>Total £m</b>
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	49	48	28	1	1	6	–	–	133
Forecast payable cash flows	(50)	(7)	(1)	(49)	(29)	(2)	(2)	–	(140)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	49	48	28	1	1	6	–	–	133
Forecast payable cash flows	(50)	(7)	(1)	(49)	(29)	(2)	(2)	–	(140)

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

At 31 December 2012 £28,167 million of total recognised derivative assets of the Bank and £25,406 million of total recognised derivative liabilities of the Bank (2011: £31,226 million of assets and £28,895 million of liabilities) had a contractual residual maturity of greater than one year.

The principal 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 and Bank should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 54.

**17 Loans and advances to banks**

	The Group		The Bank	
	<b>2012 £m</b>	2011 £m	<b>2012 £m</b>	2011 £m
Lending to banks	<b>591</b>	1,810	<b>183,896</b>	164,374
Money market placements with banks	<b>28,829</b>	30,810	<b>4,323</b>	3,536
<b>Total loans and advances to banks before allowance for impairment losses</b>	<b>29,420</b>	32,620	<b>188,219</b>	167,910
Allowance for impairment losses (note 22)	<b>(3)</b>	(14)	<b>(3)</b>	(14)
<b>Total loans and advances to banks</b>	<b>29,417</b>	32,606	<b>188,216</b>	167,896

At 31 December 2012 £4,404 million (2011: £4,128 million) of loans and advances to banks of the Group and £158,794 million (2011: £126,953 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £662 million (2011: £508 million) for the Group and £15,277 million (2011: £38,543 million) for the Bank. Collateral is held with a fair value of £662 million (2011: £511 million) for the Group and £16,107 million (2011: £38,860 million) for the Bank, all of which the Group and Bank are able to repledge.

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**18 Loans and advances to customers**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Agriculture, forestry and fishing	5,531	5,198	2,193	1,984
Energy and water supply	3,321	4,013	2,119	2,338
Manufacturing	8,530	10,061	5,495	6,188
Construction	7,526	9,722	3,601	4,203
Transport, distribution and hotels	26,568	32,882	11,233	12,473
Postal and telecommunications	1,397	1,896	983	1,537
Property companies	52,388	64,752	23,255	24,217
Financial, business and other services	49,190	64,046	29,723	27,045
Personal:				
Mortgages	337,879	348,210	89,682	94,024
Other	28,334	30,014	13,270	14,560
Lease financing	6,477	7,800	318	586
Hire purchase	5,334	5,776	590	464
Due from fellow Group undertakings	18,882	18,599	61,263	62,963
<b>Total loans and advances to customers before allowance for impairment losses</b>	<b>551,357</b>	<b>602,969</b>	<b>243,725</b>	<b>252,582</b>
Allowance for impairment losses (note 22)	(15,250)	(18,732)	(3,179)	(3,469)
<b>Total loans and advances to customers</b>	<b>536,107</b>	<b>584,237</b>	<b>240,546</b>	<b>249,113</b>

At 31 December 2012 £448,715 million (2011: £469,454 million) of loans and advances to customers of the Group and £190,968 million (2011: £195,720 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £5,087 million (2011: £16,835 million) for the Group and £5,087 million (2011: £2,585 million) for the Bank. Collateral is held with a fair value of £4,916 million (2011: £16,936 million) for the Group and £4,916 million (2011: £2,682 million) for the Bank, all of which the Group and Bank are able to repledge.

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

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Gross investment in finance leases, receivable:				
Not later than 1 year	1,271	1,287	–	44
Later than 1 year and not later than 5 years	2,049	3,126	–	253
Later than 5 years	6,232	7,067	356	593
	<b>9,552</b>	<b>11,480</b>	<b>356</b>	<b>890</b>
Unearned future finance income on finance leases	(3,027)	(3,594)	(38)	(304)
Rentals received in advance	(30)	(56)	–	–
Commitments for expenditure in respect of equipment to be leased	(18)	(30)	–	–
<b>Net investment in finance leases</b>	<b>6,477</b>	<b>7,800</b>	<b>318</b>	<b>586</b>

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**18 Loans and advances to customers** (continued)

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Not later than 1 year	835	724	–	24
Later than 1 year and not later than 5 years	1,491	2,307	–	198
Later than 5 years	4,151	4,769	318	364
<b>Net investment in finance leases</b>	<b>6,477</b>	<b>7,800</b>	<b>318</b>	<b>586</b>

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2012 and 2011 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £33 million for the Group (2011: £92 million).

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Not later than 1 year	49	56	–	5
Later than 1 year and not later than 5 years	126	137	1	1
Later than 5 years	14	20	–	–
<b>Total unguaranteed residual values</b>	<b>189</b>	<b>213</b>	<b>1</b>	<b>6</b>

**19 Securitisations and covered bonds**

**Securitisation programmes**

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by Group companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of risks and rewards of the portfolio are retained by the Group company, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs described below, the Group sponsors three conduit programmes, Argento, Cancara and Gramplan (note 20).

**Covered bond programmes**

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

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**19 Securitisations and covered bonds** (continued)

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

	2012		2011	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
<b>Securitisation programmes<sup>1</sup></b>				
UK residential mortgages	80,125	57,285	129,764	94,080
US residential mortgage-backed securities	185	221	398	398
Commercial loans	15,024	14,110	13,313	11,342
Irish residential mortgages	5,189	3,509	5,497	5,661
Credit card receivables	6,974	3,794	6,763	4,810
Dutch residential mortgages	4,547	4,682	4,933	4,777
Personal loans	4,412	2,000	–	–
PPP/PFI and project finance loans	688	104	767	110
Motor vehicle loans	1,039	1,086	3,124	2,871
	<b>118,183</b>	<b>86,791</b>	164,559	124,049
Less held by the Group		<b>(58,732)</b>		(86,637)
<b>Total securitisation programmes</b> (note 35)		<b>28,059</b>		37,412
<b>Covered bond programmes</b>				
Residential mortgage-backed	91,420	64,593	91,023	67,456
Social housing loan-backed	2,927	2,400	3,363	2,605
	<b>94,347</b>	<b>66,993</b>	94,386	70,061
Less held by the Group		<b>(26,320)</b>		(31,865)
<b>Total covered bond programmes</b> (note 35)		<b>40,673</b>		38,196
<b>Total securitisation and covered bond programmes</b>		<b>68,732</b>		75,608

<sup>1</sup>Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £19,691 million (2011: £20,435 million) held by the Group are restricted in use to repayment of the debt securities issued by the special purpose entities and other legal obligations.

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## 20 Special purpose entities

In addition to the special purpose entities discussed in note 19, which are used for securitisation and covered bond programmes, the Group sponsors three asset-backed conduits, Argento, Cancara and Grampian, which invest in debt securities and client receivables. All of the external assets in these conduits are consolidated in the Group's financial statements. The total consolidated exposures in these conduits are set out in the table below:

	Argento £m	Cancara £m	Grampian £m	Total £m
<b>At 31 December 2012</b>				
Loans and advances	141	4,342	59	4,542
Debt securities:				
Classified as loans and receivables:				
Asset-backed securities	603	367	358	1,328
Corporate and other debt securities	–	–	–	–
	603	367	358	1,328
Classified as available-for-sale financial assets:				
Asset-backed securities	396	–	143	539
Corporate and other debt securities	–	–	–	–
	396	–	143	539
<b>Total assets</b>	<b>1,140</b>	<b>4,709</b>	<b>560</b>	<b>6,409</b>
<b>At 31 December 2011</b>				
Loans and advances	130	3,962	73	4,165
Debt securities:				
Classified as loans and receivables:				
Asset-backed securities	1,022	–	2,004	3,026
Corporate and other debt securities	–	–	–	–
	1,022	–	2,004	3,026
Classified as available-for-sale financial assets:				
Asset-backed securities	733	21	796	1,550
Corporate and other debt securities	73	–	–	73
	806	21	796	1,623
<b>Total assets</b>	<b>1,958</b>	<b>3,983</b>	<b>2,873</b>	<b>8,814</b>

### Other special purpose entities

During 2009, the Group established Lloyds TSB Pension ABCS (No 1) LLP and Lloyds TSB Pension ABCS (No 2) LLP and transferred approximately £5 billion of assets, primarily comprising notes in certain of the Group's securitisation programmes, in aggregate to these entities. Further details are provided in note 41.

## 21 Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Asset-backed securities:				
Mortgage-backed securities	3,927	7,179	393	514
Other asset-backed securities	1,150	5,030	5	43
Corporate and other debt securities	402	537	150	192
<b>Total debt securities classified as loans and receivables before allowance for impairment losses</b>	<b>5,479</b>	<b>12,746</b>	<b>548</b>	<b>749</b>
Allowance for impairment losses (see note 22)	(206)	(276)	(56)	(116)
<b>Total debt securities classified as loans and receivables</b>	<b>5,273</b>	<b>12,470</b>	<b>492</b>	<b>633</b>

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



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

<b>The Group</b>	<b>Loans and advances to customers £m</b>	<b>Loans and advances to banks £m</b>	<b>Debt securities £m</b>	<b>Total £m</b>
At 1 January 2011	18,373	20	558	18,951
Exchange and other adjustments	(369)	–	2	(367)
Advances written off	(7,487)	(6)	(341)	(7,834)
Recoveries of advances written off in previous years	421	–	8	429
Unwinding of discount	(226)	–	–	(226)
Charge to the income statement	8,020	–	49	8,069
At 31 December 2011	18,732	14	276	19,022
Exchange and other adjustments	<b>(379)</b>	<b>(1)</b>	<b>(8)</b>	<b>(388)</b>
Advances written off	<b>(8,697)</b>	<b>(10)</b>	<b>(73)</b>	<b>(8,780)</b>
Recoveries of advances written off in previous years	<b>843</b>	–	<b>15</b>	<b>858</b>
Unwinding of discount	<b>(374)</b>	–	–	<b>(374)</b>
Charge to the income statement	<b>5,125</b>	–	<b>(4)</b>	<b>5,121</b>
<b>At 31 December 2012</b>	<b>15,250</b>	<b>3</b>	<b>206</b>	<b>15,459</b>

Of the Group's total allowance in respect of loans and advances to customers, £13,936 million (2011: £17,021 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the Group's total allowance in respect of loans and advances to customers, £3,309 million (2011: £3,832 million) was assessed on a collective basis.

<b>The Bank</b>	<b>Loans and advances to customers £m</b>	<b>Loans and advances to banks £m</b>	<b>Debt securities £m</b>	<b>Total £m</b>
At 1 January 2011	3,151	20	190	3,361
Exchange and other adjustments	–	–	4	4
Advances written off	(2,307)	(6)	(96)	(2,409)
Recoveries of advances written off in previous years	284	–	–	284
Unwinding of discount	(103)	–	–	(103)
Charge (release) to the income statement	2,444	–	18	2,462
At 31 December 2011	3,469	14	116	3,599
Exchange and other adjustments	<b>(65)</b>	<b>(1)</b>	<b>(4)</b>	<b>(70)</b>
Advances written off	<b>(2,073)</b>	<b>(10)</b>	<b>(58)</b>	<b>(2,141)</b>
Recoveries of advances written off in previous years	<b>325</b>	–	–	<b>325</b>
Unwinding of discount	<b>(67)</b>	–	–	<b>(67)</b>
Charge to the income statement	<b>1,590</b>	–	<b>2</b>	<b>1,592</b>
<b>At 31 December 2012</b>	<b>3,179</b>	<b>3</b>	<b>56</b>	<b>3,238</b>

Of the Bank's total allowance in respect of loans and advances to customers, £2,702 million (2011: £2,952 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the Bank's total allowance in respect of loans and advances to customers, £1,020 million (2011: £1,272 million) was assessed on a collective basis.

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**23 Available-for-sale financial assets**

The Group	2012			2011		
	Conduits £m	Other £m	Total £m	Conduits £m	Other £m	Total £m
Debt securities:						
Government securities	–	25,555	25,555	–	25,236	25,236
Other public sector securities	–	–	–	–	27	27
Bank and building society certificates of deposit	–	188	188	–	366	366
Asset-backed securities:						
Mortgage-backed securities	277	1,247	1,524	1,255	548	1,803
Other asset-backed securities	262	498	760	295	769	1,064
Corporate and other debt securities	–	1,848	1,848	73	5,718	5,791
	539	29,336	29,875	1,623	32,664	34,287
Equity shares	–	528	528	–	1,938	1,938
Treasury bills and similar securities	–	971	971	–	1,727	1,727
<b>Total available-for-sale financial assets</b>	<b>539</b>	<b>30,835</b>	<b>31,374</b>	<b>1,623</b>	<b>36,329</b>	<b>37,952</b>

The Bank	2012 £m	2011 £m
Debt securities:		
Government securities	25,418	25,067
Other public sector securities	–	27
Bank and building society certificates of deposit	159	329
Asset-backed securities:		
Mortgage-backed securities	456	497
Other asset-backed securities	88	305
Corporate and other debt securities	4,808	5,050
	30,929	31,275
Equity shares	47	47
Treasury bills and similar securities	116	29
<b>Total available-for-sale financial assets</b>	<b>31,092</b>	<b>31,351</b>

Details of the Group's asset-backed conduits shown in the table above are included in note 20.

Further information on asset-backed security exposures is provided in note 54.

At 31 December 2012 £29,754 million (2011: £42,702 million) of available-for-sale financial assets of the Group and £30,002 million (2011: £37,754 million) of the Bank had a contractual residual maturity of greater than one year.

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

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

At 31 December 2012, the Bank had sold £105 million (2011: £150 million) of debt securities to one of its subsidiary undertakings; however the related agreement is such that the Bank has retained substantially all of the risks and rewards of ownership and, as a consequence, the debt securities continue to be recognised on the Bank's balance sheet.

**24 Held-to-maturity investments**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Debt securities: government securities	–	8,098	–	8,098

During 2012 the Group has reviewed its holding of government securities classified as held-to-maturity. Since it is no longer the Group's intention to hold these to maturity, they have been reclassified as available-for-sale (note 23). Details of the impact of this reclassification are provided in note 53.

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**25 Investment properties of the Group**

	2012 £m	2011 £m
At 1 January	6,122	5,997
Exchange and other adjustments	22	(16)
Additions:		
Acquisitions of new properties	428	396
Consolidation of new subsidiary undertakings	411	922
Additional expenditure on existing properties	89	81
Total additions	928	1,399
Disposals	(1,403)	(1,151)
Changes in fair value (note 7)	(264)	(107)
<b>At 31 December</b>	<b>5,405</b>	<b>6,122</b>

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

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

	2012 £m	2011 £m
Rental income	389	388
Direct operating expenses arising from investment properties that generate rental income	42	50

Capital expenditure in respect of investment properties:

	2012 £m	2011 £m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	24	33

**26 Goodwill of the Group**

	2012 £m	2011 £m
At 1 January and 31 December	2,016	2,016
Cost <sup>1</sup>	2,362	2,362
Accumulated impairment losses	(346)	(346)
<b>At 31 December</b>	<b>2,016</b>	<b>2,016</b>

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (2011: £2,016 million), £1,836 million (or 91 per cent of the total) has been allocated to Scottish Widows and £170 million (or 8 per cent of the total) to Asset Finance.

The recoverable amount of Scottish Widows has been based on a value-in-use calculation. The calculation uses post-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 12 per cent (net of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of Asset Finance has also been based on a value in use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent (gross of tax). The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Asset Finance to fall below its balance sheet carrying value.

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**27 Value of in-force business of the Group**

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

	2012 £m	2011 £m
Acquired value of in-force non-participating investment contracts	1,312	1,391
Value of in-force insurance and participating investment contracts	5,488	5,247
<b>Total value of in-force business</b>	<b>6,800</b>	<b>6,638</b>

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

	2012 £m	2011 £m
At 1 January	1,391	1,469
Amortisation taken to income statement (note 11)	(79)	(78)
<b>At 31 December</b>	<b>1,312</b>	<b>1,391</b>

The acquired value of in-force non-participating investment contracts includes £303 million (2011: £329 million) in relation to OEIC business.

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

	2012 £m	2011 £m
At 1 January	5,247	5,898
Exchange and other adjustments	(28)	(29)
Movements in the year:		
New business	570	552
Existing business:		
Expected return	(471)	(437)
Experience variances	52	117
Assumption changes	(90)	(576)
Economic variance	208	(278)
Movement in the value of in-force business taken to income statement (note 9)	269	(622)
<b>At 31 December</b>	<b>5,488</b>	<b>5,247</b>

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

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

*Economic assumptions*

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

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

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and, since late 2012, illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. The illiquidity premium is estimated to be 73 basis points at 31 December 2012 (2011: 119 basis points). The effect of including illiquid loan assets in the calculation of the market premium for illiquidity has been to increase the value of in-force business by £44 million as at 31 December 2012. This is included as an assumption change in the table below. The effect of this change on profit before tax, after also including the impacts of movements in liabilities, is given in note 36.

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**27 Value of in-force business of the Group** (continued)

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

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

	2012 %	2011 %
Risk-free rate (value of in-force non-annuity business)	<b>2.32</b>	2.48
Risk-free rate (value of in-force annuity business)	<b>3.25</b>	3.76
Risk-free rate (financial options and guarantees)	<b>0.22 to 3.56</b>	0.22 to 3.36
Retail price inflation	<b>3.13</b>	3.35
Expense inflation	<b>3.61</b>	4.01

*Non-market risk*

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit fund these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

*Non-economic assumptions*

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

*Mortality and morbidity*

The mortality and morbidity assumptions, including allowances for improvements in longevity, are set with regard to the Group's actual experience where this provides a reliable basis and relevant industry data otherwise. For German business, appropriate industry tables have been considered.

*Lapse (persistence) and paid-up rates*

Lapse and paid up rates assumptions are reviewed each year. The most recent experience is considered along with the results of previous analyses and management's views on future experience. In determining this best estimate view, a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration and any known or expected trends in underlying data.

*Maintenance expenses*

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

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

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**28 Other intangible assets**

	The Group					The Bank	
	Brands £m	Core deposit intangibles £m	Purchased credit card relation- ships £m	Customer related intangibles £m	Capitalised software enhance- ments £m	Total £m	Capitalised software enhance- ments £m
Cost:							
At 1 January 2011	596	2,770	300	877	610	5,153	232
Exchange and other adjustments	–	–	–	–	5	5	1
Additions	–	–	–	4	369	373	259
Disposals	–	–	–	–	(25)	(25)	–
At 31 December 2011	596	2,770	300	881	959	5,506	492
Exchange and other adjustments	–	–	–	–	27	27	–
Additions	–	–	–	–	236	236	184
Disposals	–	–	–	–	(89)	(89)	(49)
<b>At 31 December 2012</b>	<b>596</b>	<b>2,770</b>	<b>300</b>	<b>881</b>	<b>1,133</b>	<b>5,680</b>	<b>627</b>
Accumulated amortisation:							
At 1 January 2011	46	793	118	398	302	1,657	114
Exchange and other adjustments	–	–	–	–	2	2	–
Charge for the year	19	399	60	88	97	663	49
Disposals	–	–	–	–	(12)	(12)	–
At 31 December 2011	65	1,192	178	486	389	2,310	163
Exchange and other adjustments	–	–	–	–	25	25	–
Charge for the year	21	368	60	40	127	616	77
Disposals	–	–	–	–	(63)	(63)	(24)
<b>At 31 December 2012</b>	<b>86</b>	<b>1,560</b>	<b>238</b>	<b>526</b>	<b>478</b>	<b>2,888</b>	<b>216</b>
<b>Balance sheet amount at 31 December 2012</b>	<b>510</b>	<b>1,210</b>	<b>62</b>	<b>355</b>	<b>655</b>	<b>2,792</b>	<b>411</b>
Balance sheet amount at 31 December 2011	531	1,578	122	395	570	3,196	329

Included within brands above are assets of £380 million (2011: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not continue indefinitely.

The core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates, and the balance sheet amount at 31 December 2012 shown above will be amortised, in accordance with the Group's accounting policy, on a straight line basis over its remaining useful life of four years (see note 2c).

The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income.

Capitalised software enhancements of the Bank and the Group principally comprise identifiable and directly associated internal staff and other costs.

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**29 Tangible fixed assets**

	The Group				The Bank			
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m
Cost:								
At 1 January 2011	2,440	4,780	6,286	13,506	1,273	3,351	–	4,624
Exchange and other adjustments	(23)	(153)	(21)	(197)	–	–	–	–
Additions	173	767	1,436	2,376	102	486	–	588
Disposals	(122)	(395)	(1,851)	(2,368)	(32)	(126)	–	(158)
Disposal of businesses	(14)	(7)	(330)	(351)	–	–	–	–
At 31 December 2011	2,454	4,992	5,520	12,966	1,343	3,711	–	5,054
Exchange and other adjustments	<b>2</b>	<b>(82)</b>	<b>(11)</b>	<b>(91)</b>	<b>(27)</b>	<b>(19)</b>	<b>(8)</b>	<b>(54)</b>
Additions	<b>225</b>	<b>711</b>	<b>1,314</b>	<b>2,250</b>	<b>152</b>	<b>538</b>	<b>168</b>	<b>858</b>
Disposals	<b>(65)</b>	<b>(306)</b>	<b>(1,924)</b>	<b>(2,295)</b>	<b>(33)</b>	<b>(86)</b>	–	<b>(119)</b>
Write-offs	–	<b>(1,562)</b>	–	<b>(1,562)</b>	–	<b>(954)</b>	–	<b>(954)</b>
<b>At 31 December 2012</b>	<b>2,616</b>	<b>3,753</b>	<b>4,899</b>	<b>11,268</b>	<b>1,435</b>	<b>3,190</b>	<b>160</b>	<b>4,785</b>
Accumulated depreciation and impairment:								
At 1 January 2011	1,001	3,046	1,269	5,316	819	2,274	–	3,093
Exchange and other adjustments	(1)	15	20	34	1	1	–	2
Impairment charged to the income statement (note 11)	–	65	–	65	–	–	–	–
Depreciation charge for the year (note 11)	137	412	885	1,434	72	273	–	345
Disposals	(37)	(349)	(966)	(1,352)	(29)	(88)	–	(117)
Disposal of businesses	(3)	(6)	(195)	(204)	–	–	–	–
At 31 December 2011	1,097	3,183	1,013	5,293	863	2,460	–	3,323
Exchange and other adjustments	<b>(8)</b>	<b>(77)</b>	<b>52</b>	<b>(33)</b>	<b>(16)</b>	<b>(17)</b>	<b>(1)</b>	<b>(34)</b>
Depreciation charge for the year (note 11)	<b>130</b>	<b>432</b>	<b>869</b>	<b>1,431</b>	<b>70</b>	<b>305</b>	<b>3</b>	<b>378</b>
Disposals	<b>(28)</b>	<b>(266)</b>	<b>(909)</b>	<b>(1,203)</b>	<b>(15)</b>	<b>(99)</b>	–	<b>(114)</b>
Write-offs	–	<b>(1,562)</b>	–	<b>(1,562)</b>	–	<b>(954)</b>	–	<b>(954)</b>
<b>At 31 December 2012</b>	<b>1,191</b>	<b>1,710</b>	<b>1,025</b>	<b>3,926</b>	<b>902</b>	<b>1,695</b>	<b>2</b>	<b>2,599</b>
<b>Balance sheet amount at 31 December 2012</b>	<b>1,425</b>	<b>2,043</b>	<b>3,874</b>	<b>7,342</b>	<b>533</b>	<b>1,495</b>	<b>158</b>	<b>2,186</b>
Balance sheet amount at 31 December 2011	1,357	1,809	4,507	7,673	480	1,251	–	1,731

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

	2012 £m	2011 £m
Receivable within 1 year	<b>1,033</b>	987
1 to 5 years	<b>1,291</b>	1,389
Over 5 years	<b>438</b>	628
<b>Total future minimum rentals receivable</b>	<b>2,762</b>	3,004

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

In addition, total future minimum sub-lease income of £30 million for the Group and £24 million for the Bank at 31 December 2012 (£40 million for the Group and £31 million for the Bank at 31 December 2011) is expected to be received under non-cancellable sub-leases of premises.

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**30 Investment in subsidiary undertakings of the Bank**

	2012 £m	2011 £m
At 1 January	40,289	40,155
Exchange and other adjustments	(6)	(4)
Additional capital injections and transfers	37	159
Disposals	(362)	(4)
Impairment	–	(17)
<b>At 31 December</b>	<b>39,958</b>	<b>40,289</b>

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

	Share class	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Scotland plc	Ordinary	Scotland	100%	Banking and financial services
Scottish Widows plc	Ordinary	Scotland	100% <sup>1</sup>	Life assurance
HBOS plc	Ordinary	Scotland	100%	Holding company
Bank of Scotland plc	Ordinary	Scotland	100% <sup>1</sup>	Banking and financial services
HBOS Insurance & Investment Group Limited	Ordinary	England	100% <sup>1</sup>	Holding company
St. Andrew's Insurance plc	Ordinary	England	100% <sup>1</sup>	General insurance
Clerical Medical Investment Group Limited	Ordinary	England	100% <sup>1</sup>	Life assurance
Clerical Medical Managed Funds Limited	Ordinary	England	100% <sup>1</sup>	Life assurance

<sup>1</sup>Indirect interest.

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

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

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



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**31 Other assets**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Assets arising from reinsurance contracts held (notes 36 and 38)	2,320	2,534	–	–
Deferred acquisition and origination costs (see below)	774	693	–	–
Settlement balances	1,332	1,193	592	357
Corporate pension asset	6,353	3,873	–	–
Investments in joint ventures and associates (note 13)	313	334	5	6
Other assets and prepayments	7,230	6,185	950	900
<b>Total other assets</b>	<b>18,322</b>	<b>14,812</b>	<b>1,547</b>	<b>1,263</b>

	2012 £m	2011 £m
Deferred acquisition and origination costs of the Group:		
At 1 January	693	602
Exchange and other adjustments	1	(1)
Acquisition and origination costs deferred, net of amounts amortised to the income statement	80	92
<b>At 31 December</b>	<b>774</b>	<b>693</b>

**32 Deposits from banks**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Liabilities in respect of securities sold under repurchase agreements	23,368	14,389	34,466	15,471
Other deposits from banks	15,037	25,421	180,259	139,121
<b>Total deposits from banks</b>	<b>38,405</b>	<b>39,810</b>	<b>214,725</b>	<b>154,592</b>

At 31 December 2012 £9,766 million (2011: £12,387 million) of deposits from banks of the Group and £140,391 million (2011: £95,083 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £23,078 million (2011: £13,933 million) for the Group and £28,907 million (2011: £22,660 million) for the Bank and a fair value of £25,682 million (2011: £14,258 million) for the Group and £29,405 million (2011: £23,302 million) for the Bank.

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

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### 33 Customer deposits

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Non-interest bearing current accounts	<b>30,633</b>	29,468	<b>17,469</b>	17,297
Interest bearing current accounts	<b>71,478</b>	72,562	<b>45,128</b>	40,214
Savings and investment accounts	<b>261,573</b>	238,132	<b>86,037</b>	79,681
Liabilities in respect of securities sold under repurchase agreements	<b>4,433</b>	7,996	<b>4,429</b>	4,117
Other customer deposits	<b>68,745</b>	76,219	<b>78,710</b>	86,244
<b>Total customer deposits</b>	<b>436,862</b>	424,377	<b>231,773</b>	227,553

At 31 December 2012 £59,044 million (2011: £48,347 million) of customer deposits of the Group and £38,900 million (2011: £39,694 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £4,429 million (2011: £7,987 million) for the Group and £4,429 million for the Bank (2011: £5,552 million) and a fair value of £4,552 million (2011: £8,088 million) for the Group and £4,552 million (2011: £5,713 million) for the Bank.

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

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Liabilities held at fair value through profit or loss (debt securities)	<b>5,700</b>	5,339	<b>5,700</b>	5,339
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	<b>24,553</b>	12,378	<b>584</b>	–
Short positions in securities	<b>2,200</b>	3,701	<b>1,053</b>	1,964
Other	<b>3,519</b>	3,537	<b>3,504</b>	3,602
	<b>30,272</b>	19,616	<b>5,141</b>	5,566
<b>Trading and other financial liabilities at fair value through profit or loss</b>	<b>35,972</b>	24,955	<b>10,841</b>	10,905

At 31 December 2012, the Group had £9,435 million (2011: £9,433 million) and the Bank had £9,087 million (2011: £9,067 million) of trading and other liabilities at fair value through profit or loss with a contractual residual maturity of greater than one year.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2012 was £6,553 million (2011: £5,487 million), which was £853 million higher than the balance sheet carrying value (2011: £148 million higher). At 31 December 2012 there was a cumulative £254 million increase (2011: £183 million decrease) in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of the Bank. Of the cumulative amount, an increase of £437 million arose in 2012 and £194 million arose in 2011.

Liabilities designated at fair value through profit or loss 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.

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### 35 Debt securities in issue

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Medium-term notes issued	28,985	62,811	23,734	50,824
Covered bonds (note 19)	40,673	38,196	16,156	11,545
Certificates of deposit issued	11,087	27,994	11,058	27,644
Securitisation notes (note 19)	28,059	37,412	7,321	8,235
Commercial paper	8,013	18,091	3,225	3,989
<b>Total debt securities in issue</b>	<b>116,817</b>	<b>184,504</b>	<b>61,494</b>	<b>102,237</b>

At 31 December 2012 £80,257 million (2011: £101,726 million) of debt securities in issue of the Group and £40,716 million (2011: £43,031 million) of the Bank had a contractual residual maturity of greater than one year.

### 36 Liabilities of the Group arising from insurance contracts and participating investment contracts

Insurance contract and participating investment contract liabilities are comprised as follows:

	2012			2011		
	Gross £m	Reinsurance <sup>1</sup> £m	Net £m	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	65,665	(2,257)	63,408	62,409	(2,452)	59,957
Participating investment contracts	16,489	–	16,489	15,631	–	15,631
	<b>82,154</b>	<b>(2,257)</b>	<b>79,897</b>	78,040	(2,452)	75,588
Non-life insurance contracts (see (2) below):						
Unearned premiums	494	(16)	478	566	(23)	543
Claims outstanding	320	(1)	319	395	(2)	393
	<b>814</b>	<b>(17)</b>	<b>797</b>	961	(25)	936
<b>Total</b>	<b>82,968</b>	<b>(2,274)</b>	<b>80,694</b>	79,001	(2,477)	76,524

<sup>1</sup>Reinsurance balances are reported within other assets (note 31).

#### (1) Life insurance

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

	Insurance contracts	Participating investment contracts	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
At 1 January 2011	61,891	17,642	79,533	(2,044)	77,489
New business	4,340	86	4,426	(156)	4,270
Changes in existing business	(3,713)	(2,096)	(5,809)	(295)	(6,104)
Change in liabilities charged to the income statement (note 10)	627	(2,010)	(1,383)	(451)	(1,834)
Exchange and other adjustments	(109)	(1)	(110)	43	(67)
At 31 December 2011	62,409	15,631	78,040	(2,452)	75,588
New business	2,757	65	2,822	(67)	2,755
Changes in existing business	668	794	1,462	253	1,715
Change in liabilities charged to the income statement (note 10)	3,425	859	4,284	186	4,470
Exchange and other adjustments	(169)	(1)	(170)	9	(161)
<b>At 31 December 2012</b>	<b>65,665</b>	<b>16,489</b>	<b>82,154</b>	<b>(2,257)</b>	<b>79,897</b>

<sup>1</sup>Reinsurance balances are reported within other assets (note 31).

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

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

	2012			2011		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	12,398	53,267	65,665	13,477	48,932	62,409
Participating investment contracts	9,646	6,843	16,489	9,488	6,143	15,631
<b>Total</b>	<b>22,044</b>	<b>60,110</b>	<b>82,154</b>	<b>22,965</b>	<b>55,075</b>	<b>78,040</b>

**With-profit fund realistic liabilities**

**(i) Business description**

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to the policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

**(ii) Method of calculation of liabilities**

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

- With-profit benefit reserve, the total asset shares for with-profit policies;
- Cost of options and guarantees (including guaranteed annuity options);
- Deductions levied against asset shares;
- Planned enhancements to with-profits benefits reserve; and
- Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market-consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 27.

**(iii) Assumptions**

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

**Investment returns and discount rates**

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

**Guaranteed annuity option take-up rates**

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

**Investment volatility**

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

**Mortality**

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

### **36 Liabilities of the Group arising from insurance contracts and participating investment contracts (continued)**

#### **Lapse rates (persistence)**

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

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

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

#### **Non-profit fund liabilities**

##### ***(i) Business description***

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

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

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

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

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

- Traditional or unit linked endowment or pensions business; and
- Life insurance business

##### ***(ii) Method of calculation of liabilities***

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

##### ***(iii) Assumptions***

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

#### **Interest rates**

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

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

#### **Mortality and morbidity**

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

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

**Lapse rates (persistence)**

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

**Maintenance expenses**

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

**Key changes in assumptions**

A detailed review of the Group's assumptions in 2012 resulted in the following key impacts on profit before tax:

- Change in persistence assumptions (£124 million decrease).
- Change in the assumption in respect of current and future mortality rates (£4 million increase).
- Change in expenses assumptions (£81 million increase).
- Inclusion of illiquid loan assets in the valuation of the annuity portfolio (£44 million increase).
- Reduction of assumed future bonus rate and move to yield curve valuation of annuities (£19 million increase).
- Addition of an allowance for the time value cost of interest rate options on traditional with-profits business (£10 million decrease).

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

**(2) Non-life insurance**

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

	2012 £m	2011 £m
Credit protection	94	206
Home	718	753
Health	2	2
<b>Total gross non-life insurance contract liabilities</b>	<b>814</b>	<b>961</b>

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

The reserving methodology and associated assumptions are set out below:

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

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

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

	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
<b>Provisions for unearned premiums</b>			
At 1 January 2011	632	(22)	610
Increase in the year	1,082	(52)	1,030
Release in the year	(1,152)	52	(1,100)
Change in provision for unearned premiums charged to income statement (note 8)	(70)	–	(70)
Exchange and other adjustments	4	(1)	3
At 31 December 2011	566	(23)	543
Increase in the year	1,081	(31)	1,050
Release in the year	(1,153)	38	(1,115)
Change in provision for unearned premiums charged to income statement (note 8)	(72)	7	(65)
<b>At 31 December 2012</b>	<b>494</b>	<b>(16)</b>	<b>478</b>

<sup>1</sup>Reinsurance balances are reported within other assets (note 31).

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

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

	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
<b>Claims and loss adjustment expenses</b>			
Notified claims	420	(4)	416
Incurred but not reported	164	(11)	153
At 1 January 2011	584	(15)	569
Cash paid for claims settled in the year	(485)	–	(485)
Increase (decrease) in liabilities:			
Arising from current year claims	470	–	470
Arising from prior year claims	(171)	12	(159)
Change in liabilities charged to income statement (note 10)	(186)	12	(174)
Exchange and other adjustments	(3)	1	(2)
At 31 December 2011	395	(2)	393
Cash paid for claims settled in the year	(455)	1	(454)
Increase (decrease) in liabilities:			
Arising from current year claims	492	–	492
Arising from prior year claims	(111)	–	(111)
Change in liabilities charged to income statement (note 10)	(74)	1	(73)
Exchange and other adjustments	(1)	–	(1)
<b>At 31 December 2012</b>	<b>320</b>	<b>(1)</b>	<b>319</b>
Notified claims	280	–	280
Incurred but not reported	40	(1)	39
<b>At 31 December 2012</b>	<b>320</b>	<b>(1)</b>	<b>319</b>
Notified claims	313	(1)	312
Incurred but not reported	82	(1)	81
At 31 December 2011	395	(2)	393

<sup>1</sup>Reinsurance balances are reported within other assets (note 31).

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

*Non-life insurance claims development table*

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

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

	Accident year							<b>2012</b>	<b>Total</b>
	2005	2006	2007	2008	2009	2010	2011		
	£m	£m	£m	£m	£m	£m	£m		
<b>Estimate of ultimate claims costs</b>									
At end of accident year	211	208	317	205	262	609	446	<b>421</b>	<b>2,679</b>
One year later	207	206	311	199	237	517	366		
Two years later	204	204	299	195	216	497			
Three years later	202	204	292	187	208				
Four years later	201	205	285	186					
Five years later	201	203	286						
Six years later	201	202							
Seven years later	200								
Current estimate in respect of above claims	200	202	286	186	208	497	366	<b>421</b>	<b>2,366</b>
Current estimate of claims relating to HBOS general insurance business transferred in 2010	272	315	388	256	279	–	–	–	<b>1,510</b>
Current estimate of cumulative claims	472	517	674	442	487	497	366	<b>421</b>	<b>3,876</b>
Cumulative payments to date	(471)	(515)	(671)	(437)	(476)	(469)	(315)	<b>(227)</b>	<b>(3,581)</b>
Liability recognised in the balance sheet	1	2	3	5	11	28	51	<b>194</b>	<b>295</b>
Liability in respect of earlier years									<b>1</b>
<b>Total liability included in the balance sheet</b>									<b>296</b>

The liability of £296 million shown in the above table excludes £13 million of unallocated claims handling expenses and £11 million of unexpired risk reserve.



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### 37 Life insurance sensitivity analysis of the Group

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

<b>31 December 2012</b>	<b>Change in variable</b>	<b>Increase (reduction) in profit before tax £m</b>	<b>Increase (reduction) in equity £m</b>
Non-annuitant mortality <sup>1</sup>	5% reduction	<b>43</b>	<b>33</b>
Annuitant mortality <sup>2</sup>	5% reduction	<b>(170)</b>	<b>(131)</b>
Lapse rates <sup>3</sup>	10% reduction	<b>117</b>	<b>90</b>
Future maintenance and investment expenses <sup>4</sup>	10% reduction	<b>199</b>	<b>153</b>
Risk-free rate <sup>5</sup>	0.25% reduction	<b>26</b>	<b>20</b>
Guaranteed annuity option take-up <sup>6</sup>	5% addition	<b>(9)</b>	<b>(7)</b>
Equity investment volatility <sup>7</sup>	1% addition	<b>(7)</b>	<b>(5)</b>
Widening of credit default spreads on corporate bonds <sup>8</sup>	0.25% addition	<b>(239)</b>	<b>(184)</b>
Increase in illiquidity premia <sup>9</sup>	0.10% addition	<b>93</b>	<b>72</b>

31 December 2011	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
Non-annuitant mortality <sup>1</sup>	5% reduction	48	36
Annuitant mortality <sup>2</sup>	5% reduction	(154)	(115)
Lapse rates <sup>3</sup>	10% reduction	123	92
Future maintenance and investment expenses <sup>4</sup>	10% reduction	207	156
Risk-free rate <sup>5</sup>	0.25% reduction	55	41
Guaranteed annuity option take-up <sup>6</sup>	5% addition	(4)	(3)
Equity investment volatility <sup>7</sup>	1% addition	(9)	(7)
Widening of credit default spreads on corporate bonds <sup>8</sup>	0.25% addition	(164)	(123)
Increase in illiquidity premia <sup>9</sup>	0.10% addition	87	66

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

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

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

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

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

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

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

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

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

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

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**38 Liabilities of the Group arising from non-participating investment contracts**

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

	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
At 1 January 2011	51,363	(65)	51,298
New business	4,194	(3)	4,191
Changes in existing business	(5,922)	11	(5,911)
Exchange and other adjustments	1	–	1
At 31 December 2011	49,636	(57)	49,579
New business	<b>4,236</b>	<b>(1)</b>	<b>4,235</b>
Changes in existing business	<b>526</b>	<b>12</b>	<b>538</b>
Exchange and other adjustments	<b>(26)</b>	–	<b>(26)</b>
<b>At 31 December 2012</b>	<b>54,372</b>	<b>(46)</b>	<b>54,326</b>

<sup>1</sup>Reinsurance balances are reported within other assets (note 31).

**39 Unallocated surplus within insurance businesses for the Group**

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

	2012 £m	2011 £m
At 1 January	<b>300</b>	643
Change in unallocated surplus recognised in the income statement (note 10)	<b>(31)</b>	(340)
Exchange and other adjustments	<b>(2)</b>	(3)
<b>At 31 December</b>	<b>267</b>	300

**40 Other liabilities**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Settlement balances	<b>1,998</b>	1,937	<b>489</b>	154
Unitholders' interest in Open Ended Investment Companies	<b>20,935</b>	18,249	–	–
Other creditors and accruals	<b>11,665</b>	12,339	<b>4,035</b>	4,210
	<b>34,598</b>	32,525	<b>4,524</b>	4,364

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**41 Retirement benefit obligations**

	2012 £m	2011 £m
<b>Charge (credit) to the Group income statement:</b>		
Past service credits and curtailment gains <sup>1</sup>	(250)	–
Other	307	186
Defined benefit pension schemes	57	186
Other post-retirement benefit schemes	11	13
Total defined benefit schemes	68	199
Defined contribution pension schemes	229	202
<b>Total charge (credit) to the income statement</b>	<b>297</b>	<b>401</b>

<sup>1</sup>In 2012, there was a net credit of £250 million following a decision to link discretionary pension increases in certain schemes to the Consumer Price Index.

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Amounts recognised in the balance sheet:</b>				
Retirement benefit assets	1,867	1,338	738	736
Retirement benefit obligations	(300)	(381)	(150)	(199)
<b>Total amounts recognised in the balance sheet</b>	<b>1,567</b>	<b>957</b>	<b>588</b>	<b>537</b>

The total amount recognised in the balance sheet relates to:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Defined benefit pension schemes	1,748	1,131	709	655
Other post-retirement benefit schemes	(181)	(174)	(121)	(118)
<b>Total amounts recognised in the balance sheet</b>	<b>1,567</b>	<b>957</b>	<b>588</b>	<b>537</b>

For accounting purposes, the assets and liabilities of the Group's post-retirement benefit schemes are allocated between the participating employers, including the Bank, in proportion to the cash contributions made to the schemes.

**Pension schemes**

*Defined benefit schemes*

The Group has established a number of defined benefit pension schemes in the UK and overseas, the three most significant being the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme (HFSPS). These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2012 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The latest full valuations of the three main schemes were carried out as at 30 June 2011; the results have been updated to 31 December 2012 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2012 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's and the Bank's obligations in respect of defined benefit schemes are funded.

During 2009, the Group made one-off contributions to the Lloyds TSB Group Pension Scheme No 1 and the Lloyds TSB Group Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. Thereafter, assuming that all distributions have been made, the value of the partnership interests will equate to a nominal amount. At 31 December 2012, the limited liability partnerships held assets of approximately £4.7 billion; cash payments of £215 million were made to the pension schemes during the year (2011 £215 million). The limited liability partnerships are fully consolidated in the Group's balance sheet (see note 20).

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**41 Retirement benefit obligations** (continued)

The Group currently expects to pay contributions of approximately £1,025 million to its defined benefit schemes in 2013.

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Amounts included in the balance sheet:</b>				
Present value of funded obligations	<b>(31,324)</b>	(28,236)	<b>(16,060)</b>	(14,635)
Fair value of scheme assets	<b>30,367</b>	28,828	<b>15,071</b>	14,549
	<b>(957)</b>	592	<b>(989)</b>	(86)
Unrecognised actuarial losses	<b>2,705</b>	539	<b>1,698</b>	741
<b>Net amount recognised in the balance sheet</b>	<b>1,748</b>	1,131	<b>709</b>	655

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Movements in the defined benefit obligation:</b>				
At 1 January	<b>(28,236)</b>	(26,862)	<b>(14,635)</b>	(14,143)
Current service cost	<b>(360)</b>	(380)	<b>(122)</b>	(141)
Employee contributions	<b>(3)</b>	(1)	–	–
Interest cost	<b>(1,373)</b>	(1,423)	<b>(595)</b>	(704)
Actuarial losses	<b>(2,607)</b>	(514)	<b>(1,172)</b>	(132)
Benefits paid	<b>995</b>	912	<b>461</b>	475
Past service cost	<b>(16)</b>	(20)	<b>(11)</b>	(10)
Curtailments	<b>250</b>	25	<b>3</b>	24
Settlements	<b>12</b>	15	<b>4</b>	–
Exchange and other adjustments	<b>14</b>	12	<b>7</b>	(4)
<b>At 31 December</b>	<b>(31,324)</b>	(28,236)	<b>(16,060)</b>	(14,635)

**Changes in the fair value of scheme assets:**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January	<b>28,828</b>	26,382	<b>14,549</b>	13,784
Expected return	<b>1,446</b>	1,627	<b>613</b>	791
Employer contributions	<b>667</b>	833	<b>164</b>	356
Employee contributions	<b>3</b>	1	–	–
Actuarial gains	<b>442</b>	926	<b>214</b>	96
Benefits paid	<b>(993)</b>	(912)	<b>(460)</b>	(475)
Settlements	<b>(16)</b>	(23)	<b>(4)</b>	–
Exchange and other adjustments	<b>(10)</b>	(6)	<b>(5)</b>	(3)
<b>At 31 December</b>	<b>30,367</b>	28,828	<b>15,071</b>	14,549
<b>Actual return on scheme assets</b>	<b>1,888</b>	2,553	<b>827</b>	887

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**41 Retirement benefit obligations** (continued)

**Assumptions**

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

	2012 %	2011 %
Discount rate	4.60	5.00
Rate of inflation		
– Retail Prices Index	2.90	3.00
– Consumer Price Index	2.00	2.00
Rate of salary increases	2.00	2.00
Rate of increase for pensions in payment	2.70	2.80

  

	2012 Years	2011 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.4	27.3
Women	29.7	28.4
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.5	28.8
Women	30.9	30.0

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2012 is assumed to live for, on average, 27.4 years for a male and 29.7 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

**Sensitivity analysis**

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

	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme asset	
	2012 £m	2011 £m	2012 £m	2011 £m
Inflation <sup>1</sup> :				
Increase of 0.2 per cent	50	12	(884)	(798)
Decrease of 0.2 per cent	(45)	(6)	815	783
Discount rate <sup>2</sup> :				
Increase of 0.2 per cent	(54)	(10)	1,056	909
Decrease of 0.2 per cent	54	17	(1,102)	(957)
Expected life expectancy of members:				
Increase of one year	74	38	(697)	(655)
Decrease of one year	(73)	(40)	686	667

<sup>1</sup>At 31 December 2012, the assumed rate of inflation is 2.90 per cent (2011: 3.00 per cent).

<sup>2</sup>At 31 December 2012, the assumed discount rate is 4.60 per cent (2011: 5.00 per cent).

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**41 Retirement benefit obligations** (continued)

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

	2012 %	2011 %	2010 %
Equities and alternative assets	<b>7.3</b>	8.3	8.3
Fixed interest gilts	<b>3.0</b>	4.0	4.5
Index linked gilts	<b>2.8</b>	3.9	4.1
Non-Government bonds	<b>4.9</b>	4.9	6.0
Property	<b>6.6</b>	7.3	7.5
Money market instruments and cash	<b>2.6</b>	3.9	4.3

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

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

With effect from 1 January 2013 the Group will adopt amendments to IAS 19 *Employee Benefits*. These amendments will change the calculation of the Group's defined benefit schemes' income statement expense, replacing expected return on scheme assets and interest cost with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset) (see note 57 on page 147). The above expected return on scheme assets will be used in determining the effect of this new accounting policy on the Group's 2013 income statement expense.

Composition of scheme assets:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Equities	<b>12,364</b>	10,728	<b>6,350</b>	5,455
Fixed interest gilts	<b>771</b>	995	<b>272</b>	368
Index linked gilts	<b>6,429</b>	6,211	<b>4,110</b>	3,895
Non-Government bonds	<b>5,014</b>	4,250	<b>2,388</b>	2,400
Property	<b>1,528</b>	1,708	<b>929</b>	1,109
Money market instruments, cash and other assets and liabilities	<b>4,261</b>	4,936	<b>1,022</b>	1,322
<b>At 31 December</b>	<b>30,367</b>	28,828	<b>15,071</b>	14,549

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

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

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**41 Retirement benefit obligations** (continued)

Experience adjustments history:

<b>The Group</b>	<b>2012</b>	2011	2010	2009	2008	2007
	<b>£m</b>	£m	£m	£m	£m	£m
Present value of defined benefit obligation	<b>(31,324)</b>	(28,236)	(26,862)	(18,796)	(15,617)	(16,795)
Fair value of scheme assets	<b>30,367</b>	28,828	26,382	16,075	13,693	16,112
(Deficit) surplus	<b>(957)</b>	592	(480)	(2,721)	(1,924)	(683)
Experience (losses) gains on scheme liabilities	<b>(501)</b>	(277)	496	(14)	(39)	(185)
Experience gains (losses) on scheme assets	<b>442</b>	926	1,624	542	(3,520)	139

<b>The Bank</b>	<b>2012</b>	2011	2010	2009	2008	2007
	<b>£m</b>	£m	£m	£m	£m	£m
Present value of defined benefit obligation	<b>(16,060)</b>	(14,635)	(14,143)	(14,363)	(12,015)	(12,899)
Fair value of scheme assets	<b>15,071</b>	14,549	13,784	12,507	10,488	12,410
	<b>(989)</b>	(86)	(359)	(1,856)	(1,527)	(489)
Experience (losses) gains on scheme liabilities	<b>(263)</b>	(122)	366	(4)	(23)	(150)
Experience gains (losses) on scheme assets	<b>214</b>	122	801	377	(2,750)	114

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

	<b>2012</b>	2011
	<b>£m</b>	£m
Current service cost	<b>360</b>	380
Interest cost	<b>1,373</b>	1,423
Expected return on scheme assets	<b>(1,446)</b>	(1,627)
Net actuarial losses recognised in the year	–	7
Past service credits	<b>(250)</b>	(25)
Settlements	<b>4</b>	8
Past service cost	<b>16</b>	20
<b>Total defined benefit pension expense</b>	<b>57</b>	186

Following a review of policy in respect of discretionary pension increases in relation to the Group's defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group's defined benefit obligation of £258 million, recognised in the Group's income statement in 2012, net of a charge of £8 million resulting from a change to the commutation factors in one of the Group's smaller schemes.

*Defined contribution schemes*

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds TSB Group Pension Scheme No. 1.

During the year ended 31 December 2012 the charge to the income statement in respect of defined contribution schemes was £229 million (2011: £202 million), representing the contributions payable by the employer in accordance with each scheme's rules.

**Other post-retirement benefit schemes**

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2008; this valuation has been updated to 31 December 2012 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.50 per cent (2011: 6.61 per cent).

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**41 Retirement benefit obligations** (continued)

Amount included in the balance sheet:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Present value of unfunded obligations	(207)	(188)	(129)	(121)
Unrecognised actuarial losses	26	14	8	3
<b>Retirement benefit obligation recognised in the balance sheet</b>	<b>(181)</b>	<b>(174)</b>	<b>(121)</b>	<b>(118)</b>

Movements in the other post-retirement benefits obligation:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January	(188)	(175)	(121)	(124)
Exchange and other adjustments	(16)	(5)	(7)	3
Insurance premiums paid	8	5	5	5
Charge for the year	(11)	(13)	(6)	(5)
<b>At 31 December</b>	<b>(207)</b>	<b>(188)</b>	<b>(129)</b>	<b>(121)</b>

**42 Deferred tax**

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Asset at 1 January	4,251	3,957	3,126	2,796
Exchange and other adjustments	(14)	4	(1)	3
Disposals	–	10	–	–
Income statement (charge) credit (note 14):				
Due to change in UK corporation tax rate	(313)	(411)	(309)	(267)
Other	(300)	1,527	613	1,196
	(613)	1,116	304	929
Amount (charged) credited to equity:				
Available-for-sale financial assets (note 47)	344	(574)	366	(602)
Cash flow hedges (note 47)	6	(262)	1	–
	350	(836)	367	(602)
<b>Asset at 31 December</b>	<b>3,974</b>	<b>4,251</b>	<b>3,796</b>	<b>3,126</b>



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**42 Deferred tax** (continued)

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Statutory position</b>				
Deferred tax assets	4,301	4,565	3,796	3,127
Deferred tax liabilities	(327)	(314)	–	(1)
<b>Net deferred tax asset</b>	<b>3,974</b>	<b>4,251</b>	<b>3,796</b>	<b>3,126</b>
<b>Tax disclosure</b>				
Deferred tax assets	8,669	7,964	3,959	3,176
Deferred tax liabilities	(4,695)	(3,713)	(163)	(50)
<b>Net deferred tax asset</b>	<b>3,974</b>	<b>4,251</b>	<b>3,796</b>	<b>3,126</b>

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

	2012 £m	2011 £m
Accelerated capital allowances	410	319
Pensions and other post-retirement benefits	(237)	(160)
Long-term assurance business	(870)	595
Allowances for impairment losses	(333)	(56)
Trading losses	927	(40)
Tax on fair value of acquired assets	28	(106)
Other temporary differences	(538)	564
<b>Deferred tax (charge) credit in the income statement</b>	<b>(613)</b>	<b>1,116</b>

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Deferred tax assets:				
Allowances for impairment losses	226	559	35	51
Other provisions	88	197	20	82
Derivatives	–	–	25	40
Available-for-sale asset revaluation	286	288	–	–
Tax losses carried forward	7,026	5,901	2,969	1,956
Accelerated capital allowances	167	–	295	234
Other temporary differences	876	1,019	615	813
<b>Total deferred tax assets</b>	<b>8,669</b>	<b>7,964</b>	<b>3,959</b>	<b>3,176</b>
Deferred tax liabilities:				
Pensions and other post retirement benefits	(357)	(120)	(120)	(20)
Accelerated capital allowances	–	(243)	–	–
Long-term assurance business	(1,849)	(979)	–	–
Tax on fair value of acquired assets	(1,741)	(1,890)	–	–
Derivatives	(354)	(173)	–	–
Effective interest rate	(34)	(45)	(2)	(3)
Other temporary differences	(360)	(263)	(41)	(27)
<b>Total deferred tax liabilities</b>	<b>(4,695)</b>	<b>(3,713)</b>	<b>(163)</b>	<b>(50)</b>

On 21 March 2012, the Government announced that the corporation tax rate applicable from 1 April 2012 would be 24 per cent. This change passed into legislation on 26 March 2012. In addition, the Finance Act 2012, which was substantively enacted on 3 July 2012, included legislation to reduce the main rate of corporation tax from 24 per cent to 23 per cent with effect from 1 April 2013. The change in the main rate of corporation tax from 25 per cent to

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**42 Deferred tax** (continued)

23 per cent has resulted in a reduction in the Group's net deferred tax asset at 31 December 2012 of £291 million, comprising the £313 million charge included in the income statement and an £22 million credit included in equity.

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

*Deferred tax assets*

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised a deferred tax asset of £7,026 million and £2,969 million for the Bank (2011: £5,901 million for the Group and £1,956 million for the Bank) in relation to trading losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these trading losses will be offset.

Deferred tax assets of £939 million for the Group (2011: £733 million) and £nil for the Bank (2011: £nil) have not been recognised in respect of trading losses carried forward, mainly in certain overseas companies and in respect of other temporary differences in the insurance business. Trading losses can be carried forward indefinitely, except for losses in Spain which expire after 18 years and in the USA which expire after 20 years.

Deferred tax assets of £330 million for the Group (2011: £384 million) and £24 million for the Bank (2011: £38 million) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2012 of £42 million for the Group (2011: £171 million) and £2 million (2011: £131 million) for the Bank, as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

**43 Other provisions**

The Group	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property £m	Other £m	Total £m
<b>At 1 January 2012</b>	<b>81</b>	<b>2,155</b>	<b>344</b>	<b>140</b>	<b>446</b>	<b>3,166</b>
Exchange and other adjustments	(2)	–	12	2	(15)	(3)
Provisions applied	(4)	(3,299)	(71)	(71)	(33)	(3,478)
Charge (release) for the year	(9)	3,575	650	2	58	4,276
<b>At 31 December 2012</b>	<b>66</b>	<b>2,431</b>	<b>935</b>	<b>73</b>	<b>456</b>	<b>3,961</b>

The Bank	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property £m	Other £m	Total £m
<b>At 1 January 2012</b>	<b>62</b>	<b>1,197</b>	<b>41</b>	<b>72</b>	<b>252</b>	<b>1,624</b>
Exchange and other adjustments	2	–	(2)	–	75	75
Provisions applied	–	(2,192)	(27)	(39)	(1)	(2,259)
Charge (release) for the year	(9)	2,602	311	–	27	2,931
<b>At 31 December 2012</b>	<b>55</b>	<b>1,607</b>	<b>323</b>	<b>33</b>	<b>353</b>	<b>2,371</b>

**Provisions for commitments**

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

**Payment protection insurance**

Following the unsuccessful legal challenge by the British Bankers' Association against the FSA and the Financial Ombudsman Service, the Lloyds Banking Group held discussions with the FSA with a view to seeking clarity around the detailed implementation of the FSA Policy Statement which set out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress in respect of payment protection insurance (PPI) sales standards. As a result, the Lloyds Banking Group concluded that there are certain circumstances where customer redress will be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2011 of £3,200 million in respect of the anticipated costs of such redress, including administration expenses.

During the first half of 2012 there was an increase in the volume of complaints being received and, although the level of complaints has declined during the second half of 2012, they are higher than had been anticipated at 31 December 2011. As a consequence, the Group believes that it is appropriate to increase its provision by a further £3,575 million at 31 December 2012. This increases the total estimated cost of redress, including administration expenses, to £6,775 million; redress payments made and expenses incurred on the 1.15 million claims paid to the end of December 2012 amounted to £4,344 million. However, there are still a number of uncertainties as to the eventual redress costs, in particular the total number of complaints and the activities of claims management companies and regulatory bodies.

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### 43 Other provisions (continued)

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

- the number of claims received: an increase of 100,000 from the level assumed would increase the provision for redress costs by £140 million;
- uphold rate of claims reviewed: an increase of one percentage point in this assumption would increase the provision by £20 million;
- average future redress payment: an increase of £100 in this assumption would increase the provision by £70 million.

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

#### Other regulatory provisions

##### *Litigation in relation to insurance branch business in Germany*

As previously disclosed, Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Group recognised a provision of £175 million with respect to this litigation and following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group has recognised a further provision of £150 million with respect to this litigation, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

##### *Interest rate hedging products*

In June 2012, a number of banks, including the Lloyds Banking Group, reached agreement with the FSA to carry out a thorough assessment of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. The Lloyds Banking Group agreed that on conclusion of this review it would provide redress to any of these customers where appropriate.

Following the completion of a pilot review of IRHP sales to small and medium-sized businesses and agreement reached with the FSA on 30 January 2013 on the principles to be adopted during the course of the wider review, the Group has provided £400 million for the estimated cost of redress and related administration costs. At 31 December 2012, £20 million of the provision had been utilised. A number of uncertainties remain as to the eventual costs given the inherent difficulties in determining the number of customers within the scope of the review and the average compensation to customers.

#### Other regulatory matters

In the course of its business, the Lloyds Banking Group is engaged in discussions with the FSA or other regulators in relation to a range of matters. In 2012 a provision of £100 million was made in respect of certain UK retail and other matters; however, the ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

#### Vacant leasehold property

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run-off over the period of under-recovery of the leases concerned, currently averaging 3 years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

#### Other

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

Other provisions include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate costs and timing of payments are uncertain. The provision held of £37 million at 31 December 2012 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

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**44 Subordinated liabilities**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Preferred securities	7,314	7,479	5,185	5,162
Undated subordinated liabilities	4,716	3,601	2,724	1,572
Dated subordinated liabilities	25,560	26,250	18,340	18,311
<b>Total subordinated liabilities</b>	<b>37,590</b>	<b>37,330</b>	<b>26,249</b>	<b>25,045</b>

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

	The Group £m	The Bank £m
At 1 January 2011	29,609	15,574
Issued during the year	10,922	10,389
Repurchases and redemptions during the year	(4,121)	(1,424)
Foreign exchange and other movements	920	506
At 31 December 2011	37,330	25,045
Issued during the year	<b>128</b>	<b>128</b>
Repurchases and redemptions during the year	<b>(864)</b>	<b>(215)</b>
Foreign exchange and other movements	<b>996</b>	<b>1,291</b>
<b>At 31 December 2012</b>	<b>37,590</b>	<b>26,249</b>

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of the specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of the holders of the dated subordinated liabilities. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2011: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Financial Services Authority, with the exception of those identified in footnote n on page 89.

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**44 Subordinated liabilities** (continued)

The Group	Note	2012 £m	2011 £m
<b>Preferred securities</b>			
6.90% Perpetual Capital Securities (US\$1,000 million)	d	<b>214</b>	247
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a	<b>601</b>	601
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a,c	<b>619</b>	646
6% Non-cumulative Redeemable Preference Shares	b	–	–
7.375% Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	c	–	16
7.875% Non-cumulative Preference Shares callable 2013 (€500 million)	c	<b>308</b>	239
7.875% Non-cumulative Preference Shares callable 2013 (US\$1,250 million)	c	<b>597</b>	470
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)		<b>226</b>	239
7.834% Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	c	<b>5</b>	5
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	c	<b>689</b>	718
13% Step-up Perpetual Capital Securities callable 2019 (£785 million)	c	<b>8</b>	12
13% Euro Step-up Perpetual Capital Securities callable 2019 (€532 million)	c	<b>48</b>	47
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US\$2,000 million)		<b>1,239</b>	1,301
13% Step-up Perpetual Capital Securities callable 2029 (£700 million)	c	<b>629</b>	612
6.071% Non-cumulative Perpetual Preferred Securities (US\$750 million)		<b>382</b>	389
6.85% Non-cumulative Perpetual Preferred Securities (US\$1,000 million)	d	<b>238</b>	316
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities (£600 million)		<b>439</b>	444
8.117% Non-cumulative Perpetual Preferred Securities (Class A) (£250 million)	d,e	<b>262</b>	260
7.754% Non-cumulative Perpetual Preferred Securities (Class B) (£150 million)		<b>98</b>	104
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		<b>227</b>	228
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	d,g	<b>239</b>	340
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	c	<b>23</b>	20
7.286% Perpetual Regulatory Tier One Securities (Series A) (£150 million)		<b>128</b>	112
7.281% Perpetual Regulatory Tier One Securities (Series B) (£150 million)		<b>95</b>	113
		<b>7,314</b>	7,479

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**44 Subordinated liabilities** (continued)

	Note	2012 £m	2011 £m
<b>Undated subordinated liabilities</b>			
Primary Capital Undated Floating Rate Notes:			
Series 1 (US\$750 million)	c,d	<b>165</b>	175
Series 2 (US\$500 million)	c,d	<b>173</b>	183
Series 3 (US\$600 million)	c,d	<b>223</b>	235
11.75% Perpetual Subordinated Bonds (£100 million)		<b>102</b>	102
6.625% Undated Subordinated Step-up Notes (£410 million)	c,d,f	<b>157</b>	173
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc)		<b>556</b>	554
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)		<b>146</b>	208
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	c	<b>152</b>	160
10.5% Subordinated Notes callable 2018 (€487 million)	n	<b>398</b>	–
10.5% Subordinated Notes callable 2018 (£775 million)	n	<b>777</b>	–
6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)	c	<b>99</b>	104
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	c	–	–
10.5% Subordinated Notes callable 2028 (£109 million)	n	<b>109</b>	–
6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)	c	<b>109</b>	118
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	b	<b>114</b>	114
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes callable 2019 (£500 million)	c	<b>4</b>	4
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	c	<b>70</b>	75
Floating Rate Undated Subordinated Notes (€500 million)	c	<b>44</b>	45
5.375% Undated Fixed to Floating Rate Subordinated Notes (US\$1,000 million)	c	<b>9</b>	12
5.125% Undated Subordinated Fixed to Floating Rate Notes (€750 million)	c	<b>45</b>	52
5.75% Undated Subordinated Step-up Notes (£600 million)		<b>3</b>	3
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	d	<b>5</b>	4
7.5% Undated Subordinated Step-up Notes (£300 million)		<b>4</b>	5
8.625% Perpetual Subordinated Notes (£200 million)	c	<b>22</b>	24
7.375% Undated Subordinated Guaranteed Bonds (£200 million) (Clerical Medical Finance plc)		<b>37</b>	36
Floating Rate Undated Subordinated Step-up Notes (€300 million)	d	<b>13</b>	10
Floating Rate Primary Capital Notes (US\$250 million)	c,d	<b>111</b>	118
10.25% Subordinated Undated Instruments (£100 million)	c	<b>1</b>	1
12% Perpetual Subordinated Bonds (£100 million)	c	<b>21</b>	30
8.75% Perpetual Subordinated Bonds (£100 million)	c	<b>5</b>	4
13.625% Perpetual Subordinated Bonds (£75 million)	c	<b>19</b>	16
9.375% Perpetual Subordinated Bonds (£50 million)	c	<b>14</b>	17
5.75% Undated Subordinated Step-up Notes (£500 million)		<b>4</b>	3
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes (€750 million) (Clerical Medical Finance plc)		<b>261</b>	231
7.375% Subordinated Undated Instruments (£150 million)	c	<b>74</b>	78
4.25% Subordinated Undated Instruments (¥17,000 million)		<b>138</b>	174
Floating Rate Undated Subordinated Notes (£524 million) (Scottish Widows Group Limited)		<b>532</b>	533
		<b>4,716</b>	3,601

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Notes to the accounts

**44 Subordinated liabilities** (continued)

	Note	2012 £m	2011 £m
<b>Dated subordinated liabilities</b>			
Subordinated Floating Rate Notes 2012 (£200 million)		–	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		464	465
5.875% Subordinated Notes 2014 (£150 million)		157	154
6.625% Subordinated Notes 2015 (£350 million)		375	357
Subordinated Step-up Floating Rate Notes 2016 (£300 million)	d	184	184
Subordinated Step-up Floating Rate Notes 2016 (€500 million)	d	172	179
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		858	902
6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015 (£750 million)		716	725
Subordinated Floating Rate Notes 2020 (€100 million)		83	87
5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)		371	367
9.625% Subordinated Bonds 2023 (£300 million)		376	319
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		–	640
6.25% Instruments 2012 (€12.8 million)		–	8
6.125% Notes 2013 (€325 million)		280	283
4.25% Subordinated Guaranteed Notes 2013 (US\$1,000 million)		619	636
11% Subordinated Bonds 2014 (£250 million)		284	290
4.875% Subordinated Notes 2015 (€1,000 million)		844	854
Callable Floating Rate Subordinated Notes 2016 (€500 million)	d	96	88
Callable Floating Rate Subordinated Notes 2016 (€500 million)	d	137	124
Subordinated Callable Notes 2016 (US\$750 million)	d,j	198	191
Subordinated Callable Notes 2017 (€1,000 million)	j	243	219
Subordinated Callable Notes 2017 (US\$1,000 million)	j	198	192
Subordinated Callable Floating Rate Instruments 2017 (Aus\$400 million)		38	38
6.75% Subordinated Callable Fixed to Floating Rate Instruments 2017 (Aus\$200 million)	k	6	5
5.109% Callable Fixed to Floating Rate Notes 2017 (Can\$500 million)	l	8	8
6.305% Subordinated Callable Fixed to Floating Rate Notes 2017 (£500 million)	m	21	22
10.5% Subordinated Bonds 2018 (£150 million)		177	177
6.75% Subordinated Fixed Rate Notes 2018 (US\$2,000 million)		1,146	1,205
10.375% Subordinated Fixed to Fixed Rate Notes 2024 callable 2019 (€154 million)	i	143	–
6.375% Subordinated Instruments 2019 (£250 million)		281	274
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		604	621
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,458	1,407
7.375% Dated Subordinated Notes 2020		4	3
6.5% Subordinated Fixed Rate Notes 2020 (US\$2,000 million)		1,345	1,360
9.375% Subordinated Bonds 2021 (£500 million)		727	709
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		152	150
6.45% Fixed to Floating Subordinated Guaranteed Bonds 2023 (€400 million) (Clerical Medical Finance plc)		181	176
7.07% Subordinated Fixed Rate Notes 2023 (€175 million)		183	174
7.625% Dated Subordinated Notes 2025 (£750 million)		915	876

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**44 Subordinated liabilities** (continued)

Note	2012 £m	2011 £m
Dated subordinated liabilities (continued)		
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)	457	463
6% Subordinated Notes 2033 (US\$750 million)	399	432
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million)	977	977
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million)	477	467
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US\$568 million)	360	368
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can\$387 million)	240	246
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus\$417 million)	280	276
11.77% Subordinated Notes 2020 (€115 million)	96	97
11.81% Subordinated Notes 2020 (€78 million)	65	65
10.55% Subordinated Notes 2019 (£1,005 million)	994	1,009
10.17% Subordinated Notes 2020 (US\$361 million)	227	234
11.84% Subordinated Notes 2020 (€496 million)	419	416
11.84% Subordinated Notes 2020 (€532 million)	450	447
10.21% Subordinated Notes 2020 (US\$1,095 million)	688	711
11.88% Subordinated Notes 2020 (€176 million)	148	148
10.24% Subordinated Notes 2020 (US\$854 million)	564	554
10.61% Subordinated Notes 2020 (£773 million)	775	776
10.33% Subordinated Notes 2021 (US\$243 million)	152	158
10.67% Subordinated Notes 2020 (£614 million)	627	616
10.69% Subordinated Notes 2020 (£517 million)	526	519
10.75% Subordinated Notes 2022 (£101 million)	100	101
10.85% Subordinated Notes 2019 (£91 million)	92	92
10.86% Subordinated Notes 2019 (£292 million)	298	293
10.89% Subordinated Notes 2020 (£207 million)	209	208
10.88% Subordinated Notes 2019 (£4 million)	4	3
10.90% Subordinated Notes 2020 (£65 million)	65	66
10.90% Subordinated Notes 2019 (£126 million)	129	126
10.91% Subordinated Notes 2023 (£100 million)	101	101
11.02% Subordinated Notes 2024 (£83 million)	83	84
10.94% Subordinated Notes 2020 (£139 million)	141	139
10.95% Subordinated Notes 2024 (£39 million)	39	39
10.97% Subordinated Notes 2020 (£39 million)	40	40
10.92% Subordinated Notes 2024 (£83 million)	84	83
11.07% Subordinated Notes 2029 (£92 million)	92	93
11.18% Subordinated Notes 2023 (£57 million)	58	58
11.21% Subordinated Notes 2023 (£67 million)	68	67
11.46% Subordinated Notes 2029 (£92 million)	93	92
11.52% Subordinated Notes 2032 (£84 million)	85	85
11.35% Subordinated Notes 2019 (€603 million)	488	507
11.42% Subordinated Notes 2020 (€30 million)	26	25
	<b>25,560</b>	26,250
<b>Total subordinated liabilities</b>	<b>37,590</b>	37,330

At 31 December 2012 £37,440 million (2011: £36,482 million) of subordinated liabilities had a contractual residual maturity of greater than one year.



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**44 Subordinated liabilities** (continued)

The Bank	Note	2012 £m	2011 £m
<b>Preferred securities</b>			
6.90% Perpetual Capital Securities (US\$1,000 million)		214	247
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a	601	601
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a,c	619	646
6% Non-cumulative Redeemable Preference Shares	b	–	–
7.375% Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	c	–	17
7.875% Non-cumulative Preference shares callable 2013 (€500 million)	c	308	239
7.875% Non-cumulative Preference shares callable 2013 (US\$1,250 million)	c	597	470
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)		226	239
7.834% Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	c	5	5
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	c	689	718
13% Step-up Perpetual Capital Securities callable 2019 (£785 million)	c	10	12
13% Step-up Perpetual Capital Securities callable 2019 (€532 million)	c	48	47
13% Step-up Perpetual Capital Securities callable 2029 (£700 million)	c	629	620
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US\$2,000 million)		1,239	1,301
		<b>5,185</b>	5,162
<b>Undated subordinated liabilities</b>			
Primary Capital Undated Floating Rate Notes:			
Series 1 (US\$750 million)	c,d	165	175
Series 2 (US\$500 million)	c,d	173	183
Series 3 (US\$600 million)	c,d	223	235
11.75% Perpetual Subordinated Bonds (£100 million)		102	102
6.625% Undated Subordinated Step-up Notes (£410 million)	c,d,f	157	173
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)		146	208
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	c	152	160
10.5% Subordinated Notes callable 2018 (€487 million)	n	398	–
10.5% Subordinated Notes callable 2018 (£775 million)	n	777	–
6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)	c	99	104
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	c	–	–
10.5% Subordinated Notes callable 2028 (£109 million)	n	109	–
6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)	c	109	118
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	c	114	114
		<b>2,724</b>	1,572
<b>Dated subordinated liabilities</b>			
Subordinated Floating Rate Notes 2012 (£200 million)		–	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		464	465
5.875% Subordinated Notes 2014 (£150 million)		157	154
6.625% Subordinated Notes 2015 (£350 million)		375	357
Subordinated Step-up Floating Rate Notes 2016 (£300 million)	d	184	184
Subordinated Step-up Floating Rate Notes 2016 (€500 million)	d	172	179
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		858	902
6.9625% Callable Subordinated Fixed to Floating Rate Notes due 2020 callable 2015 (£750 million)		754	744
Subordinated Floating Rate Notes 2020 (€100 million)		83	87
5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)		392	373
9.625% Subordinated Bonds 2023 (£300 million)		376	319

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**44 Subordinated liabilities** (continued)

The Bank (continued)	Note	2012 £m	2011 £m
<b>Dated subordinated liabilities</b> (continued)			
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
10.375% Subordinated Fixed to Fixed Rate Notes 2024 callable 2019 (€154 million)	i	143	–
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,458	1,409
7.375% Dated Subordinated Notes 2020		4	4
6.5% Subordinated Fixed Rate Notes 2020 (US\$2,000 million)		1,345	1,360
7.625% Dated Subordinated Notes 2025 (£750 million)		915	888
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (€1,147 million)		977	977
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (£466 million)		477	467
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (US\$568 million)		360	368
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Can\$387 million)		240	246
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016 (Aus\$417 million)		280	276
11.77% Subordinated Notes 2020 (€115 million)		96	97
11.81% Subordinated Notes 2020 (€78 million)		65	65
10.55% Subordinated Notes 2019 (£1,005 million)		994	1,009
10.17% Subordinated Notes 2020 (US\$361 million)		227	234
11.84% Subordinated Notes 2020 (€496 million)		419	416
11.84% Subordinated Notes 2020 (€532 million)		450	447
10.21% Subordinated Notes 2020 (US\$1,095 million)		688	711
11.88% Subordinated Notes 2020 (€176 million)		148	148
10.24% Subordinated Notes 2020 (US\$854 million)		564	554
10.61% Subordinated Notes 2020 (£773 million)		775	776
10.33% Subordinated Notes 2021 (US\$243 million)		152	158
10.67% Subordinated Notes 2020 (£614 million)		627	616
10.69% Subordinated Notes 2020 (£517 million)		526	519
10.75% Subordinated Notes 2022 (£101 million)		100	101
10.85% Subordinated Notes 2019 (£91 million)		92	92
10.86% Subordinated Notes 2019 (£292 million)		298	293
10.89% Subordinated Notes 2020 (£207 million)		209	208
10.88% Subordinated Notes 2019 (£4 million)		4	3
10.90% Subordinated Notes 2020 (£65 million)		65	66
10.90% Subordinated Notes 2019 (£126 million)		129	126
10.91% Subordinated Notes 2023 (£100 million)		101	101
11.02% Subordinated Notes 2024 (£83 million)		83	84
10.94% Subordinated Notes 2020 (£139 million)		141	139
10.95% Subordinated Notes 2024 (£39 million)		39	39
10.97% Subordinated Notes 2020 (£39 million)		40	40
10.92% Subordinated Notes 2024 (£83 million)		84	83
11.07% Subordinated Notes 2029 (£92 million)		92	93
11.18% Subordinated Notes 2023 (£57 million)		58	58
11.21% Subordinated Notes 2023 (£67 million)		68	67
11.46% Subordinated Notes 2029 (£92 million)		93	92
11.52% Subordinated Notes 2032 (£84 million)		85	85
11.35% Subordinated Notes 2019 (€603 million)		488	507
11.42% Subordinated Notes 2020 (€30 million)		26	25
		<b>18,340</b>	18,311
<b>Total subordinated liabilities</b>		<b>26,249</b>	25,045

At 31 December 2012 £26,099 million (2011: £24,845 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

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**44 Subordinated liabilities** (continued)

- a) In certain circumstances, these preference shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities. The Bank may declare no dividend or a partial dividend on these preference shares. Dividends may be reduced if the distributable profits of the Bank are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Bank.
- b) Since 2004, the Bank has had in issue 400 6 per cent non-cumulative redeemable preference shares of 25p each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Bank. The holder of the shares waived its rights to payment for the period from 1st March 2010 to 1st March 2012.
- c) In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.
- d) These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.
- e) The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.
- f) The fixed rate payable on this security was reset from 6.625 per cent to 4.64821 per cent with effect from 15 July 2010.
- g) The fixed rate on this security was reset from 7.627 per cent to 3 months Euribor plus 2.875 per cent with effect from 9 December 2011.
- h) The fixed rate on this security was reset from 6.05 per cent to 3 month Euribor plus 2.25 per cent with effect from 23 November 2011.
- i) This security was issued in February 2012 as a result of an exchange offer.
- j) The floating interest rate payable on these securities reset during 2012.
- k) The interest rate payable on this security was reset from 6.75 per cent fixed to Bank Bill Swap Rate plus 0.76 per cent with effect from 1 May 2012.
- l) The interest rate payable on this security was reset from 5.109 per cent fixed to Canadian Dealer Offered Rate plus 0.65 per cent with effect from 21 June 2012.
- m) The interest rate payable on this security was reset from 6.305 per cent fixed to 3-month Libor plus 1.2 per cent with effect from 18 October 2012.
- n) These securities do not qualify as regulatory capital and can be redeemed without the consent of the Financial Services Authority.

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**45 Share capital**

**(1) Authorised share capital**

	Group and Bank	
	2012 £m	2011 £m
<i>Sterling</i>		
1,650 million ordinary shares of £1 each	1,650	1,650
1 cumulative floating rate Preference share of £1	–	–
100 6 per cent Non-Cumulative Redeemable Preference shares of £1 each	–	–
175 million Preference shares of 25p each	44	44
	<b>1,694</b>	1,694
<i>US dollars</i>		
		US\$m
160 million Preference shares of 25 cents each	40	40
<i>Euro</i>		
		€m
160 million Preference shares of 25 cents each	40	40
<i>Japanese yen</i>		
		¥m
50 million Preference shares of ¥25 each	1,250	1,250

**(2) Issued and fully paid ordinary shares**

	2012 Number of shares	2011 Number of shares	2012 £m	2011 £m
<i>Sterling</i>				
Ordinary shares of £1 each				
<b>At 1 January and 31 December</b>	<b>1,574,285,751</b>	1,574,285,751	<b>1,574</b>	1,574

**Issued and fully paid preference shares**

The Bank has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 44.

**46 Share premium account**

	Group and Bank	
	2012 £m	2011 £m
<b>At 1 January and 31 December</b>	<b>35,533</b>	35,533

Lloyds TSB Bank plc  
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**47 Other reserves**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Other reserves comprise:				
Merger reserve	6,348	6,348	–	–
Revaluation reserve in respect of available-for-sale financial assets	(259)	668	792	2,052
Cash flow hedging reserve	590	576	(16)	(12)
Foreign currency translation reserve	(106)	(92)	98	119
<b>At 31 December</b>	<b>6,573</b>	<b>7,500</b>	<b>874</b>	<b>2,159</b>

Movements in other reserves were as follows:

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Merger reserve</b>				
<b>At 1 January and 31 December</b>	<b>6,348</b>	<b>6,348</b>	<b>–</b>	<b>–</b>

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Revaluation reserve in respect of available-for-sale financial assets</b>				
At 1 January	668	(943)	2,052	259
Adjustment on transfer from held-to-maturity portfolio	1,168	–	1,168	–
Change in fair value of available-for-sale financial assets	779	2,603	155	2,708
Deferred tax	(445)	(673)	(357)	(669)
Current tax	(3)	–	–	(1)
	1,499	1,930	966	2,038
Income statement transfers:				
Disposals (see note 9)	(3,547)	(343)	(3,118)	(234)
Deferred tax	848	30	764	48
	(2,699)	(313)	(2,354)	(186)
Impairment	42	80	–	–
Deferred tax	12	29	–	–
	54	109	–	–
Other transfers	290	(155)	169	(78)
Deferred tax	(71)	40	(41)	19
	219	(115)	128	(59)
<b>At 31 December</b>	<b>(259)</b>	<b>668</b>	<b>792</b>	<b>2,052</b>

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Cash flow hedging reserve</b>				
At 1 January	576	(125)	(12)	(10)
Change in fair value of hedging derivatives	100	893	(5)	(10)
Deferred tax	(12)	(249)	1	2
	88	644	(4)	(8)
Income statement transfers	(92)	70	–	8
Deferred tax	18	(13)	–	(2)
	(74)	57	–	6
<b>At 31 December</b>	<b>590</b>	<b>576</b>	<b>(16)</b>	<b>(12)</b>

Lloyds TSB Bank plc  
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**47 Other reserves** (continued)

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Foreign currency translation reserve</b>				
At 1 January	(92)	(8)	119	116
Currency translation differences arising in the year	(69)	(58)	(21)	3
Foreign currency gains (losses) on net investment hedges (tax: £nil)	55	(26)	–	–
<b>At 31 December</b>	<b>(106)</b>	<b>(92)</b>	<b>98</b>	<b>119</b>

**48 Retained profits**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January	5,992	4,512	4,648	771
(Loss) profit for the year <sup>1</sup>	(1,271)	(868)	(2,150)	1,537
Capital contribution	–	2,340	–	2,340
Employee share option schemes – value of employee services	–	8	–	–
<b>At 31 December</b>	<b>4,721</b>	<b>5,992</b>	<b>2,498</b>	<b>4,648</b>

<sup>1</sup>No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006.

**49 Ordinary dividends**

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

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Lloyds Banking Group, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc also agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, the Bank was prevented from making dividend payments on its ordinary shares up to that date.

**50 Share-based payments**

**Share-based payment scheme details**

During the year ended 31 December 2012 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the Lloyds TSB Bank Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group are set out below; these are managed and operated on a Lloyds Banking Group-wide basis. The amount charged to the Group's income statement in respect of Lloyds Banking Group share-based payment schemes, and which is included within staff costs (note 11), was £333 million (2011: £376 million).

**Deferred bonus plans**

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

**Lloyds Banking Group executive share option schemes**

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

**Performance conditions for executive options**

*For options granted in 2004*

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

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

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**50 Share-based payments** (continued)

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

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

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

*For options granted in 2005*

The same conditions applied as for grants made in 2004, except that:

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

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

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

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

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

**Save-As-You-Earn schemes**

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

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

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

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

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

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

**Other share option plans**

**Lloyds Banking Group Executive Share Plan 2003**

The Plan was adopted in December 2003 and under the Plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The Plan's usage has now been extended to not only

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**50 Share-based payments** (continued)

compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

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

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

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

**Lloyds Banking Group Share Buy Out Awards**

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

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

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

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

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

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

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

**HBOS share option plans**

The table below details the outstanding options for the HBOS Share Option Plan and the St James's Place Share Option Plan. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which granted options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:



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**50 Share-based payments** (continued)

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

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

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

**Other share plans**

**Lloyds Banking Group Long-Term Incentive Plan**

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

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

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

- (i) **Earnings per share (EPS):** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2008.  
If the growth in EPS reached 26 per cent, 25 per cent of this element of the award, being the threshold, would vest. If growth in EPS reached 36 per cent, 100 per cent of this element would vest.
- (ii) **Economic Profit (EP):** relevant to 50 per cent of the award. Performance was measured based on the extent to which cumulative EP targets were achieved over the three-year period.  
If the absolute improvement in adjusted EP reached 100 per cent, 25 per cent of this element of the award, being the threshold, would vest. If the absolute improvement in adjusted EP reached 202 per cent, 100 per cent of this element would vest.

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

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

- (i) **Synergy Savings:** The release of 50 per cent of the shares was dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award was broken down into three equally weighted annual tranches. Performance was assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets were achieved determined the proportion of shares to be banked each year. Any release of shares was subject to the Remuneration Committee judging the overall success of the delivery of the integration programme.
- (ii) **Integration Balanced Scorecard:** The release of the remaining 50 per cent of the shares was dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element was broken down into three equally weighted tranches. The tranches were crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

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

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

- (i) **EPS:** relevant to 50 per cent of the award. Performance was measured based on EPS growth over a three-year period from the baseline EPS of 2009.  
If the absolute improvement in adjusted EPS reached 158 per cent, 25 per cent of this element of the award, being the threshold, would vest. If absolute improvement in adjusted EPS reached 180 per cent, 100 per cent of this element would vest.  
Vesting between threshold and maximum would be on a straight line basis.
- (ii) **EP:** relevant to 50 per cent of the award. Performance was measured based on the compound annual growth rate of adjusted EP over the three financial years starting on 1 January 2010 relative to an adjusted 2009 EP base.

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**50 Share-based payments** (continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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**50 Share-based payments** (continued)

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

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

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

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

**Scottish Widows Investment Partnership Long-Term Incentive Plan**

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

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

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

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

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

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

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

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

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

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

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

	2012 Number of shares	2011 Number of shares
Outstanding at 1 January	–	–
Granted	5,452,877	–
<b>Outstanding at 31 December</b>	<b>5,452,877</b>	–

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

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**50 Share-based payments** (continued)

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

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
<b>At 31 December 2012</b>									
Exercise price range									
£0 to £1	–	–	–	46.79	0.8	311,648,405	5.43	4.9	74,766,919
£1 to £2	199.91	1.6	233,714	178.14	1.8	2,923,618	–	–	–
£2 to £3	225.69	1.9	7,811,182	–	–	–	–	–	–
£3 to £4	–	–	–	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	566.89	0.9	12,026,160
<b>At 31 December 2011</b>									
Exercise price range									
£0 to £1	–	–	–	47.94	1.7	446,965,447	4.94	4.1	82,152,838
£1 to £2	199.91	2.6	233,714	179.16	2.0	5,563,072	–	–	–
£2 to £3	225.74	2.9	9,941,155	214.16	0.9	490,513	–	–	–
£3 to £4	–	–	–	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	582.82	1.8	14,227,020

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

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

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

**Share incentive plan****Free shares**

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

The last award of free shares was made in 2008.

**Matching shares**

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

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

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## 51 Related party transactions

### Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc Group Executive Committee together with its Non-Executive Directors.

HBOS plc became a subsidiary of the Bank on 1 January 2010 and the compensation below reflects the increase in the amount of key management personnel time devoted to the Bank and its subsidiaries.

The table below details, on an aggregated basis, key management personnel compensation:

	2012 £m	2011 £m
<b>Compensation</b>		
Salaries and other short-term benefits	12	12
Post-employment benefits	–	–
Share-based payments	13	11
<b>Total compensation</b>	<b>25</b>	<b>23</b>

The aggregate of the emoluments of the directors was £7.6 million (2011: £8.5 million).

The number of directors to whom retirement benefits were accruing under defined contribution and defined benefit pension schemes were two and nil respectively (2011: four and two). Aggregate company contributions in respect of directors to defined contribution pension schemes were £23,000 (2011: £167,000).

The total for the highest paid director (António Horta-Osório) was £3,397,000 (2011: (António Horta-Osório) £4,122,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

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

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

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

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

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 2.5 per cent and 29.95 per cent in 2012 (2011: 1.09 per cent and 27.5 per cent).

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

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**51 Related party transactions** (continued)

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

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

At 31 December 2012, the Group did not provide any guarantees in respect of key management personnel (2011 £nil).

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

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

*Balances and transactions between members of the Lloyds TSB Bank group*

In accordance with IAS 27 *Consolidated and separate 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:

	2012 £m	2011 £m
Assets, included within:		
Derivative financial instruments	7,730	6,750
Loans and receivables:		
Loans and advances to banks	183,328	162,569
Loans and advances to customers	45,858	49,303
Available-for-sale financial assets	4,717	5,027
Other	169	117
	<b>241,802</b>	<b>223,766</b>
Liabilities, included within:		
Deposits from banks	185,050	118,784
Customer deposits	40,322	39,462
Derivative financial instruments	6,972	4,464
Debt securities in issue	5,663	7,159
Subordinated liabilities	67	70
Other	–	64
	<b>238,074</b>	<b>170,003</b>

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2012 the Bank earned interest income on the above asset balances of £3,307 million (2011: £2,833 million) and incurred interest expense on the above liability balances of £2,599 million (2011: £1,872 million).

In addition, the Bank raised recharges of £812 million (2011: £688 million) on its subsidiaries in respect of costs incurred and also received fees of £239 million (2011: £396 million), and paid fees of £312 million (2011: £365 million), for various services provided between the Bank and its subsidiaries.

Details of contingent liabilities and commitments entered into on behalf of fellow Lloyds Banking Group undertakings are given in note 52.

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**51 Related party transactions** (continued)

*Balances and transactions with Lloyds Banking Group plc and fellow subsidiaries of the Bank*

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Assets, included within:				
Loans and receivables:				
Loans and advances to customers	18,882	18,599	15,405	14,056
Other	200	257	12	13
	<b>19,082</b>	18,856	<b>15,417</b>	14,069
Liabilities, included within:				
Customer deposits	9,950	10,546	3,830	4,045
Derivative financial instruments	274	489	274	488
Subordinated liabilities	14,520	12,747	13,573	12,477
Debt securities in issue	–	533	–	–
	<b>24,744</b>	24,315	<b>17,677</b>	17,010

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2012 the Group earned £383 million and the Bank earned £337 million interest income on the above asset balances (2011: Group £372 million; Bank £338 million); the Group incurred £1,634 million and the Bank incurred £1,455 million interest expense on the above liability balances (2011: Group £1,175 million; Bank £1,002 million).

During the year ended 31 December 2011, the Bank received a capital contribution from Lloyds Banking Group plc in the amount of £2,340 million.

**UK Government**

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

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

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

*Government and central bank facilities*

During the year ended 31 December 2012, the Lloyds Banking Group participated in a number of schemes operated by the UK Government and central banks and made available to eligible banks and building societies.

*Credit guarantee scheme*

HM Treasury launched the Credit Guarantee Scheme in October 2008. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 31 December 2011, the Lloyds Banking Group had £23.5 billion of debt in issue under the Credit Guarantee Scheme but this was all repaid during 2012. During the year ended 31 December 2012, fees of £59 million paid to HM Treasury in respect of guaranteed funding were included in the Lloyds Banking Group's income statement (2011: £291 million).

*National Loan Guarantee Scheme*

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

*Business Growth Fund*

In May 2011 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and three other non-related parties), to commit up to £300 million of equity investment by subscribing for shares in the Business Growth Fund plc which is the company created to fulfil the role of the Business Growth Fund as set out in the British Bankers' Association's Business Taskforce Report of October 2010. As at 31 December 2012, the Lloyds Banking Group had invested £50 million (2011: £20 million) in the Business Growth Fund and carried the investment at a fair value of £44 million (2011: £16 million).

*Big Society Capital*

In January 2012 the Lloyds Banking Group agreed, together with The Royal Bank of Scotland plc (and two other non-related parties), to commit up to £50 million each of equity investment into the Big Society Capital Fund. The Fund, which was created as part of the Project Merlin arrangements, is a UK social investment fund. The Fund was officially launched on 3 April 2012 and the Lloyds Banking Group invested £12 million in the Fund during 2012.

*Funding for Lending*

In August 2012 the Lloyds Banking Group announced its support for the UK Government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Lloyds Banking Group. The initiative supports a broad range of UK-based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. The Lloyds Banking Group drew down £3.0 billion during 2012.



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## 51 Related party transactions (continued)

### *Central bank facilities*

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

### *Other government-related entities*

Other than the transactions referred to above, there were no other significant transactions with the UK Government and UK Government-controlled entities (including UK Government-controlled banks) during the period that were not made in the ordinary course of business or that were unusual in their nature or conditions.

## Other related party transactions

### *Pension funds*

The Group provides banking and some investment management services to certain of its pension funds. At 31 December 2012, customer deposits of £129 million (2011: £63 million) and investment and insurance contract liabilities of £1,213 million (2011: £928 million) related to the Group's pension funds.

### *Open Ended Investment Companies (OEICs)*

The Group manages 244 (2011: 249) Open Ended Investment Companies (OEICs), and of these 136 (2011: 142) are consolidated. The Group invested £1,563 million (2011: £1,283 million) and redeemed £1,690 million (2011: £884 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £6,479 million (2011: £4,431 million) at 31 December. The Group earned fees of £325 million from the unconsolidated OEICs during 2012 (2011: £318 million).

### *Joint ventures and associates*

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

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

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2012, these companies had total assets of approximately £10,759 million (2011: £11,500 million), total liabilities of approximately £10,956 million (2011: £10,807 million) and for the year ended 31 December 2012 had turnover of approximately £8,169 million (2011: £7,376 million) and made a net loss of approximately £488 million (2011: net profit of approximately £83 million). In addition, the Group has provided £5,146 million (2011: £5,767 million) of financing to these companies on which it received £208 million (2011: £106 million) of interest income in the year.

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## 52 Contingent liabilities and commitments

### **Interchange fees**

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

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

In parallel:

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

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

### **Interbank offered rate setting investigations**

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



## 52 Contingent liabilities and commitments (continued)

### Financial Services Compensation Scheme

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

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. The interest rate on the borrowings with HM Treasury, which total circa £20 billion, increased from 12 month LIBOR plus 30 basis points to 12 month LIBOR plus 100 basis points on 1 April 2012. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

In determining an appropriate accrual in respect of the management expenses levy, certain assumptions have been made including the proportion of total protected deposits held by the Lloyds Banking Group, the level and timing of repayments to be made by the FSCS to HM Treasury and the interest rate to be charged by HM Treasury. For the year ended 31 December 2012, the Group has charged £87 million (2011: £179 million) to the income statement in respect of the management expenses levy.

The substantial majority of the principal balance of the £20 billion loan between the FSCS and HM Treasury will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted. In March 2012, the FSCS confirmed that it expects a shortfall of approximately £802 million and that it expects to recover that amount by raising compensation levies on all deposit-taking participants over a three year period. In addition to the management expenses levy detailed above, the Group has also charged £88 million (2011: £nil) to the income statement in respect of compensation levies. The amount of future compensation levies payable by the Group depends on a number of factors including participation in the market at 31 December, the level of protected deposits and the population of deposit-taking participants.

### FSA investigation into Bank of Scotland and report on HBOS

In 2009, the FSA commenced a supervisory review into HBOS. The supervisory review was superseded when the FSA commenced an enforcement investigation into Bank of Scotland plc in relation to its Corporate division between 2006 and 2008. These proceedings have now concluded. The FSA published its Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. The FSA has committed to producing a public interest report on HBOS. The FSA has indicated that the report is expected to be published in the summer.

### Shareholder complaints

In November 2011 the Lloyds Banking Group and two former members of the Lloyds Banking Group's Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. No quantum is specified. In October 2012 the court dismissed the complaint. An appeal against this decision has been filed. The Lloyds Banking Group continues to consider that the allegations are without merit.

### Other legal actions and regulatory matters

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

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

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

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

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

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

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Contingent liabilities</b>				
Acceptances and endorsements	107	81	104	80
Other:				
Other items serving as direct credit substitutes	523	1,060	495	959
Performance bonds and other transaction-related contingencies	2,266	2,729	1,704	2,117
	<b>2,789</b>	3,789	<b>2,199</b>	3,076
<b>Total contingent liabilities</b>	<b>2,896</b>	3,870	<b>2,303</b>	3,156

	The Bank	
	2012 £m	2011 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings	12	83

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Commitments</b>				
Documentary credits and other short-term trade-related transactions	11	105	7	97
Forward asset purchases and forward deposits placed	546	596	546	596
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	7,404	7,383	932	901
Other commitments	53,196	56,527	31,354	32,511
	<b>60,600</b>	63,910	<b>32,286</b>	33,412
1 year or over original maturity	40,794	40,972	39,861	42,487
<b>Total commitments</b>	<b>101,951</b>	105,583	<b>72,700</b>	76,592

	The Bank	
	2012 £m	2011 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings	5,235	9,504

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend £52,733 million (2011: £53,459 million) for the Group and £38,527 million (2011: £36,831 million) for the Bank were irrevocable.

**Operating lease commitments**

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Not later than 1 year	310	348	162	187
Later than 1 year and not later than 5 years	987	1,187	495	640
Later than 5 years	1,332	1,489	592	606
<b>Total operating lease commitments</b>	<b>2,629</b>	3,024	<b>1,249</b>	1,433

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

**Capital commitments**

Excluding commitments of the Group in respect of investment property (note 25), capital expenditure contracted but not provided for at 31 December 2012 amounted to £279 million (2011: £296 million) for the Group and £2 million (2011: £4 million) for the Bank. Of this amount for the Group, £277 million (2011: £292 million) relates to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

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**53 Financial instruments**

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

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following 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	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
<b>At 31 December 2012</b>								
<b>Financial assets</b>								
Cash and balances at central banks	-	-	-	-	-	80,298	-	80,298
Items in the course of collection from banks	-	-	-	-	-	1,256	-	1,256
Trading and other financial assets at fair value through profit or loss	-	23,358	130,986	-	-	-	-	154,344
Derivative financial instruments	11,571	43,558	-	-	-	-	-	55,129
Loans and receivables:								
Loans and advances to banks	-	-	-	-	29,417	-	-	29,417
Loans and advances to customers	-	-	-	-	536,107	-	-	536,107
Debt securities	-	-	-	-	5,273	-	-	5,273
	-	-	-	-	570,797	-	-	570,797
Available-for-sale financial assets	-	-	-	31,374	-	-	-	31,374
<b>Total financial assets</b>	<b>11,571</b>	<b>66,916</b>	<b>130,986</b>	<b>31,374</b>	<b>570,797</b>	<b>81,554</b>	<b>-</b>	<b>893,198</b>
<b>Financial liabilities</b>								
Deposits from banks	-	-	-	-	-	38,405	-	38,405
Customer deposits	-	-	-	-	-	436,862	-	436,862
Items in course of transmission to banks	-	-	-	-	-	996	-	996
Trading and other financial liabilities at fair value through profit or loss	-	30,272	5,700	-	-	-	-	35,972
Derivative financial instruments	6,870	42,067	-	-	-	-	-	48,937
Notes in circulation	-	-	-	-	-	1,198	-	1,198
Debt securities in issue	-	-	-	-	-	116,817	-	116,817
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	82,968	82,968
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	54,372	54,372
Unallocated surplus within insurance businesses	-	-	-	-	-	-	267	267
Financial guarantees	-	-	48	-	-	-	-	48
Subordinated liabilities	-	-	-	-	-	37,590	-	37,590
<b>Total financial liabilities</b>	<b>6,870</b>	<b>72,339</b>	<b>5,748</b>	<b>-</b>	<b>-</b>	<b>631,868</b>	<b>137,607</b>	<b>854,432</b>

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**53 Financial instruments** (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
<b>The Group</b>								
At 31 December 2011								
<b>Financial assets</b>								
Cash and balances at central banks	–	–	–	–	–	60,722	–	60,722
Items in the course of collection from banks	–	–	–	–	–	1,408	–	1,408
Trading and other financial assets at fair value through profit or loss	–	18,068	121,175	–	–	–	–	139,243
Derivative financial instruments	13,913	50,929	–	–	–	–	–	64,842
Loans and receivables:								
Loans and advances to banks	–	–	–	–	32,606	–	–	32,606
Loans and advances to customers	–	–	–	–	584,237	–	–	584,237
Debt securities	–	–	–	–	12,470	–	–	12,470
	–	–	–	–	629,313	–	–	629,313
Available-for-sale financial assets	–	–	–	37,952	–	–	–	37,952
Held-to-maturity investments	–	–	–	–	–	8,098	–	8,098
<b>Total financial assets</b>	<b>13,913</b>	<b>68,997</b>	<b>121,175</b>	<b>37,952</b>	<b>629,313</b>	<b>70,228</b>	<b>–</b>	<b>941,578</b>
<b>Financial liabilities</b>								
Deposits from banks	–	–	–	–	–	39,810	–	39,810
Customer deposits	–	–	–	–	–	424,377	–	424,377
Items in course of transmission to banks	–	–	–	–	–	844	–	844
Trading and other financial liabilities at fair value through profit or loss	–	19,616	5,339	–	–	–	–	24,955
Derivative financial instruments	7,246	51,455	–	–	–	–	–	58,701
Notes in circulation	–	–	–	–	–	1,145	–	1,145
Debt securities in issue	–	–	–	–	–	184,504	–	184,504
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	79,001	79,001
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	49,636	49,636
Unallocated surplus within insurance businesses	–	–	–	–	–	–	300	300
Financial guarantees	–	–	49	–	–	–	–	49
Subordinated liabilities	–	–	–	–	–	37,330	–	37,330
<b>Total financial liabilities</b>	<b>7,246</b>	<b>71,071</b>	<b>5,388</b>	<b>–</b>	<b>–</b>	<b>688,010</b>	<b>128,937</b>	<b>900,652</b>

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53 Financial instruments (continued)

The Bank	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
<b>At 31 December 2012</b>							
<b>Financial assets</b>							
Cash and balances at central banks	-	-	-	-	-	74,078	74,078
Items in the course of collection from banks	-	-	-	-	-	806	806
Trading and other financial assets at fair value through profit or loss	-	6,049	413	-	-	-	6,462
Derivative financial instruments	1,905	30,342	-	-	-	-	32,247
Loans and receivables:							
Loans and advances to banks	-	-	-	-	188,216	-	188,216
Loans and advances to customers	-	-	-	-	240,546	-	240,546
Debt securities	-	-	-	-	492	-	492
	-	-	-	-	429,254	-	429,254
Available-for-sale financial assets	-	-	-	31,092	-	-	31,092
<b>Total financial assets</b>	<b>1,905</b>	<b>36,391</b>	<b>413</b>	<b>31,092</b>	<b>429,254</b>	<b>74,884</b>	<b>573,939</b>
<b>Financial liabilities</b>							
Deposits from banks	-	-	-	-	-	214,725	214,725
Customer deposits	-	-	-	-	-	231,773	231,773
Items in course of transmission to banks	-	-	-	-	-	445	445
Trading and other financial liabilities at fair value through profit or loss	-	5,141	5,700	-	-	-	10,841
Derivative financial instruments	1,884	28,732	-	-	-	-	30,616
Debt securities in issue	-	-	-	-	-	61,494	61,494
Financial guarantees	-	-	34	-	-	-	34
Subordinated liabilities	-	-	-	-	-	26,249	26,249
<b>Total financial liabilities</b>	<b>1,884</b>	<b>33,873</b>	<b>5,734</b>	<b>-</b>	<b>-</b>	<b>534,686</b>	<b>576,177</b>

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**53 Financial instruments** (continued)

The Bank	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
At 31 December 2011							
<b>Financial assets</b>							
Cash and balances at central banks	–	–	–	–	–	57,500	57,500
Items in the course of collection from banks	–	–	–	–	–	898	898
Trading and other financial assets at fair value through profit or loss	–	4,084	581	–	–	–	4,665
Derivative financial instruments	3,659	33,858	–	–	–	–	37,517
Loans and receivables:							
Loans and advances to banks	–	–	–	–	167,896	–	167,896
Loans and advances to customers	–	–	–	–	249,113	–	249,113
Debt securities	–	–	–	–	633	–	633
	–	–	–	–	417,642	–	417,642
Available-for-sale financial assets	–	–	–	31,351	–	–	31,351
Held-to-maturity investments	–	–	–	–	–	8,098	8,098
<b>Total financial assets</b>	<b>3,659</b>	<b>37,942</b>	<b>581</b>	<b>31,351</b>	<b>417,642</b>	<b>66,496</b>	<b>557,671</b>
<b>Financial liabilities</b>							
Deposits from banks	–	–	–	–	–	154,592	154,592
Customer deposits	–	–	–	–	–	227,553	227,553
Items in course of transmission to banks	–	–	–	–	–	487	487
Trading and other financial liabilities at fair value through profit or loss	–	5,566	5,339	–	–	–	10,905
Derivative financial instruments	905	34,126	–	–	–	–	35,031
Debt securities in issue	–	–	–	–	–	102,237	102,237
Financial guarantees	–	–	32	–	–	–	32
Subordinated liabilities	–	–	–	–	–	25,045	25,045
<b>Total financial liabilities</b>	<b>905</b>	<b>39,692</b>	<b>5,371</b>	<b>–</b>	<b>–</b>	<b>509,914</b>	<b>555,882</b>

**(2) Reclassification of financial assets**

During 2012 the Group has reviewed its holding of government securities classified as held-to-maturity. Since it is no longer the Group's intention to hold these to maturity, securities with a carrying amount of £10,811 million and a fair value of £11,979 million were reclassified as available-for-sale financial assets in December 2012. The difference between the carrying amount and the fair value has been recognised in equity.

No financial assets were reclassified in 2011.

In 2010, government securities with a fair value of £3,601 million, which are held by the Bank, were reclassified from available-for-sale financial assets to held-to-maturity investments reflecting the Group's then positive intent and ability to hold them until maturity.

In 2009, no financial assets were reclassified.

In 2008, in accordance with the amendment to IAS 39 that became applicable during that year, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, with effect from 1 July 2008, the Group transferred £2,993 million of assets previously classified as held for trading into loans and receivables. With effect from 1 November 2008, the Group transferred £437 million of assets previously classified as available-for-sale financial assets into loans and receivables. At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 6.3 per cent with the estimated recoverable cash flows of £3,524 million.

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**53 Financial instruments** (continued)

*Carrying value and fair value of reclassified assets*

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

The Group	31 December 2012		31 December 2011		31 December 2010		31 December 2009		31 December 2008	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	11	9	67	56	750	727	1,833	1,822	2,883	2,926
From available-for-sale financial assets to loans and receivables	162	203	217	219	313	340	394	422	454	402
From available-for-sale financial assets to held-to-maturity investments	–	–	3,624	3,846	3,455	3,539	–	–	–	–
From held-to-maturity investments to available-for-sale financial assets	4,998	4,998	–	–	–	–	–	–	–	–
<b>Total carrying value and fair value</b>	<b>5,171</b>	<b>5,210</b>	<b>3,908</b>	<b>4,121</b>	<b>4,518</b>	<b>4,606</b>	<b>2,227</b>	<b>2,244</b>	<b>3,337</b>	<b>3,328</b>

During the year ended 31 December 2012, the carrying value of the assets reclassified to loans and receivables decreased by £111 million (2011: £779 million) due to sales and maturities of £137 million (2011: £734 million), foreign exchange and other movements of £4 million (£58 million) less accretion of discount of £30 million (2011: £13 million).

No financial assets have been reclassified in accordance with paragraphs 50B, 50D or 50E of IAS 39 in since 2008; the following disclosures relate to those assets which were so reclassified in 2008.

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

The table below shows the additional gains (losses) that would have been recognised in the income statement if the reclassifications had not occurred.

The Group	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables	1	(3)	(34)	208	(347)

The table below shows the additional gains (losses) that would have been recognised in other comprehensive income if the reclassifications had not occurred.

The Group	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables	24	(68)	69	161	(108)

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

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

The Group	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From held for trading to loans and receivables:					
Net interest income	–	1	24	55	31
Impairment losses	–	–	(6)	(49)	(158)
<b>Total amounts recognised</b>	<b>–</b>	<b>1</b>	<b>18</b>	<b>6</b>	<b>(127)</b>

The Group	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
From available-for-sale financial assets to loans and receivables:					
Net interest income	1	2	1	34	3
Impairment losses	5	(8)	(2)	(56)	(23)
<b>Total amounts recognised</b>	<b>6</b>	<b>(6)</b>	<b>(1)</b>	<b>(22)</b>	<b>(20)</b>

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**53 Financial instruments** (continued)

**(3) Fair values of financial assets and liabilities**

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

	The Group				The Bank			
	2012		2011		2012		2011	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
<b>Financial assets</b>								
Cash and balances at central banks	<b>80,298</b>	<b>80,298</b>	60,722	60,722	<b>74,078</b>	<b>74,078</b>	57,500	57,500
Items in the course of collection from banks	<b>1,256</b>	<b>1,256</b>	1,408	1,408	<b>806</b>	<b>806</b>	898	898
Trading and other financial assets at fair value through profit or loss	<b>154,344</b>	<b>154,344</b>	139,243	139,243	<b>6,462</b>	<b>6,462</b>	4,665	4,665
Derivative financial instruments	<b>55,129</b>	<b>55,129</b>	64,842	64,842	<b>32,247</b>	<b>32,247</b>	37,517	37,517
Loans and receivables:								
Loans and advances to banks	<b>29,417</b>	<b>29,406</b>	32,606	32,554	<b>188,216</b>	<b>188,205</b>	167,896	167,870
Loans and advances to customers	<b>536,107</b>	<b>525,300</b>	584,237	568,428	<b>240,546</b>	<b>238,387</b>	249,113	243,910
Debt securities	<b>5,273</b>	<b>5,402</b>	12,470	10,953	<b>492</b>	<b>380</b>	633	749
	<b>570,797</b>	<b>560,108</b>	629,313	611,935	<b>429,254</b>	<b>426,972</b>	417,642	412,529
Available-for-sale financial assets	<b>31,374</b>	<b>31,374</b>	37,952	37,952	<b>31,092</b>	<b>31,092</b>	31,351	31,351
Held-to-maturity investments	–	–	8,098	8,144	–	–	8,098	8,144
<b>Financial liabilities</b>								
Deposits from banks	<b>38,405</b>	<b>38,739</b>	39,810	40,012	<b>214,725</b>	<b>214,985</b>	154,592	154,696
Customer deposits	<b>436,862</b>	<b>438,699</b>	424,377	425,125	<b>231,773</b>	<b>232,019</b>	227,553	227,385
Items in course of transmission to banks	<b>996</b>	<b>996</b>	844	844	<b>445</b>	<b>445</b>	487	487
Trading and other financial liabilities at fair value through profit or loss	<b>35,972</b>	<b>35,972</b>	24,955	24,955	<b>10,841</b>	<b>10,841</b>	10,905	10,905
Derivative financial instruments	<b>48,937</b>	<b>48,937</b>	58,701	58,701	<b>30,616</b>	<b>30,616</b>	35,031	35,031
Notes in circulation	<b>1,198</b>	<b>1,198</b>	1,145	1,145	–	–	–	–
Debt securities in issue	<b>116,817</b>	<b>122,411</b>	184,504	182,558	<b>61,494</b>	<b>64,857</b>	102,237	100,468
Liabilities arising from non-participating investment contracts	<b>54,372</b>	<b>54,372</b>	49,636	49,636	–	–	–	–
Financial guarantees	<b>48</b>	<b>48</b>	49	49	<b>34</b>	<b>34</b>	32	32
Subordinated liabilities	<b>37,590</b>	<b>39,028</b>	37,330	33,047	<b>26,249</b>	<b>27,093</b>	25,045	23,388

*Valuation methodology*

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

Wherever possible, fair values have been 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.

Fair value information is not provided for items that do not meet the definition of a financial instrument. 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.

**Fair value of financial instruments carried at amortised cost**

*Cash and balances at central banks and items in the course of collection from banks*

The fair value approximates carrying value due to their short-term nature.

*Loans and receivables*

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



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**53 Financial instruments** (continued)

The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset-backed securities and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables (see page 108), are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

*Deposits from banks and customer deposits*

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

*Items in course of transmission to banks*

The fair value approximates carrying value due to their short-term nature.

*Notes in circulation*

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

*Debt securities in issue and subordinated liabilities*

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices. The difference between fair value and amortised cost is driven both by interest rates and the Group's credit rating.

*Held-to-maturity investments*

The fair values of government securities are based on market prices whereas the carrying value is based on cost, the difference being interest rate driven. In 2012, these assets were transferred to the available-for-sale portfolio and carried at fair value at 31 December 2012.

**Valuation of financial instruments carried at fair value**

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

*Level 1 portfolios*

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

*Level 2 portfolios*

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

*Level 3 portfolios*

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

**Valuation control framework**

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

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

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

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**53 Financial instruments** (continued)

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

<b>Valuation hierarchy</b>				
<b>The Group</b>	<b>Level 1 £m</b>	<b>Level 2 £m</b>	<b>Level 3 £m</b>	<b>Total £m</b>
<b>At 31 December 2012</b>				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	13,632	–	13,632
Loans and advances to banks	–	919	–	919
Debt securities:				
Government securities	18,524	2,207	–	20,731
Other public sector securities	–	1,056	–	1,056
Bank and building society certificates of deposit	68	3,326	–	3,394
Asset-backed securities:				
Mortgage-backed securities	151	687	–	838
Other asset-backed securities	258	1,565	–	1,823
Corporate and other debt securities	5,692	17,847	1,519	25,058
	24,693	26,688	1,519	52,900
Equity shares	84,604	72	1,787	86,463
Treasury and other bills	430	–	–	430
<b>Total trading and other financial assets at fair value through profit or loss</b>	<b>109,727</b>	<b>41,311</b>	<b>3,306</b>	<b>154,344</b>
Available-for-sale financial assets				
Debt securities:				
Government securities	25,555	–	–	25,555
Other public sector securities	–	–	–	–
Bank and building society certificates of deposit	42	146	–	188
Asset-backed securities:				
Mortgage-backed securities	–	1,524	–	1,524
Other asset-backed securities	–	687	73	760
Corporate and other debt securities	22	1,826	–	1,848
	25,619	4,183	73	29,875
Equity shares	21	99	408	528
Treasury and other bills	869	16	86	971
<b>Total available-for-sale financial assets</b>	<b>26,509</b>	<b>4,298</b>	<b>567</b>	<b>31,374</b>
Derivative financial instruments	76	54,116	937	55,129
<b>Total financial assets carried at fair value</b>	<b>136,312</b>	<b>99,725</b>	<b>4,810</b>	<b>240,847</b>
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,700	–	5,700
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	24,553	–	24,553
Short positions in securities	1,850	350	–	2,200
Other	15	3,504	–	3,519
	1,865	28,407	–	30,272
<b>Total trading and other financial liabilities at fair value through profit or loss</b>	<b>1,865</b>	<b>34,107</b>	<b>–</b>	<b>35,972</b>
Derivative financial instruments	36	48,358	543	48,937
Financial guarantees	–	–	48	48
<b>Total financial liabilities carried at fair value</b>	<b>1,901</b>	<b>82,465</b>	<b>591</b>	<b>84,957</b>

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**53 Financial instruments** (continued)

**Valuation hierarchy**

<b>The Group</b>	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2011				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	9,766	–	9,766
Loans and advances to banks	–	1,355	–	1,355
Debt securities:				
Government securities	21,326	2,041	–	23,367
Other public sector securities	375	808	–	1,183
Bank and building society certificates of deposit	–	3,248	–	3,248
Asset-backed securities:				
Mortgage-backed securities	187	524	–	711
Other asset-backed securities	178	1,605	203	1,986
Corporate and other debt securities	5,098	15,048	1,423	21,569
	27,164	23,274	1,626	52,064
Equity shares	74,403	41	1,315	75,759
Treasury and other bills	299	–	–	299
<b>Total trading and other financial assets at fair value through profit or loss</b>	<b>101,866</b>	<b>34,436</b>	<b>2,941</b>	<b>139,243</b>
Available-for-sale financial assets				
Debt securities:				
Government securities	25,143	93	–	25,236
Other public sector securities	27	–	–	27
Bank and building society certificates of deposit	323	43	–	366
Asset-backed securities:				
Mortgage-backed securities	–	1,803	–	1,803
Other asset-backed securities	–	807	257	1,064
Corporate and other debt securities	41	5,738	12	5,791
	25,534	8,484	269	34,287
Equity shares	55	96	1,787	1,938
Treasury and other bills	972	755	–	1,727
<b>Total available-for-sale financial assets</b>	<b>26,561</b>	<b>9,335</b>	<b>2,056</b>	<b>37,952</b>
Derivative financial instruments	204	63,161	1,477	64,842
<b>Total financial assets carried at fair value</b>	<b>128,631</b>	<b>106,932</b>	<b>6,474</b>	<b>242,037</b>
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,339	–	5,339
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	12,378	–	12,378
Short positions in securities	3,168	533	–	3,701
Other	–	3,537	–	3,537
	3,168	16,448	–	19,616
<b>Total trading and other financial liabilities at fair value through profit or loss</b>	<b>3,168</b>	<b>21,787</b>	<b>–</b>	<b>24,955</b>
Derivative financial instruments	35	57,925	741	58,701
Financial guarantees	–	–	49	49
<b>Total financial liabilities carried at fair value</b>	<b>3,203</b>	<b>79,712</b>	<b>790</b>	<b>83,705</b>

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

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**53 Financial instruments** (continued)

**Valuation hierarchy**

<b>The Bank</b>	<b>Level 1 £m</b>	<b>Level 2 £m</b>	<b>Level 3 £m</b>	<b>Total £m</b>
<b>At 31 December 2012</b>				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	21	–	21
Loans and advances to banks	–	191	–	191
Debt securities:				
Government securities	3,781	–	–	3,781
Bank and building society certificates of deposit	–	926	–	926
Asset-backed securities:				
Mortgage-backed securities	–	130	–	130
Other asset-backed securities	–	17	–	17
Corporate and other debt securities	–	1,294	–	1,294
	<b>3,781</b>	<b>2,367</b>	<b>–</b>	<b>6,148</b>
Equity shares	2	11	–	13
Treasury and other bills	89	–	–	89
<b>Total trading and other financial assets at fair value through profit or loss</b>	<b>3,872</b>	<b>2,590</b>	<b>–</b>	<b>6,462</b>
Available-for-sale financial assets				
Debt securities:				
Government securities	25,418	–	–	25,418
Other public sector securities	–	–	–	–
Bank and building society certificates of deposit	38	121	–	159
Asset-backed securities:				
Mortgage-backed securities	–	456	–	456
Other asset-backed securities	–	88	–	88
Corporate and other debt securities	–	4,808	–	4,808
	<b>25,456</b>	<b>5,473</b>	<b>–</b>	<b>30,929</b>
Equity shares	–	47	–	47
Treasury and other bills	15	16	85	116
<b>Total available-for-sale financial assets</b>	<b>25,471</b>	<b>5,536</b>	<b>85</b>	<b>31,092</b>
Derivative financial instruments	2	31,480	765	32,247
<b>Total financial assets carried at fair value</b>	<b>29,345</b>	<b>39,606</b>	<b>850</b>	<b>69,801</b>
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,700	–	5,700
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	584	–	584
Short positions in securities	703	350	–	1,053
Other	–	3,504	–	3,504
	<b>703</b>	<b>4,438</b>	<b>–</b>	<b>5,141</b>
<b>Total trading and other financial liabilities at fair value through profit or loss</b>	<b>703</b>	<b>10,138</b>	<b>–</b>	<b>10,841</b>
Derivative financial instruments	6	30,122	488	30,616
Financial guarantees	–	–	34	34
<b>Total financial liabilities carried at fair value</b>	<b>709</b>	<b>40,260</b>	<b>522</b>	<b>41,491</b>

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**53 Financial instruments** (continued)

**Valuation hierarchy**

<b>The Bank</b>	<b>Level 1 £m</b>	<b>Level 2 £m</b>	<b>Level 3 £m</b>	<b>Total £m</b>
At 31 December 2011				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	69	–	69
Debt securities:				
Government securities	1,008	–	–	1,008
Other public sector securities	–	–	–	–
Bank and building society certificates of deposit	–	1,479	–	1,479
Asset-backed securities				
Mortgage-backed securities	–	99	–	99
Other asset-backed securities	–	19	–	19
Corporate and other debt securities	–	1,900	–	1,900
	1,008	3,497	–	4,505
Equity shares	4	12	–	16
Treasury and other bills	75	–	–	75
<b>Total trading and other financial assets at fair value through profit or loss</b>	<b>1,087</b>	<b>3,578</b>	<b>–</b>	<b>4,665</b>
Available-for-sale financial assets				
Debt securities:				
Government securities	25,067	–	–	25,067
Other public sector securities	27	–	–	27
Bank and building society certificates of deposit	323	6	–	329
Asset-backed securities:				
Mortgage-backed securities	–	497	–	497
Other asset-backed securities	–	152	153	305
Corporate and other debt securities	–	5,050	–	5,050
	25,417	5,705	153	31,275
Equity shares	4	43	–	47
Treasury and other bills	20	9	–	29
<b>Total available-for-sale financial assets</b>	<b>25,441</b>	<b>5,757</b>	<b>153</b>	<b>31,351</b>
Derivative financial instruments	3	36,389	1,125	37,517
<b>Total financial assets carried at fair value</b>	<b>26,531</b>	<b>45,724</b>	<b>1,278</b>	<b>73,533</b>
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss (debt securities)	–	5,339	–	5,339
Trading liabilities:				
Short positions in securities	1,431	533	–	1,964
Other	–	3,602	–	3,602
	1,431	4,135	–	5,566
<b>Total trading and other financial liabilities at fair value through profit or loss</b>	<b>1,431</b>	<b>9,474</b>	<b>–</b>	<b>10,905</b>
Derivative financial instruments	3	34,322	706	35,031
Financial guarantees	–	–	32	32
<b>Total financial liabilities carried at fair value</b>	<b>1,434</b>	<b>43,796</b>	<b>738</b>	<b>45,968</b>

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**53 Financial instruments** (continued)**Valuation methodology***Asset-backed securities*

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

*Equity investments (including venture capital)*

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

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

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

*Unquoted equities and property partnerships in the life funds*

Third party valuations are used to obtain the fair value of unquoted investments. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

*Derivatives*

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

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives 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.

Level 3 derivatives also include £nil (2011: £14 million) in respect of credit default swaps written on level 3 negative basis asset-backed securities.

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**53 Financial instruments** (continued)

**Movements in level 3 portfolio**

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

The Group	Trading and other financial assets at fair value through profit or loss £m	Available- for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2011	2,836	2,646	810	6,292
Exchange and other adjustments	(8)	(45)	(2)	(55)
Gains recognised in the income statement	139	78	670	887
Losses recognised in other comprehensive income	–	(148)	–	(148)
Purchases	518	343	–	861
Sales	(747)	(580)	–	(1,327)
Transfers into the level 3 portfolio	331	146	47	524
Transfers out of the level 3 portfolio	(128)	(384)	(48)	(560)
At 31 December 2011	2,941	2,056	1,477	6,474
Exchange and other adjustments	10	(60)	12	(38)
Gains (losses) recognised in the income statement	166	(356)	(584)	(774)
Losses recognised in other comprehensive income	–	(58)	–	(58)
Purchases	513	218	45	776
Sales	(570)	(1,358)	(13)	(1,941)
Transfers into the level 3 portfolio	337	138	–	475
Transfers out of the level 3 portfolio	(91)	(13)	–	(104)
<b>At 31 December 2012</b>	<b>3,306</b>	<b>567</b>	<b>937</b>	<b>4,810</b>
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2012	85	(33)	(584)	(532)
Losses recognised in other comprehensive income relating to those assets held at 31 December 2012	–	(24)	–	(24)
Gains recognised in the income statement relating to those assets held at 31 December 2011	203	31	176	410
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	–	(132)	–	(132)

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

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2011	203	54	257
Losses recognised in the income statement	585	5	590
Redemptions	–	(10)	(10)
Transfers into the level 3 portfolio	18	–	18
Transfers out of the level 3 portfolio	(65)	–	(65)
At 31 December 2011	741	49	790
Exchange and other adjustments	10	–	10
Gains recognised in the income statement	(227)	(3)	(230)
Additions	28	2	30
Redemptions	(25)	–	(25)
Transfers into the level 3 portfolio	16	–	16
<b>At 31 December 2012</b>	<b>543</b>	<b>48</b>	<b>591</b>
Gains recognised in the income statement relating to those liabilities held at 31 December 2012	223	3	226
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	(93)	(5)	(98)

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

Included within the gains (losses) recognised in the income statement are losses of £306 million (2011: gains of £312 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

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**53 Financial instruments** (continued)

Included within the gains (losses) recognised in other comprehensive income are losses of £24 million (2011: losses of £132 million) related to financial instruments that are held in the level 3 portfolio at the year end.

The Bank	Trading and other financial assets at fair value through profit or loss £m	Available- for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2011	93	371	544	1,008
Exchange and other adjustments	(2)	(1)	–	(3)
Gains recognised in the income statement	8	–	630	638
Losses recognised in other comprehensive income	–	(4)	–	(4)
Purchases	–	2	–	2
Sales	(99)	51	–	(48)
Transfers into the level 3 portfolio	–	105	–	105
Transfers out of the level 3 portfolio	–	(371)	(49)	(420)
At 31 December 2011	–	153	1,125	1,278
Exchange and other adjustments	–	–	12	12
Losses recognised in the income statement	–	–	(415)	(415)
Losses recognised in other comprehensive income	–	–	–	–
Purchases	–	–	45	45
Sales	–	(141)	(2)	(143)
Transfers into the level 3 portfolio	–	85	–	85
Transfers out of the level 3 portfolio	–	(12)	–	(12)
<b>At 31 December 2012</b>	<b>–</b>	<b>85</b>	<b>765</b>	<b>850</b>
Losses recognised in the income statement relating to those assets held at 31 December 2012	–	–	(415)	(415)
Losses recognised in other comprehensive income relating to those assets held at 31 December 2012	–	–	–	–
Gains recognised in the income statement relating to those assets held at 31 December 2011	–	–	101	101
Losses recognised in other comprehensive income relating to those assets held at 31 December 2011	–	(4)	–	(4)

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

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2011	169	42	211
Losses recognised in the income statement	582	–	582
Redemptions	–	(10)	(10)
Transfers out of the level 3 portfolio	(45)	–	(45)
At 31 December 2011	706	32	738
Exchange and other adjustments	10	–	10
Gains recognised in the income statement	(246)	–	(246)
Additions	28	2	30
Redemptions	(10)	–	(10)
<b>At 31 December 2012</b>	<b>488</b>	<b>34</b>	<b>522</b>
Gains recognised in the income statement relating to those liabilities held at 31 December 2012	246	–	246
Losses recognised in the income statement relating to those liabilities held at 31 December 2011	(93)	–	(93)

Included within the gains (losses) recognised in the income statement are losses of £169 million (2011: gains of £8 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

Including within the gains (losses) recognised in other comprehensive income are losses of £nil (2011: losses of £4 million) related to financial instruments that are held in the level 3 portfolio at the year end.



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**53 Financial instruments** (continued)

**Sensitivity of level 3 valuations**

			At 31 December 2012			At 31 December 2011		
Valuation basis/technique	Main assumptions	Carrying value £m	Effect of reasonably possible alternative assumptions		Carrying value £m	Effect of reasonably possible alternative assumptions		
			Favourable changes £m	Unfavourable changes £m		Favourable changes £m	Unfavourable changes £m	
<b>Trading and other financial assets at fair value through profit or loss:</b>								
Asset-backed securities	Lead manager or broker quote/consensus pricing from market data provider.	Use of single pricing source	–	–	–	203	1	(1)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	2,081	80	(59)	1,823	56	(59)
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	1,225	–	–	915	n/a	n/a
			<b>3,306</b>			2,941		
<b>Available-for-sale financial assets:</b>								
Asset-backed securities	Lead manager or broker quote/consensus pricing from market data provider	Use of single pricing source	73	–	–	257	1	(1)
Equity and venture capital investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	494	36	(11)	1,799	183	(88)
			<b>567</b>			2,056		
<b>Derivative financial assets</b>	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>937</b>	<b>71</b>	<b>(69)</b>	1,477	88	(20)
<b>Financial assets</b>			<b>4,810</b>			6,474		
<b>Derivative financial liabilities</b>	Industry standard model/consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>543</b>	–	–	741	–	–
<b>Financial guarantees</b>			<b>48</b>	–	–	49	–	–
<b>Financial liabilities</b>			<b>591</b>			790		

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**53 Financial instruments** (continued)

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

*Asset-backed securities*

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

*Derivative financial instruments*

- (i) In respect of the embedded equity conversion feature of the enhanced capital notes, the sensitivity was based on the absolute difference between the actual price of the enhanced capital note and the closest, alternative broker quote available plus the impact of applying a 10 bps increase/decrease in the market yield used to derive a market price for similar bonds without the conversion feature. The effect of interdependency of the assumptions is not material to the effect of applying reasonably possible alternative assumptions to the valuations of derivative financial instruments.
- (ii) In respect of credit default swaps written on level 3 negative basis asset-backed securities, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

*Venture capital and equity investments*

Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds. The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment, as described in the valuation methodology section above. Reasonably possible alternative valuations for these investments have been calculated by reference to the relevant approach taken as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

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

**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 during 2012 and 2011.

	2012 £m	2011 £m
At 1 January	1,226	570
Income statement (credit) charge	(209)	718
Transfers	(120)	(62)
<b>At 31 December</b>	<b>897</b>	<b>1,226</b>

Represented by:

	2012 £m	2011 £m
Credit Valuation Adjustment	928	1,425
Debit Valuation Adjustment	(174)	(493)
Funding Valuation Adjustment	143	294
	<b>897</b>	<b>1,226</b>

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 interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

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.

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 become 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.

### 53 Financial instruments (continued)

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 £154 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 £69 million of the overall CVA balance at 31 December 2012).

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 CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £113 million to £287 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £345 million fall in the overall valuation adjustment to £409 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 certain uncollateralised derivative positions where the Group considers that this cost is included in market pricing. 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 £14 million.

#### *(ii) Uncollateralised derivative valuation adjustments – monoline counterparties*

The Group has no significant derivative exposures remaining against monoline counterparties.

#### *(iii) 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 2012, the Group's derivative trading business held mid to bid-offer valuation adjustments of £103 million (2011: £85 million).

#### *(iv) Libor/Overnight Index Swap (OIS) basis*

The Group's derivative trading business applies £74 million (2011: £74 million) of valuation adjustments against the changing market approach to valuing derivatives that are subject to daily collateral margin, where standard market practice is to pay interest on an Overnight Index Swap (OIS) basis rather than a Libor rate.

No credit valuation adjustment is taken on collateralised swaps.

#### *Own credit adjustments*

The carrying amount of issued notes that are designated under the IAS 39 fair value option is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2012, the own credit adjustment arising from the fair valuation of £5,700 million (2011: £5,339 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a loss of £437 million (2011: a gain of £194 million).

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**53 Financial instruments (continued)**

**(4) Transfers of financial assets**

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

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

As set out in note 19, included within loans and receivables are loans securitised under the Group's securitisation programmes. The Group retains all or a majority of the risks and rewards associated with these loans and they are retained on the Group's balance sheet. Assets transferred into the Group's securitisation programmes are not available to be used by the Group during the term of those arrangements.

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

	The Group		The Bank	
	Carrying value of transferred assets £m	Carrying value of associated liabilities £m	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
<b>At 31 December 2012</b>				
<b>Repurchase and securities lending transactions</b>				
Trading and other financial assets at fair value through profit or loss	10,612	620	3,174	2,588
Available-for-sale financial assets	8,967	4,693	24,784	8,499
Loans and receivables:				
Loans and advances to customers	19,015	6,662	1,083	1,016
Debt securities classified as loans and receivables	498	346	1,089	812
<b>Securitisation programmes</b>				
Loans and receivables:				
Loans and advances to customers <sup>1</sup>	118,183	28,059 <sup>2</sup>	51,167	10,435

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

<sup>2</sup> Excludes securitisation notes held by the Group (£58,732 million).

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

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

	The Group				The Bank			
	Carrying amount of ongoing exposure in balance sheet				Carrying amount of ongoing exposure in balance sheet			
	At fair value through profit or loss				At fair value through profit or loss			
	Loans and receivables £m	Designated upon initial recognition £m	Fair value of ongoing exposure £m	Maximum exposure to loss £m	Loans and receivables £m	Designated upon initial recognition £m	Fair value of ongoing exposure £m	Maximum exposure to loss £m
<b>At 31 December 2012</b>								
Debt securities	119	–	102	119 <sup>1</sup>	119	–	102	119 <sup>1</sup>
Fund investments	–	70	70	100 <sup>2</sup>	–	–	–	–
<b>Total</b>	<b>119</b>	<b>70</b>	<b>172</b>	<b>219</b>	<b>119</b>	<b>–</b>	<b>102</b>	<b>119</b>

<sup>1</sup> Amount represents the carrying amount of the asset.

<sup>2</sup> Amount represents the carrying amount of the asset plus undrawn commitments of £30 million.

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

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

The Group and the Bank have no obligation or option to repurchase any of the assets transferred.

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### 53 Financial instruments (continued)

#### Amounts recognised in the income statement in 2012

In respect of debt securities shown above, an amount of £2 million was recognised during the year (£5 million cumulatively since derecognition) within net interest income.

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

### 54 Financial risk management

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

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; liquidity risk and insurance 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 and predominantly in the United Kingdom, the European Union, Australia and the United States. Credit risk appetite is set at Board level and is described and reported through a suite of metrics devised from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems 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, which includes amounts held to cover unit-linked and With-Profit funds liabilities, is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Loans and receivables:				
Loans and advances to banks, net <sup>1</sup>	29,417	32,606	188,216	167,896
Loans and advances to customers, net <sup>1</sup>	536,107	584,237	240,546	249,113
Debt securities, net <sup>1</sup>	5,273	12,470	492	633
Deposit amounts available for offset, net <sup>2</sup>	(5,728)	(4,174)	(4,366)	(4,171)
	565,069	625,139	424,888	413,471
Available-for-sale financial assets (excluding equity shares)	30,846	36,015	31,045	31,304
Held-to-maturity investments	–	8,098	–	8,098
Trading and other financial assets at fair value through profit or loss (excluding equity shares) <sup>3</sup> :				
Loans and advances	14,551	11,121	212	69
Debt securities, treasury and other bills	53,330	52,363	6,237	4,580
	67,881	63,484	6,449	4,649
Derivative assets:				
Derivative assets, before netting	55,129	64,842	32,247	37,517
Amounts available for offset under master netting arrangements <sup>2</sup>	(38,158)	(46,618)	(17,185)	(23,733)
	16,971	18,224	15,062	13,784
Assets arising from reinsurance contracts held	2,320	2,534	–	–
Financial guarantees	9,520	10,831	8,660	9,489
Irrevocable loan commitments and other credit-related contingencies <sup>4</sup>	55,629	57,329	40,830	39,987
<b>Maximum credit risk exposure</b>	<b>748,236</b>	<b>821,654</b>	<b>526,934</b>	<b>520,782</b>
<b>Maximum credit risk exposure before offset items</b>	<b>792,122</b>	<b>872,446</b>	<b>548,485</b>	<b>548,686</b>

<sup>1</sup>Amounts shown net of related impairment allowances.

<sup>2</sup>Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

<sup>3</sup>Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's with-profits funds for which credit risk is largely borne by the policyholders. Consequently the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

<sup>4</sup>See note 52 – Contingent liabilities and commitments for further information.

## Notes to the accounts

**54 Financial risk management** (continued)**B. Credit quality of assets***Loans and receivables*

The disclosures in the table above are produced under the management basis used for the Lloyds Banking Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant business combination such as the transfer of HBOS in 2010, this management basis, which includes the allowance for loan losses in place at the date of the acquisition of HBOS by the Lloyds Banking Group on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

The analysis of lending between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

**Loans and advances – The Group**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
Neither past due nor impaired	29,386	319,613	41,223	117,613	478,449	14,551
Past due but not impaired	31	12,880	922	1,527	15,329	–
Impaired – no provision required	–	741	1,530	1,504	3,775	–
– provision held	3	7,391	2,124	33,003	42,518	–
Gross	29,420	340,625	45,799	153,647	540,071	14,551
Allowance for impairment losses	(3)	(2,845)	(1,326)	(17,601)	(21,772)	–
Fair value adjustments	–				(1,074)	–
<b>Net</b>	<b>29,417</b>				<b>517,225</b>	<b>14,551</b>
Due from fellow Lloyds Banking Group undertakings	–				18,882	–
<b>Total loans and advances</b>	<b>29,417</b>				<b>536,107</b>	<b>14,551</b>

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2011</b>						
Neither past due nor impaired	32,494	330,727	41,448	146,655	518,830	11,121
Past due but not impaired	15	12,742	1,093	2,509	16,344	–
Impaired – no provision required	6	1,364	1,604	3,544	6,512	–
– provision held	105	6,701	2,940	44,116	53,757	–
Gross	32,620	351,534	47,085	196,824	595,443	11,121
Allowance for impairment losses	(14)	(2,731)	(1,848)	(23,139)	(27,718)	–
Fair value adjustments	–				(2,087)	–
<b>Net</b>	<b>32,606</b>				<b>565,638</b>	<b>11,121</b>
Due from fellow Lloyds Banking Group undertakings	–				18,599	–
<b>Total loans and advances</b>	<b>32,606</b>				<b>584,237</b>	<b>11,121</b>

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2h. All impaired loans which exceed certain thresholds, principally within the Group's wholesale and corporate businesses, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £34,533 million (2011: £48,142 million).

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54 Financial risk management (continued)

Loans and advances which are neither past due nor impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
Good quality	28,833	313,372	30,924	60,510		14,514
Satisfactory quality	174	4,532	8,579	33,477		28
Lower quality	10	552	862	18,153		6
Below standard, but not impaired	369	1,157	858	5,473		3
<b>Total loans and advances which are neither past due nor impaired</b>	<b>29,386</b>	<b>319,613</b>	<b>41,223</b>	<b>117,613</b>	<b>478,449</b>	<b>14,551</b>
<b>31 December 2011</b>						
Good quality	32,141	323,060	29,123	71,907		11,065
Satisfactory quality	171	5,432	9,747	42,311		45
Lower quality	9	970	1,127	24,676		11
Below standard, but not impaired	173	1,265	1,451	7,761		–
Total loans and advances which are neither past due nor impaired	32,494	330,727	41,448	146,655	518,830	11,121

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models.

Loans and advances which are past due but not impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
0-30 days	–	5,996	744	860	7,600	–
30-60 days	3	2,667	138	131	2,936	–
60-90 days	2	1,750	29	328	2,107	–
90-180 days	6	2,467	5	56	2,528	–
Over 180 days	20	–	6	152	158	–
<b>Total loans and advances which are past due but not impaired</b>	<b>31</b>	<b>12,880</b>	<b>922</b>	<b>1,527</b>	<b>15,329</b>	<b>–</b>
<b>31 December 2011</b>						
0-30 days	1	5,989	868	1,163	8,020	–
30-60 days	9	2,618	195	481	3,294	–
60-90 days	4	1,833	25	260	2,118	–
90-180 days	–	2,302	4	159	2,465	–
Over 180 days	1	–	1	446	447	–
Total loans and advances which are past due but not impaired	15	12,742	1,093	2,509	16,344	–

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

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**54 Financial risk management** (continued)

**Loans and advances – The Bank**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
Neither past due nor impaired	4,857	86,555	22,546	62,395	171,496	212
Past due but not impaired	31	2,117	358	364	2,839	–
Impaired – no provision required	–	307	869	466	1,642	–
– provision held	3	703	1,097	4,685	6,485	–
Gross	4,891	89,682	24,870	67,910	182,462	212
Allowance for impairment losses (note 22)	(3)	(229)	(495)	(2,455)	(3,179)	–
<b>Net</b>	<b>4,888</b>	<b>89,453</b>	<b>24,375</b>	<b>65,455</b>	<b>179,283</b>	<b>212</b>
Due from fellow Lloyds Banking Group undertakings	183,328				61,263	–
<b>Total loans and advances</b>	<b>188,216</b>				<b>240,546</b>	<b>212</b>

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2011</b>						
Neither past due nor impaired	5,222	90,625	22,014	64,284	176,923	69
Past due but not impaired	15	2,159	443	647	3,249	–
Impaired – no provision required	–	390	888	485	1,763	–
– provision held	105	850	1,470	5,364	7,684	–
Gross	5,342	94,024	24,815	70,780	189,619	69
Allowance for impairment losses (note 22)	(14)	(240)	(731)	(2,498)	(3,469)	–
<b>Net</b>	<b>5,328</b>	<b>93,784</b>	<b>24,084</b>	<b>68,282</b>	<b>186,150</b>	<b>69</b>
Due from fellow Lloyds Banking Group undertakings	162,568				62,963	–
<b>Total loans and advances</b>	<b>167,896</b>				<b>249,113</b>	<b>69</b>

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £5,003 million (2011: £5,853 million).



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54 Financial risk management (continued)

**Loans and advances which are neither past due nor impaired – The Bank**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
Good quality	4,694	86,249	17,081	39,571		209
Satisfactory quality	142	293	4,525	18,040		3
Lower quality	1	9	569	3,763		–
Below standard, but not impaired	20	4	371	1,021		–
<b>Total loans and advances which are neither past due nor impaired</b>	<b>4,857</b>	<b>86,555</b>	<b>22,546</b>	<b>62,395</b>	<b>171,496</b>	<b>212</b>
31 December 2011						
Good quality	5,101	90,217	15,962	38,006		18
Satisfactory quality	105	381	4,754	21,151		41
Lower quality	9	19	706	4,410		10
Below standard, but not impaired	7	8	592	717		–
Total loans and advances which are neither past due nor impaired	5,222	90,625	22,014	64,284	176,923	69

**Loans and advances which are past due but not impaired – The Bank**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2012</b>						
0-30 days	–	1,011	284	193	1,488	–
30-60 days	3	441	68	22	531	–
60-90 days	2	253	6	46	305	–
90-180 days	6	412	–	38	450	–
Over 180 days	20	–	–	65	65	–
<b>Total loans and advances which are past due but not impaired</b>	<b>31</b>	<b>2,117</b>	<b>358</b>	<b>364</b>	<b>2,839</b>	<b>–</b>
31 December 2011						
0-30 days	1	1,131	338	156	1,625	–
30-60 days	9	429	99	87	615	–
60-90 days	4	260	6	108	374	–
90-180 days	–	339	–	46	385	–
Over 180 days	1	–	–	250	250	–
Total loans and advances which are past due but not impaired	15	2,159	443	647	3,249	–

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

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**54 Financial risk management** (continued)

**Debt securities classified as loans and receivables**

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

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
The Group							
<b>At 31 December 2012</b>							
Asset-backed securities:							
Mortgage-backed securities	637	1,109	877	745	368	191	3,927
Other asset-backed securities	541	57	199	107	245	1	1,150
	<b>1,178</b>	<b>1,166</b>	<b>1,076</b>	<b>852</b>	<b>613</b>	<b>192</b>	<b>5,077</b>
Corporate and other debt securities	150	–	–	–	–	252	402
<b>Total debt securities classified as loans and receivables</b>	<b>1,328</b>	<b>1,166</b>	<b>1,076</b>	<b>852</b>	<b>613</b>	<b>444</b>	<b>5,479</b>

At 31 December 2011

Asset-backed securities:

Mortgage-backed securities	2,008	2,326	1,423	1,024	369	29	7,179
Other asset-backed securities	3,585	430	374	237	403	1	5,030
	5,593	2,756	1,797	1,261	772	30	12,209
Corporate and other debt securities	150	–	67	–	–	320	537
<b>Total debt securities classified as loans and receivables</b>	<b>5,743</b>	<b>2,756</b>	<b>1,864</b>	<b>1,261</b>	<b>772</b>	<b>350</b>	<b>12,746</b>

The Bank

**At 31 December 2012**

Asset-backed securities:

Mortgage-backed securities	36	47	37	32	155	86	393
Other asset-backed securities	–	5	–	–	–	–	5
	<b>36</b>	<b>52</b>	<b>37</b>	<b>32</b>	<b>155</b>	<b>86</b>	<b>398</b>
Corporate and other debt securities	150	–	–	–	–	–	150
<b>Total debt securities classified as loans and receivables</b>	<b>186</b>	<b>52</b>	<b>37</b>	<b>32</b>	<b>155</b>	<b>86</b>	<b>548</b>

At 31 December 2011

Asset-backed securities:

Mortgage-backed securities	100	54	51	114	62	133	514
Other asset-backed securities	–	–	11	–	31	1	43
	100	54	62	114	93	134	557
Corporate and other debt securities	150	–	42	–	–	–	192
<b>Total debt securities classified as loans and receivables</b>	<b>250</b>	<b>54</b>	<b>104</b>	<b>114</b>	<b>93</b>	<b>134</b>	<b>749</b>

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**54 Financial risk management** (continued)

**Available-for-sale financial assets (excluding equity shares)**

An analysis of available-for-sale financial assets is included in note 23. The credit quality of available-for-sale financial assets (excluding equity shares) is set out below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>The Group</b>							
<b>At 31 December 2012</b>							
<i>Debt securities</i>							
Government securities	18,227	7,328	–	–	–	–	25,555
Bank and building society certificates of deposit	–	75	71	42	–	–	188
<i>Asset-backed securities:</i>							
Mortgage-backed securities	976	212	50	120	166	–	1,524
Other asset-backed securities	336	241	116	–	67	–	760
	1,312	453	166	120	233	–	2,284
Corporate and other debt securities	293	281	567	600	85	22	1,848
<b>Total debt securities</b>	<b>19,832</b>	<b>8,137</b>	<b>804</b>	<b>762</b>	<b>318</b>	<b>22</b>	<b>29,875</b>
Treasury bills and other bills	866	–	16	89	–	–	971
<b>Total held as available-for-sale financial assets</b>	<b>20,698</b>	<b>8,137</b>	<b>820</b>	<b>851</b>	<b>318</b>	<b>22</b>	<b>30,846</b>
<b>At 31 December 2011</b>							
<i>Debt securities</i>							
Government securities	19,051	6,179	–	–	–	6	25,236
Other public sector securities	–	–	–	–	–	27	27
Bank and building society certificates of deposit	81	177	71	37	–	–	366
<i>Asset-backed securities:</i>							
Mortgage-backed securities	626	491	398	185	103	–	1,803
Other asset-backed securities	399	299	224	34	90	18	1,064
	1,025	790	622	219	193	18	2,867
Corporate and other debt securities	1,609	856	2,351	341	–	88	5,245
<b>Total debt securities</b>	<b>21,766</b>	<b>8,002</b>	<b>3,044</b>	<b>597</b>	<b>193</b>	<b>139</b>	<b>33,741</b>
Treasury bills and other bills	1,717	–	10	–	–	–	1,727
	23,483	8,002	3,054	597	193	139	35,468
<i>Due from fellow group undertakings:</i>							
Corporate and other debt securities							546
<b>Total held as available-for-sale financial assets</b>							<b>36,014</b>

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54 Financial risk management (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>The Bank</b>							
<b>At 31 December 2012</b>							
<i>Debt securities</i>							
Government securities	18,089	7,329	–	–	–	–	25,418
Bank and building society certificates of deposit	–	75	46	38	–	–	159
Asset-backed securities:							
Mortgage-backed securities	155	119	40	85	57	–	456
Other asset-backed securities	35	53	–	–	–	–	88
	190	172	40	85	57	–	544
Corporate and other debt securities	21	70	–	–	–	–	91
Total debt securities	18,300	7,646	86	123	57	–	26,212
Treasury bills and other bills	15	–	16	85	–	–	116
	18,315	7,646	102	208	57	–	26,328
Due from fellow Group undertakings:							
Corporate and other debt securities							4,717
<b>Total held as available-for-sale financial assets</b>							<b>31,045</b>
<b>At 31 December 2011</b>							
<i>Debt securities</i>							
Government securities	18,962	6,105	–	–	–	–	25,067
Other public sector securities	–	–	–	–	–	27	27
Bank and building society certificates of deposit	81	178	38	32	–	–	329
Asset-backed securities:							
Mortgage-backed securities	63	267	95	72	–	–	497
Other asset-backed securities	132	139	21	7	6	–	305
	195	406	116	79	6	–	802
Corporate and other debt securities	–	–	–	–	–	22	22
Total debt securities	19,238	6,689	154	111	6	49	26,247
Treasury bills and other bills	21	–	8	–	–	–	29
	19,259	6,689	162	111	6	49	26,276
Due from fellow Group undertakings:							
Corporate and other debt securities							5,028
<b>Total held as available-for-sale financial assets</b>							<b>31,304</b>

**Held-to-maturity investments**

The Group no longer holds any held-to-maturity investments, an analysis of the credit quality of the Group's held-to-maturity investments at 31 December 2011 is provided below:

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>The Group and the Bank</b>							
Government securities	6,319	1,779	–	–	–	–	8,098

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**54 Financial risk management** (continued)

**Debt securities, treasury and other bills held at fair value through profit or loss**

An analysis of trading and other financial assets at fair value through profit or loss is included in note 15. The credit quality of debt securities, treasury and other bills held at fair value through profit or loss is set out below.

The Group	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>At 31 December 2012</b>							
<i>Trading assets</i>							
Government securities	3,688	277	–	–	–	–	3,965
Bank and building society certificates of deposit	–	2,182	907	77	–	–	3,166
Asset-backed securities:							
Mortgage-backed securities	42	10	78	–	–	–	130
Other asset-backed securities	2	14	4	1	–	–	21
	44	24	82	1	–	–	151
Corporate and other debt securities	385	148	330	278	30	1	1,172
Total debt securities held as trading assets	4,117	2,631	1,319	356	30	1	8,454
Treasury bills and other bills	370	4	–	–	–	–	374
Total held as trading assets	4,487	2,635	1,319	356	30	1	8,828
<i>Other assets held at fair value through profit or loss</i>							
Government securities	14,557	1,606	220	372	1	10	16,766
Other public sector securities	694	205	131	6	–	20	1,056
Bank and building society certificates of deposit	–	94	134	–	–	–	228
Asset-backed securities:							
Mortgage-backed securities	219	95	264	122	–	8	708
Other asset-backed securities	263	383	732	359	16	49	1,802
	482	478	996	481	16	57	2,510
Corporate and other debt securities	3,107	2,732	7,304	6,633	2,115	1,795	23,686
Total debt securities held at fair value through profit or loss	18,840	5,115	8,785	7,492	2,132	1,882	44,246
Treasury bills and other bills	56	–	–	–	–	–	56
Total other assets held at fair value through profit or loss	18,896	5,115	8,785	7,492	2,132	1,882	44,302
	23,383	7,750	10,104	7,848	2,162	1,883	53,130
Due from fellow Group undertakings:							
Corporate and other debt securities							200
Total held at fair value through profit or loss							53,330
<b>At 31 December 2011</b>							
<i>Trading assets</i>							
Government securities	1,994	6	–	–	–	–	2,000
Bank and building society certificates of deposit	1	1,147	1,573	142	–	–	2,863
Asset-backed securities:							
Mortgage-backed securities	64	33	1	–	1	–	99
Other asset-backed securities	19	151	52	–	–	–	222
	83	184	53	–	1	–	321
Corporate and other debt securities	315	141	312	490	151	179	1,588
Total debt securities held as trading assets	2,393	1,478	1,938	632	152	179	6,772
Treasury bills and other bills	224	75	–	–	–	–	299
Total held as trading assets	2,617	1,553	1,938	632	152	179	7,071
<i>Other assets held at fair value through profit or loss</i>							
Government securities	17,667	1,027	950	642	644	437	21,367
Other public sector securities	908	170	35	59	11	–	1,183
Bank and building society certificates of deposit	–	330	55	–	–	–	385
Asset-backed securities:							
Mortgage-backed securities	194	45	255	116	–	2	612
Other asset-backed securities	321	198	794	382	53	16	1,764
	515	243	1,049	498	53	18	2,376
Corporate and other debt securities	3,114	2,111	6,197	5,195	1,199	2,165	19,981
Total other assets held at fair value through profit or loss	22,204	3,881	8,286	6,394	1,907	2,620	45,292
Total held at fair value through profit or loss	24,821	5,434	10,224	7,026	2,059	2,799	52,363

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**54 Financial risk management** (continued)

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

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>The Bank</b>							
<b>At 31 December 2012</b>							
<i>Trading assets</i>							
Government securities	3,504	277	–	–	–	–	3,781
Bank and building society certificate of deposits	–	545	304	77	–	–	926
<i>Asset-backed securities:</i>							
Mortgage backed securities	42	10	78	–	–	–	130
Other asset backed securities	2	14	–	1	–	–	17
	44	24	78	1	–	–	147
Corporate and other debt securities	64	59	331	278	30	1	763
Total debt securities held as trading assets	3,612	905	713	356	30	1	5,617
Treasury bills and other bills	85	4	–	–	–	–	89
Total held as trading assets	3,697	909	713	356	30	1	5,706
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	267	20	99	2	388
Total other assets held at fair value through profit or loss	–	–	267	20	99	2	388
	3,697	909	980	376	129	3	6,094
<i>Due from fellow Group undertakings:</i>							
Corporate and other debt securities							143
<b>Total held at fair value through profit or loss</b>							<b>6,237</b>
<b>At 31 December 2011</b>							
<i>Trading assets</i>							
Government securities	1,002	6	–	–	–	–	1,008
Bank and building society certificates of deposit	–	85	1,252	142	–	–	1,479
Corporate and other debt securities	103	141	312	390	151	179	1,276
<i>Asset backed securities:</i>							
Mortgage backed securities	64	34	1	–	–	–	99
Other asset backed securities	19	–	–	–	–	–	19
	83	34	1	–	–	–	118
Total debt securities	1,188	266	1,565	532	151	179	3,881
Treasury bills and other bills	–	75	–	–	–	–	75
Total held as trading assets	1,188	341	1,565	532	151	179	3,956
<i>Other assets held at fair value through profit or loss</i>							
Corporate and other debt securities	–	–	–	–	–	496	496
Total other assets held at fair value through profit or loss	–	–	–	–	–	496	496
	1,188	341	1,565	532	151	675	4,452
<i>Due from fellow Group undertakings:</i>							
Corporate and other debt securities							128
<b>Total held at fair value through profit or loss</b>							<b>4,580</b>

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**54 Financial risk management** (continued)

**Derivative financial instruments**

An analysis of derivative assets is given in note 16. The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the Group's maximum credit risk relating to derivative assets of £16,972 million for the Group and £15,063 million for the Bank (2011: £18,224 million for the Group and £13,784 million for the Bank), cash collateral of £5,429 million for the Group and £2,758 million for the Bank (2011: £5,269 million for the Group and £2,970 million for the Bank) was held and a further £1,387 million for the Group and £10 million for the Bank was due from OECD banks (2011: £7,875 million for the Group and £5,176 million for the Bank).

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>The Group</b>							
<b>At 31 December 2012</b>							
Trading	226	13,507	18,130	5,046	6,439	210	43,558
Hedging	–	6,038	4,596	111	824	2	11,571
<b>Total derivative financial instruments</b>	<b>226</b>	<b>19,545</b>	<b>22,726</b>	<b>5,157</b>	<b>7,263</b>	<b>212</b>	<b>55,129</b>

At 31 December 2011

Trading	313	25,268	14,474	6,612	3,588	1,738	51,993
Hedging	35	8,717	3,237	786	9	65	12,849
<b>Total derivative financial instruments</b>	<b>348</b>	<b>33,985</b>	<b>17,711</b>	<b>7,398</b>	<b>3,597</b>	<b>1,803</b>	<b>64,842</b>

**The Bank**

**At 31 December 2012**

Trading	74	7,353	9,165	3,367	2,600	110	22,669
Hedging	–	1,112	595	29	112	–	1,848
	<b>74</b>	<b>8,465</b>	<b>9,760</b>	<b>3,396</b>	<b>2,712</b>	<b>110</b>	<b>24,517</b>
Due from fellow Group undertakings							7,730
<b>Total derivative financial instruments</b>							<b>32,247</b>

At 31 December 2011

Trading	183	15,901	6,266	3,935	1,820	65	28,170
Hedging	–	1,936	481	164	7	8	2,596
	183	17,837	6,747	4,099	1,827	73	30,766
Due from fellow Group undertakings							6,751
<b>Total derivative financial instruments</b>							<b>37,517</b>

**Assets arising from reinsurance contracts held**

Of the assets arising from reinsurance contracts held at 31 December 2012 of £2,320 million (2011: £2,535 million), £764 million (2011: £842 million) were due from insurers with a credit rating of AA or above.

**Financial guarantees and irrevocable loan commitments**

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

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**54 Financial risk management** (continued)**C. Collateral held as security for financial assets**

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

**Loans and receivables**

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

*Loans and advances to banks*

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

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £662 million for the Group and £15,277 million for the Bank (2011: £508 million for the Group and £38,543 million for the Bank), against which the Group held collateral with a fair value of £662 million for the Group and £16,107 million for the Bank (2011: £511 million for the Group and £38,860 million for 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.

*Loans and advances to customers*

The Group holds collateral against loans and advances to customers in the form of mortgages over residential and commercial real estate, charges over business assets such as premises, inventory and accounts receivable, charges over financial instruments such as debt securities and equities, and guarantees received from third parties.

**Retail lending***Mortgages*

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

**The Group**

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
<b>31 December 2012</b>				
Less than 70 per cent	131,277	3,283	1,470	136,030
70 per cent to 80 per cent	61,677	1,962	846	64,485
80 per cent to 90 per cent	52,651	2,314	1,114	56,079
90 per cent to 100 per cent	36,428	2,092	1,133	39,653
Greater than 100 per cent	37,580	3,229	3,569	44,378
<b>Total</b>	<b>319,613</b>	<b>12,880</b>	<b>8,132</b>	<b>340,625</b>

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2011				
Less than 70 per cent	137,224	3,203	1,420	141,847
70 per cent to 80 per cent	60,236	1,894	843	62,973
80 per cent to 90 per cent	53,113	2,250	1,103	56,466
90 per cent to 100 per cent	40,236	2,182	1,196	43,614
Greater than 100 per cent	39,918	3,213	3,503	46,634
<b>Total</b>	<b>330,727</b>	<b>12,742</b>	<b>8,065</b>	<b>351,534</b>



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**54 Financial risk management** (continued)

**The Bank**

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
<b>31 December 2012</b>				
Less than 70 per cent	43,724	706	282	44,712
70 per cent to 80 per cent	15,322	314	114	15,750
80 per cent to 90 per cent	12,052	335	136	12,523
90 per cent to 100 per cent	8,470	330	144	8,944
Greater than 100 per cent	6,987	432	334	7,753
<b>Total</b>	<b>86,555</b>	<b>2,117</b>	<b>1,010</b>	<b>89,682</b>

	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
31 December 2011				
Less than 70 per cent	44,954	699	292	45,945
70 per cent to 80 per cent	15,864	315	142	16,321
80 per cent to 90 per cent	12,567	347	186	13,100
90 per cent to 100 per cent	9,536	360	203	10,099
Greater than 100 per cent	7,704	438	417	8,559
<b>Total</b>	<b>90,625</b>	<b>2,159</b>	<b>1,240</b>	<b>94,024</b>

*Other*

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

The majority of non-mortgage retail lending is unsecured. At 31 December 2012, impaired non-mortgage lending amounted to £2,328 million, net of an impairment allowance of £1,326 million (2011: £2,696 million, net of an impairment allowance of £1,848 million). The fair value of the collateral held in respect of this lending was £48 million (2011: £43 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £42,145 million (2011: £42,541 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are monitored throughout the credit lifecycle in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

**Wholesale lending**

*Reverse repurchase transactions*

There were reverse repurchase agreements which are accounted for as collateralised loans with a carrying value of £5,087 million for the Group and £5,087 million for the Bank (2011: £16,835 million for the Group and £2,585 million for the Bank), against which the Group held collateral with a fair value of £4,916 million for the Group and £4,916 million for the Bank (2011: £16,936 million for the Group and £2,682 million for the Bank), all of which the Group is able to repledge. Included in these amounts are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £2 million for the Group and £nil for the Bank (2011: £34 million for the Group and £nil for the Bank). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

*Impaired secured lending*

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

## Notes to the accounts

**54 Financial risk management** (continued)

At 31 December 2012, impaired secured wholesale lending amounted to £17,257 million, net of an impairment allowance of £15,193 million (2011: £23,913 million, net of an impairment allowance of £20,675 million). The fair value of the collateral held in respect of impaired secured wholesale lending was £9,414 million (2011: £13,977 million) for the Group. In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured wholesale lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

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

*Unimpaired secured lending*

Unimpaired secured wholesale lending amounted to £74,485 million (2011: £96,381 million). Wholesale lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination. The types of collateral taken and the frequency with which collateral is required at origination is dependent upon the size and structure of the borrower. For exposures to corporate customers and other large institutions, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a mortgage debenture over the company's undertaking and one or more of its assets, and keyman insurance. The Group maintains policies setting out acceptable collateral, maximum loan-to-value ratios and other criteria to be considered when reviewing a loan application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the customer. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, the provision of collateral will not determine the outcome of a credit application. The fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay debt.

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

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

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

**Trading and other financial assets at fair value through profit or loss (excluding equity shares)**

In respect of trading and other financial assets at fair value through profit or loss, the fair value of collateral accepted under reverse repurchase transactions which are accounted for as collateralised loans that the Group is permitted by contract or custom to sell or repledge was £19,629 million for the Group and £2,629 million for the Bank (2011: £15,765 million for the Group and £nil for the Bank). Of this, £15,640 million for the Group and £1,325 million for the Bank (2011: £3,740 million for the Group and £nil for the Bank) was sold or repledged.

In addition, securities held as collateral in the form of stock borrowed amounted to £38,040 million for the Group and £30,855 million for the Bank (2011: £10,438 million for the Group and £78,222 million for the Bank). Of this amount, £36,549 million for the Group and £11,093 million for the Bank (2011: £5,308 million for the Group and £47,989 million for the Bank) had been resold or repledged as collateral for the Group's own transactions.

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

**Derivative assets, after offsetting of amounts under master netting arrangements**

The Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £16,972 million for the Group and £15,063 million for the Bank (2011: £18,224 million for the Group and £13,784 million for the Bank), cash collateral of £5,429 million for the Group and £2,758 million for the Bank (2011: £5,269 million for the Group and £2,970 million for the Bank) was held.

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

**Irrevocable loan commitments and other credit-related contingencies**

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

At 31 December 2012, there were irrevocable loan commitments and other credit-related contingencies of £55,629 million for the Group and £40,830 million for the Bank (2011: £57,329 million for the Group and £39,987 million for the Bank). Collateral is held as security, in the event that lending is drawn down, on £17,697 million for the Group and £14,192 million for the Bank (2011: £13,279 million for the Group and £9,071 million for the Bank) of these balances.

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

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**54 Financial risk management** (continued)

**D. Collateral pledged as security**  
**Repo and stock lending transactions**

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

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £48,077 million for the Group and £28,593 million for the Bank (2011: £39,679 million for the Group and £29,015 million for the Bank). In addition, the following financial assets on the balance sheet have been pledged as collateral as part of securities lending transactions:

*Assets pledged*

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Trading and other financial assets at fair value through profit or loss	10,000	3,102	635	20
Loans and advances to customers	11,603	37,926	–	–
Debt securities classified as loans and receivables	154	398	177	351
Available-for-sale financial assets	4,251	1,618	16,321	10,374
	<b>26,008</b>	<b>43,044</b>	<b>17,133</b>	<b>10,745</b>

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 19 and 20.

**E. Collateral repossessed**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Residential property	936	968	125	158
Other	6	13	–	–
	<b>942</b>	<b>981</b>	<b>125</b>	<b>158</b>

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

**F. Credit market exposures**

The Group's credit market exposures primarily relate to asset-backed securities exposures held in the Commercial Banking division and at the Group's centre. An analysis of the carrying value of these exposures, which are classified as loans and receivables (note 21), available-for-sale financial assets (note 23) or trading and other financial assets at fair value through profit or loss (note 15) depending on the nature of the investment, is set out below.

	Loans and receivables £m	Available-for-sale £m	Trading £m	Net exposure as at 31 December 2012 £m	Net exposure as at 31 December 2011 £m
<b>Mortgage-backed securities:</b>					
US residential	3,312	–	–	3,312	4,063
Non-US residential	286	1,411	130	1,827	3,125
Commercial	253	113	–	366	1,788
	<b>3,851</b>	<b>1,524</b>	<b>130</b>	<b>5,505</b>	<b>8,976</b>
<b>Collateralised debt obligations</b>					
Collateralised loan obligations	272	23	–	295	1,162
Others	–	–	–	–	264
	<b>272</b>	<b>23</b>	<b>–</b>	<b>295</b>	<b>1,426</b>
Federal family education loan programme student loans	119	135	–	254	3,526
Personal sector	368	11	–	379	511
Other asset-backed securities	392	591	21	1,004	656
Total uncovered asset-backed securities	<b>5,002</b>	<b>2,284</b>	<b>151</b>	<b>7,437</b>	<b>15,095</b>
Negative basis <sup>1</sup>	–	–	–	–	186
<b>Total</b>	<b>5,002</b>	<b>2,284</b>	<b>151</b>	<b>7,437</b>	<b>15,281</b>
Direct	3,674	1,745	151	5,570	10,705
Conduits (note 20)	1,328	539	–	1,867	4,576
<b>Total</b>	<b>5,002</b>	<b>2,284</b>	<b>151</b>	<b>7,437</b>	<b>15,281</b>

<sup>1</sup> Negative basis means bonds held with separate matching credit default swap protection.

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**54 Financial risk management** (continued)

An analysis of these asset-backed securities by credit rating is provided below.

	Net Exposure £m	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Below B £m
Mortgage-backed securities:								
US residential mortgage-backed securities:								
Prime	645	124	207	129	123	39	16	7
Alt-A	2,667	513	856	533	508	162	65	30
Sub-prime	–	–	–	–	–	–	–	–
	<b>3,312</b>	<b>637</b>	<b>1,063</b>	<b>662</b>	<b>631</b>	<b>201</b>	<b>81</b>	<b>37</b>
Non-US residential mortgage-backed securities	1,827	981	286	102	196	262	–	–
Commercial mortgage-backed securities	366	23	–	241	87	15	–	–
	<b>5,505</b>	<b>1,641</b>	<b>1,349</b>	<b>1,005</b>	<b>914</b>	<b>478</b>	<b>81</b>	<b>37</b>
Collateralised loan obligations	295	56	80	114	–	16	29	–
Federal family education loan programme student loans	254	151	84	19	–	–	–	–
Personal sector	379	369	8	–	–	1	1	–
Other asset-backed securities	1,004	375	70	191	107	148	113	–
<b>Total at 31 December 2012</b>	<b>7,437</b>	<b>2,592</b>	<b>1,591</b>	<b>1,329</b>	<b>1,021</b>	<b>643</b>	<b>224</b>	<b>37</b>
Total at 31 December 2011	15,281	6,974	3,643	2,320	1,529	770	16	29

**(2) Market risk**

**Interest rate risk**

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There is a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

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

The Group and the Bank establish two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. 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 majority of the hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate capital issuances.

At 31 December 2012 the aggregate notional principal of interest rate swaps designated as fair value hedges was £136,375 million (2011: £110,943 million) for the Group and £93,989 million (2011: £53,808 million) for the Bank with a net fair value asset of £4,314 million (2011: asset of £5,483 million) for the Group and a net fair value liability of £9 million (2011: asset of £1,687 million) for the Bank (note 16). The gains recognised on the hedging instruments were £572 million (2011: £1,982 million) for the Group and £529 million (2011: £732 million) for the Bank. The losses on the hedged items attributable to the hedged risk were £560 million (2011: £1,999 million) for the Group and £549 million (2011: £835 million) for the Bank.

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2012 was £86,190 million (2011: £207,343 million) for the Group and £78,763 million (2011: £1,075 million) for the Bank with a net fair value asset of £200 million (2011: liability of £358 million) for the Group and a net fair value liability of £53 million (2011: £18 million) for the Bank (note 16). In 2012, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £6 million (2011: loss of £13 million) for the Group and a gain of £4 million (2011: £nil) for the Bank.

**Currency risk**

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market risk function in London.

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.

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**54 Financial risk management** (continued)

The Group hedges part of the currency translation risk of the net investment in certain foreign operations using currency borrowings. The Bank does not hedge its exposure. At 31 December 2012 the aggregate principal of the Group's currency borrowings was £2,489 million (2011: £2,245 million). In 2012, an ineffectiveness loss of £1 million before and after tax (2011: ineffectiveness gain of £23 million before tax and £17 million after tax) was recognised in the income statement arising from net investment hedges.

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
<b>Functional currency of Group operations</b>				
Euro:				
Gross exposure	919	585	(96)	(44)
Net investment hedge	(842)	(848)	–	–
	77	(263)	(96)	(44)
US dollar:				
Gross exposure	316	341	48	49
Net investment hedge	(542)	(122)	–	–
	(226)	219	48	49
Swiss franc:				
Gross exposure	6	15	(13)	(4)
Net investment hedge	(9)	–	–	–
	(3)	15	(13)	(4)
Australian dollar:				
Gross exposure	1,104	1,232	(29)	(5)
Net investment hedge	(1,077)	(1,226)	–	–
	27	6	(29)	(5)
Japanese yen:				
Gross exposure	19	20	19	20
Net investment hedge	(19)	–	–	–
	–	20	19	20
Other non-sterling	106	170	231	356
<b>Total structural foreign currency exposures, after net investment hedges</b>	<b>(19)</b>	<b>167</b>	<b>160</b>	<b>372</b>

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**54 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. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

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

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>The Group</b>						
<b>At 31 December 2012</b>						
Deposits from banks	13,757	3,556	11,187	8,566	1,381	38,447
Customer deposits	332,383	15,059	39,315	51,189	3,055	441,001
Trading and other financial liabilities at fair value through profit or loss	11,621	4,720	10,454	6,931	3,765	37,491
Debt securities in issue	14,200	10,890	16,192	65,091	27,451	133,824
Liabilities arising from non-participating investment contracts	27,205	–	–	–	27,167	54,372
Subordinated liabilities	20	1,911	2,863	18,118	31,481	54,393
<b>Total non-derivative financial liabilities</b>	<b>399,186</b>	<b>36,136</b>	<b>80,011</b>	<b>149,895</b>	<b>94,300</b>	<b>759,528</b>

Derivative financial liabilities:

Gross settled derivatives – outflows	2,331	3,243	7,097	51,424	33,678	97,773
Gross settled derivatives – inflows	(2,026)	(2,790)	(6,853)	(50,384)	(32,145)	(94,198)
Gross settled derivatives – net flows	305	453	244	1,040	1,533	3,575
Net settled derivative liabilities	39,177	224	1,088	3,189	1,252	44,930
<b>Total derivative financial liabilities</b>	<b>39,482</b>	<b>677</b>	<b>1,332</b>	<b>4,229</b>	<b>2,785</b>	<b>48,505</b>

At 31 December 2011

Deposits from banks	19,402	5,863	5,517	10,469	1,292	42,543
Customer deposits	326,125	16,534	33,670	44,920	11,948	433,197
Trading and other financial liabilities at fair value through profit or loss	10,284	2,336	3,516	6,491	4,127	26,754
Debt securities in issue	34,839	27,207	26,164	74,503	39,440	202,153
Liabilities arising from non-participating investment contracts	27,429	–	–	–	22,207	49,636
Subordinated liabilities	191	258	3,022	15,551	30,002	49,024
<b>Total non-derivative financial liabilities</b>	<b>418,270</b>	<b>52,198</b>	<b>71,889</b>	<b>151,934</b>	<b>109,016</b>	<b>803,307</b>

Derivative financial liabilities:

Gross settled derivatives – outflows	12,644	12,595	11,664	44,033	36,544	117,480
Gross settled derivatives – inflows	(4,101)	(10,134)	(10,261)	(38,360)	(30,102)	(92,958)
Gross settled derivatives – net flows	8,543	2,461	1,403	5,673	6,442	24,522
Net settled derivative liabilities	55,299	748	1,356	4,208	968	62,579
<b>Total derivative financial liabilities</b>	<b>63,842</b>	<b>3,209</b>	<b>2,759</b>	<b>9,881</b>	<b>7,410</b>	<b>87,101</b>

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £9,520 million at 31 December 2012 (2011: £10,831 million) with £4,865 million expiring within one year; £1,302 million between one and three years; £1,729 between three and five years; and £1,624 million over five years (2011: £4,989 million expiring within one year; £2,008 million between one and three years; £2,198 between three and five years; and £1,636 million over five years).

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

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £45 million (2011: £158 million) per annum for the Group and £1 million (2011: £113 million) for the Bank which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

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**54 Financial risk management** (continued)

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>The Bank</b>						
<b>At 31 December 2012</b>						
Deposits from banks	58,497	13,946	45,992	89,550	7,232	215,217
Customer deposits	178,523	7,761	16,071	13,942	17,430	233,727
Trading and other financial liabilities at fair value through profit or loss	894	190	894	6,585	3,757	12,320
Debt securities in issue	5,414	7,805	7,248	29,013	22,554	72,034
Subordinated liabilities	–	1,593	2,539	13,242	23,885	41,259
<b>Total non-derivative financial liabilities</b>	<b>243,328</b>	<b>31,295</b>	<b>72,744</b>	<b>152,332</b>	<b>74,858</b>	<b>574,557</b>
Gross settled derivatives – outflows	2,588	1,601	5,850	39,477	23,558	73,074
Gross settled derivatives – inflows	(2,398)	(1,132)	(5,686)	(39,280)	(22,797)	(71,293)
Gross settled derivatives – net flows	190	469	164	197	761	1,781
Net settled derivative liabilities	26,699	45	246	854	547	28,391
<b>Total derivative financial liabilities</b>	<b>26,889</b>	<b>514</b>	<b>410</b>	<b>1,051</b>	<b>1,308</b>	<b>30,172</b>

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>At 31 December 2011</b>						
Deposits from banks	63,234	14,674	13,715	58,187	6,783	156,593
Customer deposits	171,251	13,072	22,093	17,928	8,134	232,478
Trading and other financial liabilities at fair value through profit or loss	784	449	776	6,491	3,601	12,101
Debt securities in issue	22,344	20,606	16,036	38,974	28,696	126,656
Subordinated liabilities	163	247	1,136	9,099	23,473	34,118
<b>Total non-derivative financial liabilities</b>	<b>257,776</b>	<b>49,048</b>	<b>53,756</b>	<b>130,679</b>	<b>70,687</b>	<b>561,946</b>
Gross settled derivatives – outflows	8,757	2,678	3,746	21,792	13,752	50,725
Gross settled derivatives – inflows	(685)	(1,024)	(2,753)	(17,504)	(9,592)	(31,558)
Gross settled derivatives – net flows	8,072	1,654	993	4,288	4,160	19,167
Net settled derivative liabilities	30,308	548	54	190	76	31,176
<b>Total derivative financial liabilities</b>	<b>38,380</b>	<b>2,202</b>	<b>1,047</b>	<b>4,478</b>	<b>4,236</b>	<b>50,343</b>

Liabilities of the Group arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-2 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>At 31 December 2012</b>	<b>25,968</b>	<b>920</b>	<b>3,015</b>	<b>12,635</b>	<b>40,430</b>	<b>82,968</b>
At 31 December 2011	748	1,724	5,257	18,132	53,140	79,001

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

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**54 Financial risk management** (continued)

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

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>The Group</b>					
<b>31 December 2012</b>					
Acceptances and endorsements	73	–	33	1	107
Other contingent liabilities	1,236	662	144	747	2,789
Total contingent liabilities	1,309	662	177	748	2,896
Lending commitments	65,739	14,493	17,486	3,676	101,394
Other commitments	557	–	–	–	557
Total commitments	66,296	14,493	17,486	3,676	101,951
<b>Total contingents and commitments</b>	<b>67,605</b>	<b>15,155</b>	<b>17,663</b>	<b>4,424</b>	<b>104,847</b>

31 December 2011					
Acceptances and endorsements	81	–	–	–	81
Other contingent liabilities	1,514	1,092	426	757	3,789
Total contingent liabilities	1,595	1,092	426	757	3,870
Lending commitments	71,216	13,999	17,380	2,287	104,882
Other commitments	701	–	–	–	701
Total commitments	71,917	13,999	17,380	2,287	105,583
Total contingents and commitments	73,512	15,091	17,806	3,044	109,453

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>The Bank</b>					
<b>31 December 2012</b>					
Acceptances and endorsements	70	–	33	1	104
Other contingent liabilities	890	515	53	741	2,199
Total contingent liabilities	960	515	86	742	2,303
Lending commitments	42,151	13,191	15,081	1,725	72,148
Other commitments	552	–	–	–	552
Total commitments	42,703	13,191	15,081	1,725	72,700
<b>Total contingents and commitments</b>	<b>43,663</b>	<b>13,706</b>	<b>15,167</b>	<b>2,467</b>	<b>75,003</b>

31 December 2011					
Acceptances and endorsements	80	–	–	–	80
Other contingent liabilities	1,187	1,025	237	627	3,076
Total contingent liabilities	1,267	1,025	237	627	3,156
Lending commitments	42,574	19,316	12,505	1,504	75,899
Other commitments	693	–	–	–	693
Total commitments	43,267	19,316	12,505	1,504	76,592
Total contingents and commitments	44,534	20,341	12,742	2,131	79,748

**(4) Insurance risk**

Insurance risk is the risk of reductions in earnings capital and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

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



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## 55 Capital

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds Banking Group Senior Asset and Liability Committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Group's regulatory capital is divided into tiers depending on level of subordination and ability to absorb losses. Core tier 1 capital as defined in the FSA letter to the British Bankers' Association in May 2009, comprises mainly shareholders' equity and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected loss over accounting provisions and certain securitisation positions. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and available-for-sale assets. Tier 1 capital, as defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook (GENPRU), is core tier 1 capital plus tier 1 capital securities less 50 per cent of material holdings in financial companies. Tier 2 capital, defined by GENPRU, comprises qualifying subordinated debt and some additional provisions and reserves after deducting 50 per cent of the excess of expected loss over accounting provisions, and certain securitisation positions and material holdings in financial companies. Total capital is the sum of tier 1 and tier 2 capital after deducting investments in subsidiaries and associates that are not consolidated for regulatory purposes. In the case of the Group, this means that the net assets of its life assurance and general insurance businesses are excluded from its total regulatory capital.

The Group's capital resources are summarised as follows:

	2012 £m	2011 £m
Tier 1 capital	49,076	50,220
Tier 2 capital	23,246	25,214
	<b>72,322</b>	75,434
Supervisory deductions	<b>(21,192)</b>	(23,159)
<b>Total capital</b>	<b>51,130</b>	52,275

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities; for example the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital.

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

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

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

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

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

During the year, the individual entities within the Group and the Group complied with all of the externally imposed capital requirements to which they are subject.

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**56 Cash flow statements**

**a Change in operating assets**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Change in loans and receivables	<b>53,559</b>	39,254	<b>(12,104)</b>	(14,065)
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	<b>(2,402)</b>	6,190	<b>3,400</b>	(16,271)
Change in other operating assets	<b>(3,469)</b>	(1,392)	<b>(6)</b>	73
<b>Change in operating assets</b>	<b>47,688</b>	44,052	<b>(8,710)</b>	(30,263)

**b Change in operating liabilities**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Change in deposits from banks	<b>(1,325)</b>	(10,480)	<b>60,209</b>	36,329
Change in customer deposits	<b>12,871</b>	8,111	<b>4,589</b>	3,732
Change in debt securities in issue	<b>(66,944)</b>	(35,812)	<b>(40,088)</b>	(4,880)
Change in derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	<b>1,304</b>	14,251	<b>(4,462)</b>	14,407
Change in investment contract liabilities	<b>7,421</b>	793	–	–
Change in other operating liabilities	<b>(570)</b>	(5)	<b>(57)</b>	552
<b>Change in operating liabilities</b>	<b>(47,243)</b>	(23,142)	<b>20,191</b>	50,140

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**56 Cash flow statements** (continued)

**c Non-cash and other items**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Depreciation and amortisation	2,126	2,175	455	394
Impairment of tangible fixed assets	–	65	–	–
Revaluation of investment properties	264	107	–	–
Allowance for loan losses	5,121	8,069	1,592	2,462
Write-off of allowance for loan losses	(7,922)	(7,405)	(1,816)	(2,125)
Impairment of available-for-sale financial assets	42	80	–	–
Change in insurance contract liabilities	3,934	(2,091)	–	–
Customer goodwill payments provision	–	–	–	–
Payment protection insurance provision	3,575	3,200	2,602	1,867
German insurance business litigation provision	150	175	–	–
Other provision movements	379	(294)	263	(213)
Net charge (credit) in respect of defined benefit schemes	68	199	118	63
Impact of consolidation and deconsolidation of OEICs <sup>1</sup>	(829)	(6,094)	–	–
Unwind of discount on impairment allowances	(374)	(226)	(67)	(103)
Foreign exchange element on balance sheet <sup>2</sup>	586	161	(166)	172
Liability management (gains) losses within other income <sup>3</sup>	–	(599)	–	–
Interest expense on subordinated liabilities	3,189	1,608	2,292	688
(Profit) loss on disposal of businesses	7	21	–	–
Other non-cash items	(3,449)	679	(2,805)	343
<b>Total non-cash items</b>	<b>6,867</b>	<b>(170)</b>	<b>2,468</b>	<b>3,548</b>
Contributions to defined benefit schemes	(672)	(838)	(170)	(361)
Payments in respect of customer goodwill payments provision	–	(497)	–	–
Payments in respect of payment protection insurance provision	(3,299)	(1,045)	(2,192)	(640)
Other	12	6	–	–
<b>Total other items</b>	<b>(3,959)</b>	<b>(2,374)</b>	<b>(2,362)</b>	<b>(1,001)</b>
<b>Non-cash and other items</b>	<b>2,908</b>	<b>(2,544)</b>	<b>106</b>	<b>2,547</b>

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

<sup>2</sup>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.

<sup>3</sup>A number of capital transactions entered into by the Group in 2012 and 2011 involved the exchange of existing securities for new issues and as a result there was no related cash flow.

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**56 Cash flow statements** (continued)

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

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Cash and balances with central banks	<b>80,298</b>	60,722	<b>74,078</b>	57,500
Less: mandatory reserve deposits <sup>1</sup>	<b>(580)</b>	(1,070)	<b>(307)</b>	(528)
	<b>79,718</b>	59,652	<b>73,771</b>	56,972
Loans and advances to banks	<b>29,417</b>	32,606	<b>188,216</b>	167,896
Less: amounts with a maturity of three months or more and balances due from fellow Lloyds Banking Group undertakings	<b>(8,077)</b>	(6,369)	<b>(186,879)</b>	(165,919)
	<b>21,340</b>	26,237	<b>1,337</b>	1,977
<b>Total cash and cash equivalents</b>	<b>101,058</b>	85,889	<b>75,108</b>	58,949

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

Included within cash and cash equivalents of the Group at 31 December 2012 is £17,889 million (2011: £21,601 million) held within the Group's life funds, which is not immediately available for use in the business.

**e Acquisition of group undertakings and businesses**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Additional capital injections to subsidiaries	–	–	<b>(37)</b>	(159)
Acquisition of and additional investment in associates and joint ventures	<b>(11)</b>	(10)	–	–
Net cash (outflow) inflow arising from acquisitions in the year	<b>(11)</b>	(10)	<b>(37)</b>	(159)
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	–	(3)	–	–
<b>Net cash inflow</b>	<b>(11)</b>	(13)	<b>(37)</b>	(159)

**f Disposal of group undertakings and businesses**

	The Group		The Bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Net assets and liabilities disposed of	<b>44</b>	319	<b>362</b>	4
Loss on sale of businesses	<b>(7)</b>	(21)	–	–
Cash and cash equivalents disposed of	–	–	–	–
<b>Net cash inflow from disposals</b>	<b>37</b>	298	<b>362</b>	4

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**57 Future accounting developments**

Pronouncement	Nature of change	IASB effective date
Amendments to IAS 1 <i>Presentation of Financial Statements – ‘Presentation of Items of Other Comprehensive Income’</i>	Requires entities to group items presented in other comprehensive income on the basis of whether they are potentially reclassified to profit or loss subsequently.	Annual periods beginning on or after 1 July 2012.
Amendments to IFRS 7 <i>Financial Instruments: Disclosures – ‘Disclosures-Offsetting Financial Assets and Financial Liabilities’</i>	Requires an entity to disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's balance sheet.	Annual and interim periods beginning on or after 1 January 2013.
IFRS 10 <i>Consolidated Financial Statements</i>	Supersedes IAS 27 <i>Consolidated and Separate Financial Statements and SIC-12 Consolidation – Special Purpose Entities</i> and establishes the principles for when the Group controls another entity and therefore is required to consolidate the other entity in the Group's financial statements. The implementation of IFRS 10 will result in the Group consolidating certain entities that were previously not consolidated, and deconsolidating certain entities which were previously consolidated. The effect of applying IFRS 10 in 2012 would have been to recognise an increase in total assets and total liabilities at 31 December 2012 of approximately £8.3 billion resulting in no change to shareholders' equity. There would have been no impact on the result for the year to 31 December 2012.	Annual periods beginning on or after 1 January 2013.
IFRS 12 <i>Disclosure of Interests in Other Entities</i>	Requires an entity to disclose information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.	Annual periods beginning on or after 1 January 2013.
IFRS 13 <i>Fair Value Measurement</i>	Defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements. It applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements.	Annual and interim periods beginning on or after 1 January 2013.
Amendments to IAS 19 <i>Employee Benefits</i>	Prescribes the accounting and disclosure by employers for employee benefits. The main change is that actuarial gains and losses (remeasurements) in respect of defined benefit pension schemes are no longer permitted to be deferred using the corridor approach and must be recognised immediately in other comprehensive income. In addition, revised IAS 19 also replaces interest cost and expected return on plan assets with a net interest amount that is calculated by applying the discount rate to the net defined benefit liability (asset). Had the Group adopted these changes in 2012, the loss for the year to 31 December 2012 would have been approximately £40 million higher and other comprehensive income net of tax some £1.6 billion lower. As at 31 December 2012, unrecognised actuarial losses of some £2.7 billion and deferred tax assets of £0.6 billion would have been recognised and shareholders' equity would have been £2.1 billion lower.	Annual periods beginning on or after 1 January 2013.
Amendments to IAS 32 <i>Financial Instruments: Presentation – ‘Offsetting Financial Assets and Financial Liabilities’</i>	Inserts application guidance to address inconsistencies identified in applying the offsetting criteria used in the standard. Some gross settlement systems may qualify for offsetting where they exhibit certain characteristics akin to net settlement.	Annual periods beginning on or after 1 January 2014.
IFRS 9 <i>Financial Instruments</i> <sup>1,2</sup>	Replaces those parts of IAS 39 <i>Financial Instruments: Recognition and Measurement</i> relating to the classification, measurement and derecognition of financial assets and liabilities. IFRS 9 requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments and eliminates the available-for-sale financial asset and held-to-maturity investment categories in IAS 39. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss where that part of the fair value change attributable to an entity's own credit risk is recorded in other comprehensive income.	Annual periods beginning on or after 1 January 2015.

<sup>1</sup>As at 1 March 2013, this pronouncement is awaiting EU endorsement.

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

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**58 Approval of the financial statements and other information**

The financial statements were approved by the directors of Lloyds TSB Bank plc on 1 March 2013.

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

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

