IFRS 9
“Financial Instruments”: Transition

Lloyds Banking Group plc

March 2018

BASIS OF PREPARATION

At 31 December 2017, Lloyds Banking Group plc and its subsidiaries (the Group) prepared its financial statements in accordance with IAS 39 “Financial Instruments: Recognition and Measurement”. From 1 January 2018, the Group, in common with other listed entities within the European Union (EU), implemented IFRS 9 “Financial Instruments”.

In accordance with the transition requirements of IFRS 9, comparative information for 2017 will not be restated and transitional adjustments will be accounted through retained earnings as at 1 January 2018, the date of initial application.

The purpose of this document is to set out the impact to the Group’s financial position of applying IFRS 9. Where noted, figures are presented on an underlying basis. See note 51(c) of the 2017 Annual Report and Accounts for a reconciliation of the IAS 39 allowance of impairment losses between underlying and statutory.

FORWARD LOOKING STATEMENTS

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SUMMARY

Overall transition impact of implementing the new accounting standard is in line with previous guidance:

- Shareholders' equity has been reduced by £1,180 million, or 3 per cent, driven by the effects of additional impairment provisions following the implementation of the expected credit loss methodology and fair value adjustments following the reclassification of certain financial assets to be measured at fair value rather than amortised cost.
- Common equity tier 1 (CET 1) ratio reduced by 30 basis points, before transitional relief, as the effect of the reduction in shareholders' equity has been partially offset by other regulatory adjustments. After taking transitional relief into account the reduction in the CET 1 ratio is 1 basis point.
- The leverage ratio has reduced 10 basis points before transitional relief.
- Tangible net asset value per share 1.6 pence lower at 51.7 pence.

Earnings may be more volatile in future financial years as economic expectations change

- Whilst the change in accounting standard is not expected to change long-run actual losses, it does change the timing of recognition.
- The Group anticipates that over the longer term the impairment charge is likely to be more volatile under IFRS 9. However absent changes in the current economic outlook, in the near-term the impairment charge is expected to be relatively stable. In the 2017 preliminary announcement, the Group indicated that it expects an asset quality ratio of around 35 basis points through the cycle and less than 30 basis points per annum through the plan period and in 2018, including IFRS 9.

The capital framework is still evolving

- Whilst the basis for transitional relief has been finalised there remain aspects of the capital framework that continue to be uncertain and subject to further discussion with the regulatory bodies.

INTRODUCTION

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

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

Classification and measurement: IFRS 9 requires financial assets to be classified into one of the following measurement categories: fair value through profit or loss, fair value through other comprehensive income and amortised cost. Classification is made on the basis of the objectives of the entity’s business model for managing its financial assets and the contractual cash flow characteristics of the instruments. The requirements for derecognition are broadly unchanged from IAS 39. The standard also retains most of the IAS 39 requirements for financial liabilities except for those designated at fair value through profit or loss whereby that part of the fair value change attributable to the entity’s own credit risk is recorded in other comprehensive income. The Group early adopted this requirement with effect from 1 January 2017, and its impact is not included in this document.

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

The following table summarises the adjustments arising on the adoption of IFRS 9 to the Group's balance sheet as at 1 January 2018.

	As at 31 December 2017 £m	Classification £m	Measurement £m	Impairment £m	Adjusted as at 1 January 2018 £m
Assets					
Cash and balances at central banks	58,521	–	–	–	**58,521**
Trading and other financial assets at fair value through profit or loss	162,878	13,308	(178)	–	**176,008**
Derivative financial instruments	25,834	(360)	–	–	**25,474**
Financial assets at amortised cost:					
Loans and advances to banks	6,611	(2,364)	–	(1)	**4,246**
Loans and advances to customers	472,498	(10,474)	14	(1,022)	**461,016**
Debt securities	3,643	(329)	–	–	**3,314**
	482,752	(13,167)	14	(1,023)	**468,576**
Financial assets at fair value through other comprehensive income		42,972	(55)	–	**42,917**
Available-for-sale financial assets	42,098	(42,098)	–	–	
Deferred tax assets	2,284	–	22	300	**2,606**
Other assets	37,742	(655)	–	(10)	**37,077**
Total assets	812,109	–	(197)	(733)	**811,179**
Equity and liabilities					
Liabilities					
Deposits from customers and banks	447,928	–	–	–	**447,928**
Financial liabilities at fair value through profit or loss	50,877	48	10	–	**50,935**
Derivative financial instruments	26,124	–	–	–	**26,124**
Debt securities in issue	72,450	(48)	–	–	**72,402**
Liabilities arising from insurance and investment contracts	118,860	–	–	–	**118,860**
Other liabilities	23,259	–	–	(3)	**23,256**
Other provisions	5,546	–	–	243	**5,789**
Subordinated liabilities	17,922	–	–	–	**17,922**
Total liabilities	762,966	–	10	240	**763,216**
Equity					
Shareholders' equity	43,551	–	(207)	(973)	**42,371**
Other equity instruments	5,355	–	–	–	**5,355**
Non-controlling interests	237	–	–	–	**237**
Total equity	49,143	–	(207)	(973)	**47,963**
Total equity and liabilities	812,109	–	(197)	(733)	**811,179**

Note: adjustments in respect of classification and measurement are detailed on pages 14 to 16 and those relating to impairment on pages 4 to 13.

IMPAIRMENT

Overview

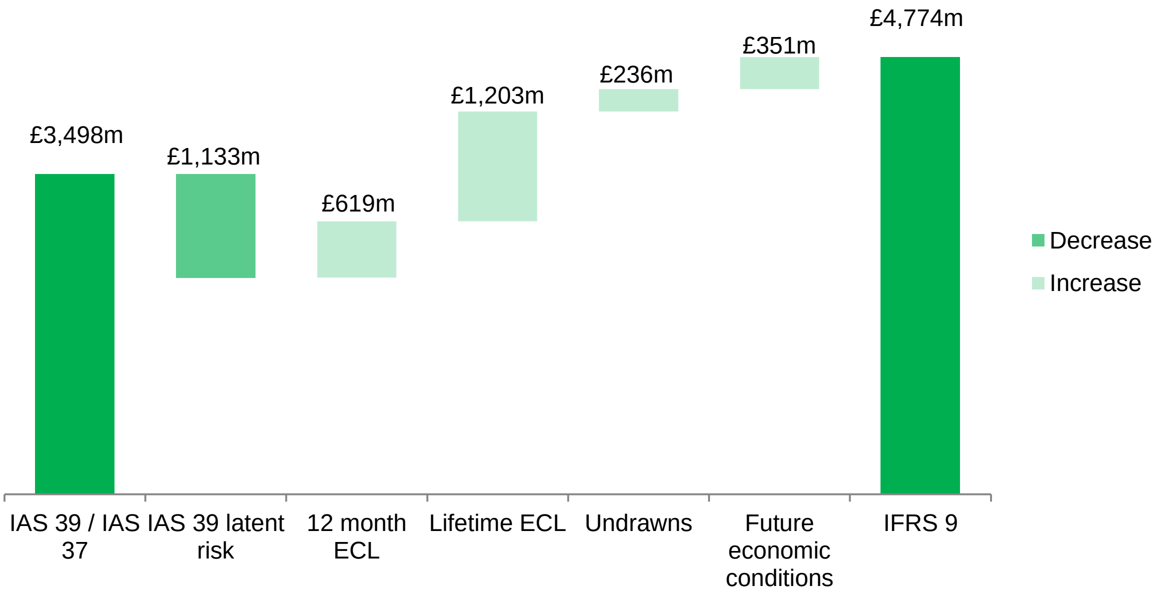
The implementation of IFRS 9 has required the Group to both adapt existing credit models and develop new models and supporting processes in order to calculate the expected credit loss (ECL) allowance.

Financial instruments within the scope of the impairment requirements of IFRS 9, which are principally loans and advances to customers and undrawn lending commitments, are classified into one of three stages. Unless purchased or originated credit impaired, newly originated assets are classified as Stage 1 and remain in that stage unless there is considered to have been a significant increase in credit risk since initial recognition, at which point the asset is reclassified to Stage 2. Assets which have defaulted or are otherwise considered to be credit impaired are allocated to Stage 3. When determining the staging of an asset, consideration is given to both the period over which the Group will be exposed to credit risk and the effect on the level of credit risk of a range of possible future economic conditions.

The stage of an asset determines the level of ECL allowance required. Expected credit losses are calculated by using an appropriate probability of default, adjusted to take into account a range of possible future economic scenarios, and applying this to the estimated exposure of the Group at the point of default after taking into account the value of any collateral held or other mitigants of loss and including the impact of discounting using the effective interest rate. Stage 1 assets carry an ECL allowance equivalent to the expected credit losses that result from those default events that are possible within 12 months of the reporting date (12-month expected credit losses). Assets classified as Stage 2 and Stage 3 carry an ECL allowance equivalent to the expected credit losses arising over the lifetime of the asset (lifetime expected credit losses).

The resulting ECL allowance is reviewed to ensure that all risks in the portfolio have been adequately captured. To the extent that this is not the case, post-model adjustments are made to ensure the overall adequacy of the allowance.

The overall impact upon the Group's impairment provisions is shown below on an underlying basis, and is explained in more detail in the following pages.



Key judgements and estimates

The implementation of IFRS 9 required management to make a number of judgements, assumptions and estimates. In some cases these are significant and can result in the introduction of measurement uncertainty to the ECL allowance. A summary of the key judgements made by management is set out below.

Definition of default

The probability of default (PD) of an exposure, both over a 12 month period and over its lifetime is a key input to the measurement of the ECL allowance. Default has occurred when there is evidence that the customer is experiencing significant financial difficulty which is likely to affect the ability to repay amounts due.

The Group has adopted the following definition of default:

- For all products, factors indicating an unlikeliness to pay;
- A backstop of 180 days past due for UK mortgages; and
- A backstop of 90 days past due for all other products.

This definition is aligned to the regulatory definition of default used by the Group for capital and regulatory reporting except that the Group has made the decision to treat forborne non-performing past term interest only mortgages as credit impaired.

IFRS 9 contains a rebuttable presumption that default occurs no later than when a payment is 90 days past due. For UK mortgages the Group has assumed a backstop of 180 days past due. This is more closely aligned to the risk management practices used by the Group. In addition, mortgage exposures more than 90 days past due, but less than 180 days, typically show high cure rates. The impact on the Group's ECL allowance of this assumption is not material.

Origination PDs

The assessment of a significant increase in credit risk and consequently whether an asset should be transferred from Stage 1 to Stage 2 is a relative measure, where the risk at the reporting date is compared to the risk at initial recognition; PDs have been used as part of this process. As the standard has been applied retrospectively at the initial application date, it has been necessary to source PDs at initial recognition and other risk information for the on balance sheet assets and undrawn commitments at 1 January 2018. In many cases this information is not available and consequently, where this is the case proxies and estimates have been used. Proxies for PDs at initial recognition include use of regulatory PDs; use of best available origination credit risk data; use of credit risk data at the first available date; and the application of a PD threshold above which assets are placed in Stage 2. In addition, the Group has not created a forward looking view of PDs at initial recognition for the back book as to do so would involve the use of hindsight and could introduce the risk of bias. The use of proxies and simplifications are not considered to materially impact the ECL allowance on transition.

Lifetime of an exposure

To derive the PDs necessary to calculate the ECL allowance it is necessary to estimate the expected life of each financial instrument. A range of approaches has been adopted across different product groupings including the full contractual life and taking into account behavioural factors such as early repayments and refinancing. For Retail assets, the Group has defined the lifetime for each product by analysing the time taken for all losses to be observed and for a material proportion of the assets to fully resolve through either closure or write-off. For revolving products, the Group has considered the losses beyond the contractual term and over which the Group is exposed to credit risk. For Commercial overdraft facilities, the average behavioural life has been used.

Significant increase in credit risk (SICR)

Performing assets are classified as either Stage 1 or Stage 2; assets classified as Stage 2 have experienced a SICR since initial recognition. The Group has used the following three criteria for determining whether there has been a SICR:

- A quantitative test based on relative and absolute PD movements linked to internal credit rating grades;
- Qualitative indicators such as watchlists and other indicators of historic delinquency; and
- A backstop of 30 days past due.

The setting of precise trigger points combined with risk indicators requires judgement. In deciding on the Group's policy, alternative indicators were considered and assessed against credit risk expert views. The selected indicators will be kept under regular review to confirm their continued appropriateness. Testing performed as part of the implementation process demonstrated that most assets subject to SICR were identified before reaching 30 days past due. Within Retail, the indicators used to assess staging include some types of forbearance even when the underlying PD has improved to a level which would indicate no significant increase in credit risk since origination. Materially all forborne assets are allocated to either Stage 2 or Stage 3.

Assets can also move back to Stage 1 from Stage 2 should the credit risk subsequently improve and no longer represent a significant increase in credit risk since origination. For Retail products, the Group policy includes certain cure periods whereby assets remain in Stage 2 for periods of between six and twelve months regardless of the PD at the reporting date.

Loss given default

In the event of a customer or issuer defaulting, the Loss Given Default (LGD) that the Group will incur will depend upon the exposure at default (EAD) and the effect of any collateral or other forms of loss mitigation that may be available. The Group has analysed the key drivers of EAD across its product sets. The primary inputs include balance, expected repayments, the ability of the obligor to drawdown and resulting estimated usage of undrawn commitments over time and the time to default. Assets were segmented for purposes of estimating exposure, with consideration given to product type, balance, limit, months in arrears, the remaining term, and the sector.

The timing of the default event is important because it will affect the size of the exposure at risk. For Retail portfolios the Group estimates the most likely point at which an account will default, and then estimates an exposure to loss and the associated loss given default at this point. At transition, the difference between this approach and a more complex multiple points of loss approach was estimated to be immaterial, and this will be assessed on an ongoing basis. For Commercial products the EAD is calculated at multiple points, with probabilities associated with each point of default. For undrawn exposures credit conversion factors are used to estimate the future balances that could expose the Group to credit risk.

The impact of collateral upon the loss that the Group will incur has been estimated through a combination of historic and forward looking information and judgement. The impact of different economic scenarios on the value of collateral and recoveries is taken into account where these impacts are material.

Forward looking information

The measurement of expected credit losses is required to reflect an unbiased probability-weighted range of possible future outcomes. IFRS 9 provides only limited guidance on how this should be achieved in practice and consequently a number of different approaches have evolved across the industry.

The Group has developed an economic model to project sixteen key impairment drivers using information derived mainly from external sources. These drivers include factors such as the unemployment rate, the house price index, commercial property prices and corporate credit spreads. The model generates in excess of 2,000 scenarios; these are mapped to industry-wide historical loss data which is used to rank the scenarios by severity of loss. Four scenarios are selected to represent the range of outcomes from the loss distribution; the central scenario reflects the Group's base case assumptions used for medium term planning purposes, an upside and a downside scenario are also selected together with a severe downside scenario. Rare occurrences of adverse economic events can lead to relatively large credit losses which means that typically the most likely outcome is less than the probability weighted outcome of the range of possible future events. To allow for this a relatively unlikely severe downside scenario is therefore included. At 1 January 2018, the base case, upside and downside scenarios each carry a 30 per cent weighting; the severe downside scenario is weighted at 10 per cent. The choice of alternative scenarios and the probability weighting is a combination of quantitative analysis and judgemental assessment to ensure that the full range of possible outcomes and material non-linearity are captured.

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

The key UK economic assumptions made by the Group in each of the four scenarios used as at 1 January 2018 are shown below. The base case scenario is aligned to the Group's core planning assumptions; the figures have been averaged over the five year period 2018 to 2022.

	Base case %	**Upside %**	**Downside %**	**Severe downside %**
Interest rates	**1.18**	**2.44**	**0.84**	**0.01**
Unemployment	**5.0**	**4.0**	**6.1**	**7.1**
House price growth	**2.7**	**7.0**	**(2.4)**	**(8.2)**
CRE price growth	**0.0**	**3.0**	**(2.5)**	**(5.4)**

The table below shows the extent to which a higher ECL allowance has been recognised to take account of forward looking information.

Probability-weighted ECL	**Base Case Scenario**	**Difference**
£4,774m	**£4,423m**	**£351m (8%)**

Analysis

Lending portfolio by stage

The table below shows the allocation of the Group's loans and advances to customers by stage.

	Total £m	Loans in Stage 1 £m	%	Loans in Stage 2 £m	%	Loans in Stage 3[3] £m	%
At 1 January 2018							
Retail:							
Secured	**292,140**	**251,707**	***86***	**35,399**	***12***	**5,034**	***2***
Consumer Lending	**38,062**	**32,721**	***86***	**4,504**	***12***	**837**	***2***
Other[1]	**11,456**	**10,817**	***94***	**561**	***5***	**78**	***1***
	341,658	**295,245**	***86***	**40,464**	***12***	**5,949**	***2***
Commercial Banking – Core	**96,134**	**87,616**	***91***	**6,607**	***7***	**1,911**	***2***
Other[2]	**27,418**	**21,617**	***79***	**4,606**	***17***	**1,195**	***4***
Total Gross Lending	**465,210**	**404,478**	***87***	**51,677**	***11***	**9,055**	***2***
Expected credit losses	**(4,464)**	**(626)**		**(1,731)**		**(2,107)**	
	460,746	**403,852**		**49,946**		**6,948**	
Fair value adjustments	**270**						
Net balance sheet carrying value	**461,016**						

Note: Figures are shown on an underlying basis and exclude undrawn commitments.

[1] Includes certain European retail lending portfolios and lending to smaller business customers.

[2] Includes reverse repo transactions and non-core Commercial lending including run-off and the Irish lending portfolio.

[3] Under IAS 39 the Group regarded assets that were impaired as being non-performing. Credit impaired assets under IFRS 9 are defined more broadly and, in particular, include forborne non-performing past-term interest only mortgages.

The table below analyses Stage 2 loans by days past due. Assets are transferred to Stage 2 after there has been a significant increase in credit risk. It is therefore a relative measure; the lending is largely performing and a significant proportion is expected to either return to Stage 1 or mature with no credit losses being incurred. There was no equivalent classification under IAS 39.

	0-30 days £m	%	Over 30 days £m	%	Total £m
Retail:					
Secured	32,621	92	2,778	8	**35,399**
Consumer Lending	4,357	97	147	3	**4,504**
Other	511	91	50	9	**561**
	37,489	93	2,975	7	**40,464**
Commercial - Core	6,517	99	90	1	**6,607**
Other	4,573	99	33	1	**4,606**
Total	48,579	94	3,098	6	**51,677**

Note: Figures are shown on an underlying basis.

Expected credit losses

The net impact of IFRS 9 on transition is an increase in impairment allowances of £1,276 million which is analysed as follows:

	IAS 39 Latent risk £m	12-month expected loss £m	Lifetime expected loss £m	Undrawn commitments £m	Multiple economic scenarios £m	**Total £m**
Retail						
Secured	(561)	24	371	1	226	**61**
Consumer lending	(232)	383	328	161	10	**650**
Other	(29)	38	15	14	3	**41**
	(822)	445	714	176	239	**752**
Commercial Banking						
- Core	(183)	104	316	59	60	**356**
Other	(128)	70	173	1	52	**168**
Total	(1,133)	619	1,203	236	351	**1,276**

Comprising:	
Loans and advances to customers	**1,022**
Undrawn commitments	**243**
Other	**11**
	1,276

The key drivers for the provision movements from IAS 39 to IFRS 9 for the Group are as follows:

- Latent risk: under IAS 39 provisions were held against losses that had been incurred at the balance sheet date but had either not been specifically identified or adequately captured in the provisioning models. Under IFRS 9 assets which have not defaulted are allocated to Stages 1 and 2 and an appropriate expected credit loss allowance made.
- 12-month expected loss: IFRS 9 requires that for financial assets where there has been no significant increase in credit risk since origination (Stage 1) a loss allowance equivalent to 12-month expected credit losses should be held. Under IAS 39 these balances would not be specifically provided against although a provision for latent risk would be held.
- Lifetime expected credit loss: financial assets that have experienced a significant increase in credit risk since initial recognition (Stage 2) and credit impaired assets (Stage 3) are required to carry a lifetime expected credit loss allowance. Under IAS 39, Stage 2 assets were treated as performing and consequently no specific impairment provision was held, although a proportion of the provision held against latent risks was held against these assets. Assets treated as impaired under IAS 39 carried a provision reducing the carrying value to the estimated recoverable amount.
- Undrawn commitments: IFRS 9 requires a loss allowance to be held against undrawn lending commitments. Previously, an impairment provision would only have been held in the event that the commitment was irrevocable and a loss event had occurred.
- Multiple economic scenarios: IFRS 9 requires that the expected credit loss allowance should reflect an unbiased range of possible future economic outcomes. This was not required under IAS 39.

Exposure at default (EAD)

The table below shows provision coverage as a percentage of EAD. As EAD captures the projected balance at default, inclusive of undrawn commitments, management consider this a more meaningful measure of provision coverage.

	Stage 1 EAD £m	Stage 1 ECL £m	Stage 1 Coverage ratio %	Stage 2 EAD £m	Stage 2 ECL £m	Stage 2 Coverage ratio %
Retail:						
Secured	265,467	31	–	35,262	789	*2.2*
Consumer Lending	59,684	483	*0.8*	5,096	484	*9.5*
Other	12,428	52	*0.4*	559	23	*4.1*
	337,579	566	*0.2*	40,917	1,296	*3.2*
Commercial - Core	124,693	126	*0.1*	8,114	414	*5.1*
Other	24,298	80	*0.3*	4,622	148	*3.2*
Total	**486,570**	**772**	***0.2***	**53,653**	**1,858**	***3.5***

	Stage 3 EAD £m	Stage 3 ECL £m	Stage 3 Coverage ratio[1] %	Total EAD £m	Total ECL £m	Total Coverage ratio[1] %
Retail:						
Secured	5,034	684	*13.6*	305,763	1,504	*0.5*
Consumer Lending	837	328	*58.6*	65,617	1,295	*2.0*
Other	78	27	*42.2*	13,065	102	*0.8*
	5,949	1,039	*18.4*	384,445	2,901	*0.8*
Commercial - Core	1,911	634	*33.2*	134,718	1,174	*0.9*
Other	1,195	434	*36.3*	30,115	662	*2.2*
Total	**9,055**	**2,107**	***24.0***	**549,278**	**4,737**	***0.9***

ECL allowances comprise:	**£m**
• Against drawn balances	4,464
• Against undrawn balances	273
	4,737

Note: Figures are shown on an underlying basis.

[1] The coverage ratio for Consumer Lending and Retail Other Stage 3 assets has been calculated after excluding balances in Recoveries amounting to £291 million which have been written down to their recoverable amount.

[2] Consumer Lending and Retail Other provisions for Stages 1 and 2 include amounts relating to provisions against the residual values of vehicles subject to finance leasing agreements. These provisions are included within the calculation of the coverage ratios.

The table below shows the Stage 2 exposure at default analysed by days past due.

	EAD 0-30 days £m	EAD Over 30 days £m	EAD Total £m	ECL 0-30 days £m	ECL Over 30 days £m	ECL Total £m
Retail:						
Secured	32,458	2,804	35,262	586	203	789
Consumer Lending	4,950	146	5,096	440	44	484
Other	510	49	559	18	5	23
	37,918	2,999	40,917	1,044	252	1,296
Commercial – Core	8,024	90	8,114	414	–	414
Other	4,589	33	4,622	142	6	148
Total	**50,531**	**3,122**	**53,653**	**1,600**	**258**	**1,858**

	Coverage ratio 0-30 days %	Coverage ratio Over 30 days %	Coverage ratio Total %
Retail:			
Secured	1.8	7.2	2.2
Consumer Lending	8.9	30.1	9.5
Other	3.5	10.2	4.1
	2.8	8.4	3.2
Commercial – Core	5.2	–	5.1
Other	3.1	18.2	3.2
Total	**3.2**	**8.3**	**3.5**

Credit quality

The table below shows the credit quality of drawn customer lending balances. It has been prepared using IFRS 9 probabilities of default, including the effects of forward looking information, with the Group's internal credit rating grades.

The internal credit ratings systems used by the Group differ between Retail and Commercial, reflecting the different characteristics of these exposures and the way they are managed internally and are set out below. All PDs include forward looking information and are based on 12 month values, with the exception of credit impaired.

The definitions of good quality, satisfactory quality, lower quality and below standard applying to Retail and Commercial are therefore not the same and consequently no totals are provided.

	Retail		**Commercial**	
	RMS [1]	PD	CMS [2]	PD
Good quality	1-6	0%-4.5%	1-10	0%-0.51%
Satisfactory quality	7-9	4.5%-14%	11-14	0.51%-3%
Lower quality	10	14%-20%	15-18	3%-20%
Below standard	11-13	20%-100%	19	20%-100%
Credit impaired	14	100%	20-23	100%

[1] Internal rating grade - Retail master scale.

[2] Internal rating grade - Commercial master scale

The table below shows the credit quality of the Group's loans and advances to customers analysed by stage.

	Retail - mortgages £m	Retail – other £m	Commercial £m	Total £m
Stage 1				
Good quality	259,842	40,779	64,560	
Satisfactory quality	26	4,074	33,010	
Lower quality	1	215	1,705	
Below standard	175	91	–	
	260,044	45,159	99,275	404,478
Stage 2				
Good quality	32,070	2,214	81	
Satisfactory quality	4,395	1,229	2,544	
Lower quality	823	383	3,646	
Below standard	2,837	921	534	
	40,125	4,747	6,805	51,677
Stage 3				
Credit impaired	5,475	1,260	2,320	9,055
Total	**305,644**	**51,166**	**108,400**	**465,210**

Note: Figures are shown on an underlying basis.

[1] The analysis of lending between retail and commercial has been prepared based upon the type of exposures and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and smaller businesses, whilst included within commercial are exposures to corporate customers and other large institutions.

CLASSIFICATION AND MEASUREMENT

Overview

Under IFRS 9, the classification and subsequent measurement of financial assets is principally determined by the entity's business model. The standard sets out three types of business model:

- Hold to collect: it is intended to hold the asset to maturity to earn interest, collecting repayments of principal and interest from the customer. These assets are accounted for at amortised cost.
- Hold to collect and sell: this model is similar to the hold to collect model, except that the entity may elect to sell some or all of the assets before maturity as circumstances change. These assets are accounted for at fair value through other comprehensive income (FVOCI).
- Hold to sell: the entity originates or purchases an asset with the intention of disposing of it in the short or medium term to benefit from capital appreciation. These assets are held at fair value through profit or loss (FVTPL). An entity may also designate assets at FVTPL upon initial recognition where it reduces an accounting mismatch. An entity may elect to measure certain holdings of equity instruments at FVOCI, which would otherwise have been measured at FVTPL.

The Group has assessed its business models in order to determine the appropriate IFRS 9 classification. The Retail and Commercial Banking loan books are generally held to collect contractual cash flows until the lending matures and meet the criteria to remain at amortised cost. Certain portfolios are subject to higher levels of sales and have been classified as FVOCI. Within the Group's insurance business assets are managed on a fair value basis and continue to be accounted for at FVTPL.

In order to be accounted for at amortised cost or FVOCI, it is necessary for individual instruments to have contractual cash flows that are solely payments of principal and interest (SPPI). A small proportion of the Group's assets do not meet this requirement, for example some asset-backed securities, and have therefore been reclassified to FVTPL.

Certain Commercial Banking loans contain symmetric two-way break clauses which in certain circumstances, in the event of the loan being prepaid, would result in the Group paying the customer an amount in net contractual settlement. Under the requirements of the original IFRS 9 standard, loan agreements containing such clauses would fail the SPPI test and would be therefore accounted for at FVTPL. However the October 2017 amendment to IFRS 9 has clarified that this is not the case. The amendment is effective from 1 January 2019 however in order to reflect all the effects of IFRS 9 at the same time, the Group has decided to apply the amendment from 1 January 2018. The amendment is still subject to EU endorsement and the Group assumes this will occur during 2018.

Classification

The table below summarises the classification changes (before applying consequential remeasurement) as a result of applying the IFRS 9 business model and cash flow tests to the balance sheet as at 1 January 2018.

Balance sheet line item	IFRS 9 Measurement category	In £m	Out £m	IFRS 9 allocation	Net reclassification £m
Financial assets					
Financial assets at FVTPL	FVTPL	14,447	(1,139)	FVOCI	13,308
Derivative assets	FVTPL (Der)		(360)	FVTPL	(360)
Loans and advances					
− Banks	AC		(90)	FVOCI	(2,364)
			(2,274)	FVTPL	
− Customers	AC		(10,474)	FVTPL	(10,474)
− Debt securities	AC		(329)	FVOCI	(329)
			(13,167)		(13,167)
Financial assets at FVOCI	FVOCI	42,972	–		42,972
Available-for-sale assets			(684)	FVTPL	
			(41,414)	FVOCI	
			(42,098)		(42,098)
Other assets	AC		(655)	FVTPL	(655)
Financial liabilities					
Financial liabilities at FVTPL	FVTPL	48			48
Debt securities in issue	AC		(48)	FVTPL	(48)
Total		57,467	(57,467)		–

There has been a reduction in loans and advances accounted for at amortised cost of £13,167 million largely driven by:

- lending assets transferred from the banking business to the insurance business in recent years totalling £6,882 million which had been accounted for at amortised cost in the Group's accounts under IAS 39. Upon implementation of IFRS 9, these assets have been designated at FVTPL, in common with other assets within the insurance business, as they are backing insurance and investment contract liabilities which either have cash flows that are contractually based upon the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise. Loans and advances to banks of £2,274 million have been transferred to FVTPL for similar reasons.
- assets held by the Commercial business totalling £3,116 million have been reclassified to FVTPL having not met the requirements of the SPPI test. These assets are principally holdings of notes issued by securitisation vehicles. Whilst the credit quality of these notes is generally good, there is a contractual linkage to the underlying asset pools which are exposed to residual value risk.
- A further £847 million of Commercial lending assets have been reclassified following changes in the business model.

The reduction in loans and advances has been mirrored by an increase in assets at FVTPL. Assets which were classified as available-for-sale under IAS 39 have been reclassified to FVOCI except for certain instruments failing the SPPI test which have been reclassified as FVTPL.

Measurement

There has been a pre-tax charge of £229 million (£207 million net of tax) arising from the reclassification of assets and liabilities to FVTPL or FVOCI and consequent remeasurement to fair value. This amount largely relates to the lending assets transferred from the banking to the insurance business; the fair value of the Commercial Banking assets transferred to FVTPL was not materially different from carrying value.

EARNINGS IMPACTS

The Group has used the IFRS 9 option not to restate comparatives, making the initial application date 1 January 2018. The application date fixes the transition requirements of IFRS 9 and so it is not possible to produce fully compliant comparatives nor a restated profit for the year ended 31 December 2017.

The drivers of the impairment charge under IFRS 9 are expected to be:

- Defaults and write-offs of credit impaired assets (stage 3)
- Significant increases in credit risk causing material changes to stage 2 assets and expected credit losses
- Significant changes in economic conditions leading to assets moving between stages and changes in probabilities of default
- Relative size of new business growth (stage 1 provisions)

The Group anticipates that over the longer term the impairment charge is likely to be more volatile under IFRS 9. However absent changes in the current economic outlook, in the near-term the impairment charge is expected to be relatively stable.

Consistent with IAS 39, loans are written off when there is no realistic probability of recovery. Accordingly, the Group’s policy on when financial assets are written-off will not significantly change on adoption of IFRS 9 and therefore reporting of write-offs is expected to be unchanged. Similarly the treatment and recognition of recoveries is unaffected by the implementation of IFRS 9.

REGULATORY CAPITAL

Capital and leverage ratios

An analysis of the key impacts on the Group's capital and leverage ratios as a result of applying the requirements of IFRS 9 is set out in the table below:

						As at 1 January 2018	
	As at 31 Dec 2017 £m	Reduction in shareholders' equity/total assets[1, 2] £m	Excess expected loss absorption[3] £m	Deferred tax, threshold and other movements[4] £m	Eligible provisions (tier 2)[5] £m	IFRS 9 (Full impact) £m	IFRS 9 (Transitional arrangements applied)[6] £m
Capital resources							
Common equity tier 1 capital	**29,647**	**(956)**	**467**	**(98)**	**–**	**29,060**	**29,629**
Transitional tier 1 capital	**36,329**	**(956)**	**467**	**(98)**	**–**	**35,742**	**36,311**
Fully loaded tier 1 capital	**34,977**	**(956)**	**467**	**(98)**	**–**	**34,390**	**34,960**
Transitional total capital	**44,659**	**(956)**	**467**	**(98)**	**564**	**44,636**	**44,672**
Fully loaded total capital	**38,994**	**(956)**	**467**	**(98)**	**564**	**38,971**	**39,007**
Risk-weighted assets	**210,919**			**281**		**211,200**	**210,945**
Capital ratios							
Common equity tier 1 capital ratio[7]	**14.1%**					**13.8%**	**14.0%**
Transitional tier 1 capital ratio	**17.2%**					**16.9%**	**17.2%**
Fully loaded tier 1 capital ratio	**16.6%**					**16.3%**	**16.6%**
Transitional total capital ratio	**21.2%**					**21.1%**	**21.2%**
Fully loaded total capital ratio	**18.5%**					**18.5%**	**18.5%**
Leverage							
Total exposure							
Total exposure measure	**657,234**	**(717)**	**467**	**(98)**		**656,886**	**656,980**
UK leverage ratio	**5.3%**					**5.2%**	**5.3%**

1 Excludes the impact of IFRS 9 on the Group's Insurance business as this falls outside the scope of the Group's regulatory capital consolidation.

2 The reduction in shareholders' equity (capital) comprises a reduction of £970 million in relation to impairment and an increase of £14 million in relation to classification and measurement. The reduction in total assets (leverage) comprises a reduction of £731 million in relation to impairment and an increase of £14 million in relation to classification and measurement.

3 The excess of regulatory expected losses over impairment provisions and value adjustments at 31 December 2017 was £498 million, of which £467 million has been utilised to partially absorb the increase in impairment provisions through equity. The remaining £31 million of expected losses relates to equity exposures risk-weighted under the IRB Approach which cannot be offset against impairment provisions.

4 The reduction in capital resources and leverage reflects the impact of threshold deductions and the net deferred tax asset (DTA) deduction following the increase in impairment provisions. The increase in risk-weighted assets is driven by the additional DTA temporary differences, partially offset by the threshold movement and a reduction in Standardised credit risk exposures relating to the increased impairment provisions.

5 Predominantly reflects the surplus of non-defaulted impairment provisions that cannot be absorbed by regulatory expected losses, arising as a result of the increase in impairment provisions.

6 The common equity tier 1 capital ratio at 31 December 2017 (14.06 per cent) reduces by 1 basis point on an IFRS 9 basis, post application of the transitional arrangements (14.05 per cent).

7 The common equity tier 1 ratio was 14.4 per cent on a pro forma basis upon recognition of one dividend paid by the Insurance business in February 2018 in relation to its 2017 earnings.

The impact on the Group's CET 1 capital ratio before transitional relief at 1 January 2018 is a reduction of 30 basis points after taking account of the offset against regulatory expected losses. After transitional relief the impact is 1 basis point.

European arrangements for transitional capital relief allow both the initial net impact on CET 1 capital resulting from the increase in impairment provisions under IFRS 9 ECL and the capital impact of any subsequent increases in Stage 1 and Stage 2 ECLs (net of movements in regulatory expected losses) to be phased in over a five year transition period. The phase in factors will allow 95 per cent of the resultant "transitional adjustment" to be added back to CET 1 capital in 2018, reducing down to 85 per cent in 2019, 70 per cent in 2020, 50 per cent in 2021 and 25 per cent in 2022, with full recognition of the impact on CET 1 capital from 2023. The effect of adding back the transitional adjustment to CET1 capital will result in further consequential adjustments to Tier 2 capital (eligible provisions) and risk-weighted assets.

Application of the transitional arrangements to the Group's "full impact" capital position at 1 January 2018 results in the following adjustments:

- An increase to equity of £0.5 billion predominantly reflecting 95 per cent of the tax adjusted add-back for the increase in non-defaulted impairment provisions that either cannot be absorbed by regulatory expected losses (IRB portfolios) or that are netted against gross credit risk exposures (Standardised portfolios);
- A resultant positive movement in threshold and DTA deductions of £0.1 billion;
- A consequential adjustment to reduce tier 2 eligible provisions by £0.5 billion, reflecting the fact that these have been added back through common equity tier 1 capital;
- A reduction in risk-weighted assets of £0.3 billion reflecting the reduction in risk-weighted DTA temporary differences, offset in part by the movement in the threshold and the increase in Standardised credit risk-weighted assets following the add-back, through common equity tier 1 capital, of impairment provisions previously offset against the gross credit risk exposures.

The increase in the leverage measure, following the application of the transitional arrangements, reflects the impact of the movement in the threshold and DTA deductions.

Capital management

The Group manages capital within an established regulatory framework to ensure that it has sufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. The Group's assessment of capital sufficiency involves, inter alia, forward looking estimates of the impact of a base case economic scenario together with a number of stressed scenarios.

The implementation of IFRS 9 potentially increases bank capital volatility. Under stress, this is primarily a result of provisioning for assets that are not in default at an earlier stage than would have been the case under IAS 39. In addition it is currently unclear how the IFRS 9 requirement to reflect the outcome of multiple future economic scenarios within the calculation of the ECL allowance should be reflected in capital stress tests.

The Group notes that the UK regulatory authorities have already publicly announced, via the Financial Policy Committee (FPC), that the change in accounting standard will not change the cumulative losses banks incur during any given stress period (the losses will however be provided for at an earlier point in the stress) and that the FPC will take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in de facto increases in capital requirements. In the short term the regulatory transitional arrangements, which the Group has adopted, will provide some stability in capital requirements against increased provisioning, measurement uncertainty and volatility, introduced in the accounting by the adoption of IFRS 9.

GOVERNANCE AND CONTROL

Implementation

In view of the significant changes being introduced by IFRS 9, a number of years ago a programme was established to coordinate the implementation across the Group. Based on the requirements of IFRS 9 an accounting policy framework was established. Divisional finance and risk teams used this framework to identify data and systems requirements and developed plans to meet these requirements. Progress was monitored in each of the divisions by a divisional steering committee, often chaired by the divisional finance or risk director. Progress across the Group was monitored by the Programme Steering Committee chaired by the Group Financial Controller and comprising senior representatives of finance and risk functions. Issues of technical interpretation were escalated by divisions to a central policy team who considered the matter and provided guidance, supported by external professional advisors. The Group's IT function was used to develop the models required to perform the revised impairment calculations and these were subject to detailed review and approval through the Group's normal model governance procedures. Upon completion of the model development, a number of dry runs were conducted to embed the models and develop an understanding of the results.

During the course of the programme, there have been regular updates provided to the Group Executive Committee and Audit Committee. Key judgements and decisions have been the subject of review and approval by the Audit Committee.

Ongoing

The Group's risk management framework is implemented through a "Three Lines of Defence" model which defines clear responsibilities and accountabilities and ensures effective independent oversight and assurance activities take place covering key decisions. Business management are the first line of defence and have responsibility for risk decisions, identifying, measuring, monitoring and controlling risks within their areas of accountability. Risk division is the second line of defence providing oversight and independent challenge to key risk decisions taken by business management and Group Audit is the third line of defence.

The implementation of IFRS 9 has not altered this basic model. The Group's overall credit risk appetite also remains unchanged with the controls in place in the business for the extension and subsequent monitoring of credit exposure. Some additional management information is being prepared to assist in monitoring portfolio quality and provision coverage reflecting some of the changes introduced by IFRS 9.

It has been necessary to develop some new processes and related controls to support the calculation of the Group's expected credit losses. In particular, new governance processes have been established to consider the economic scenarios to be used and their weighting. A committee under the chairmanship of the Chief Economist will meet quarterly. This committee will report to the Chief Financial Officer and Chief Risk Officer and summary findings dealing with all aspects of the expected credit loss calculation will be presented to the Group Audit Committee.

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