Lloyds Banking Group plc

Pillar 3 Disclosures
31 December 2011

CONTENTS

FORWARD LOOKING STATEMENTS

This document includes certain forward looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans of Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group 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 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 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; 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 ability to attract and retain senior management and other employees; requirements or limitations imposed on the Group as a result of HM Treasury's investment in the Group; the ability to complete satisfactorily the disposal of certain assets as part of the Group's EU State Aid obligations; the extent of any future impairment charges or write-downs caused by depressed asset valuations; market related trends and developments; exposure to regulatory scrutiny, legal proceedings or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors; 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.

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

FOREWORD

This document presents the consolidated Pillar 3 disclosures of Lloyds Banking Group plc ('the Group') as at 31 December 2011. Publication of this document fulfils a key requirement of the original Basel II Framework, encouraging market discipline by providing a comprehensive analysis of the Group's capital resources and Pillar 1 capital requirements, its risk exposures and its risk management framework, thereby allowing market participants to assess the capital adequacy of the Group.

The disclosures produced within this document have been prepared in accordance with minimum disclosure requirements established under the Capital Requirements Directive ('CRD'), as amended. These include new market risk and securitisation disclosure requirements for 2011, a result of the full implementation at year end of the 'CRD 3' package of amendments (commonly referred to as Basel 2.5). Directive imposed disclosure requirements are interpreted within the UK through the Financial Service Authority's ('FSA') Prudential Sourcebook for Banks, Building Societies and Investment Firms ('BIPRU').

In meeting these disclosure requirements the Group has considered the work undertaken by the European Banking Authority ('EBA') and its predecessor Committee of European Banking Supervisors ('CEBS') and both national and international trade associations in interpreting Pillar 3 disclosure requirements and in establishing best practice guidelines.

In satisfaction of significant subsidiary disclosure requirements, summary information pertaining to the consolidated capital resources and consolidated capital requirements of Lloyds TSB Bank plc ('Lloyds TSB Bank Group') and Bank of Scotland plc ('BOS Group') can be found in Appendix 1 and Appendix 2 of the document.

Remuneration disclosures produced in compliance with CRD 3 requirements on the disclosure of remuneration can be found in Appendix 3 of the document.

SUMMARY ANALYSIS

A high level summary analysis of the consolidated capital position and credit risk exposures of the Group as at 31 December 2011 is provided below.

CAPITAL RATIOS

	2011 Ratio %	2010 Ratio %
Core tier 1 capital ratio	**10.8%**	10.2%
Tier 1 capital ratio	**12.5%**	11.6%
Total capital ratio	**15.6%**	15.2%

Total capital resources as at 31 December 2011 amounted to £55.0bn (2010: £61.8bn), including tier 1 capital of £44.0bn (2010: £47.1bn). Core tier 1 capital amounted to £38.0bn (2010: £41.4bn).

RISK WEIGHTED ASSETS AND PILLAR 1 CAPITAL REQUIREMENT

Total Risk Weighted Assets ('RWAs') as at 31 December 2011 amounted to £352.3bn (2010: £406.4bn), generating a Pillar 1 capital requirement of £28.2bn (2010: £32.5bn). A summary breakdown of total RWAs by risk type is provided in the table below.

	2011 Risk Weighted Assets £m	2010 Risk Weighted Assets £m
Credit risk	**302,231**	358,940
Counterparty credit risk	**12,644**	11,565
Market risk	**6,877**	4,217
Operational risk	**30,589**	31,650
Total	**352,341**	406,372

Credit risk RWAs comprise £198.7bn (66%) of RWAs calculated under the Internal Ratings Based ('IRB') Approach (2010: £234.4bn, 65%) and £103.5bn (34%) of RWAs calculated under the Standardised Approach (2010: £124.5bn, 35%).

Key Movements

- Credit risk RWAs decreased by £56.7bn during the year, reflecting reductions across all banking divisions driven by balance sheet reductions of non-core assets, lower core lending balances and stronger management of risk. Retail Division credit risk RWAs reduced by £5.5bn mainly due to lower lending balances and the reducing mix of unsecured lending. Wholesale Division and Commercial Division credit risk RWAs reduced by £38.3bn primarily reflecting balance sheet reductions including treasury asset sales and the run down of non-core asset portfolios. Credit risk RWAs within Wealth & International Division have reduced by £9.9bn as a result of asset run-off, write offs and foreign exchange movements.

- Market risk RWAs increased by £2.7bn, primarily reflecting the impact of new VaR model measures under CRD 3 which were formally implemented on 31 December 2011.

CREDIT RISK EXPOSURES

Total credit risk exposures (excluding counterparty credit risk exposures) as at 31 December 2011 amounted to £807.6bn (2010: £878.5bn) on an exposure at default ('EAD') basis.

This comprises £617.6bn (76%) of exposures risk weighted under the IRB Approach (2010: £697.8bn, 79%) and £190.0bn (24%) of exposures risk weighted under the Standardised Approach (2010: £180.7bn, 21%). A summary analysis of credit risk exposures is provided in the table below.

Exposure Category	2011 Credit Risk Exposure £m	2011 Risk Weighted Assets £m	2011 Average Risk Weight %
Corporates	137,947	86,725	63%
Central governments and central banks	17,714	1,299	7%
Institutions	11,892	2,426	20%
Retail	419,019	98,823	24%
Equities	15	57	370%
Securitisation positions	31,027	9,376	30%
Total – IRB Approach	617,614	198,706	32%
Central governments and central banks	72,442	57	0%
Institutions	1,177	399	34%
Corporates	34,805	33,478	96%
Retail	8,032	6,030	75%
Secured on real estate property	38,037	31,473	83%
Items belonging to regulatory high risk categories	2,433	3,603	148%
Securitisation positions	-	-	-
Other [1]	33,072	28,485	86%
Total – Standardised Approach	189,998	103,525	54%
TOTAL	807,612	302,231	37%

Exposure Category	2010 Credit Risk Exposure £m	2010 Risk Weighted Assets £m	2010 Average Risk Weight %
Corporates	156,878	108,830	69%
Central governments and central banks	22,920	1,290	6%
Institutions	23,927	4,371	18%
Retail	435,321	105,474	24%
Equities	2,331	5,529	237%
Securitisation positions	56,392	8,954	16%
Total – IRB Approach	697,769	234,448	34%
Central governments and central banks	40,168	60	0%
Institutions	825	292	35%
Corporates	44,386	40,965	92%
Retail	10,103	7,560	75%
Secured on real estate property	42,925	35,582	83%
Items belonging to regulatory high risk categories	170	236	139%
Securitisation positions	8	28	350%
Other [1]	42,148	39,769	94%
Total – Standardised Approach	180,733	124,492	69%
TOTAL	878,502	358,940	41%

Notes

[1] Other exposures include exposures to regional governments and local authorities, administrative bodies and non-commercial undertakings, multilateral development banks, short term claims on institutions and corporates, past due items, collective investment undertakings and other items.

INTRODUCTION

The Capital Requirements Directive (as amended) governs the implementation of the Basel II Framework within the European Union ('EU'). The purpose of this legislation is to provide a modern prudential framework for credit institutions and investment firms across the EU through greater risk sensitivity and reflecting more sophisticated approaches and improvements in the risk management practices of credit institutions and investment firms.

Prudential requirements under the Basel II Framework are determined by the three pillars.

PILLAR 1 – MINIMUM CAPITAL REQUIREMENTS

The first pillar focuses on the determination of the minimum capital required to support the firm's exposure to credit, market and operational risks. A range of approaches, varying in sophistication, are available under the Basel II Framework to use in measuring these risks and determining the minimum level of capital required. The main approaches are set out in the table below.

Risk	Complexity Least	– – – – – – – – – – – – – – – – – – ►	Most
Wholesale Credit	Standardised Approach	Foundation Internal Ratings Based Approach (FIRB)	Advanced Internal Ratings Based Approach (AIRB)
Retail Credit	Standardised Approach	-	Retail Internal Ratings Based Approach (RIRB)
Counterparty Credit	Standardised Approach	Foundation Internal Ratings Based Approach (FIRB)	Advanced Internal Ratings Based Approach (AIRB)
Market	Standardised Approach	-	Internal Models Approach (IMA)
Operational	Basic Indicator Approach (BIA)	Standardised Approach (TSA)	Advanced Measurement Approach (AMA)

Minimum capital requirements under Pillar 1 are more commonly expressed as risk weighted assets ('RWAs'), being 12.5 times the minimum capital required.

Credit Risk

The Standardised Approach to calculating credit risk capital requirements relies on the application of a standardised set of risk weightings to credit risk exposures based on the categorisation of the exposure and the criteria specified within the BIPRU provisions. Where available, external credit ratings supplied by External Credit Assessment Institutions ('ECAIs' - for example, Standard & Poor's, Moody's or Fitch) can be used in determining the credit quality of the exposure and therefore the appropriate risk weight to apply. The Standardised Approach also recognises the application of certain credit risk mitigation techniques.

The IRB Approach represents a significantly more developed method of calculating credit risk capital requirements. It is further sub-divided into two distinct approaches for wholesale exposures – the Foundation IRB Approach and the Advanced IRB Approach. For retail exposures, a single approach referred to as the Retail IRB Approach is available and is equivalent in complexity to the Advanced IRB Approach. Application of any IRB approach requires approval from the FSA and oversees regulators as necessary.

IRB approaches require firms to make use of their own internal assessment, subject to regulatory floors, of the probability of a counterparty defaulting ('PD'). In addition, firms applying the Advanced IRB Approach and / or Retail IRB Approach are required to use internal credit conversion factors in deriving exposure at default ('EAD') amounts and internal estimates of loss given default ('LGD') in a downturn. Firms applying the Foundation IRB Approach are also required to use credit conversion factors and LGD components within their calculations, but these are set by the regulator.

Under each of the IRB approaches referred to above, the three risk components (PD, EAD and LGD) form the base inputs to the formulae used to derive the credit risk capital requirement that applies to the exposure. This reflects the capital required to cover any unexpected loss in relation to the exposure.

In addition to calculating an unexpected loss capital requirement, an expected loss ('EL') is also derived for each exposure under the IRB approach by multiplying the PD, EAD and LGD risk components together, as follows:

EL = (PD% * EAD * LGD%)

Subject to the calibration methodology used in the calculation of PD, the impact of cyclical economic conditions on EL is dampened or removed (i.e. where EL is aligned to a long run average PD and a downturn LGD). As such, the EL calculated represents the estimate of the monetary amount the business expects to lose from an obligor within a 12 month outcome window, irrespective of current economic conditions.

The expected loss is compared to the level of accounting impairment provisions raised. Where expected losses are in excess of accounting impairment provisions the resultant 'excess EL' is deducted from capital resources, split equally between Tier 1 and Tier 2 capital. Where accounting impairment provisions exceed expected losses, a 'surplus provision' may be recognised in Tier 2 capital subject to certain restrictions.

Firms applying an IRB Approach must use their model outputs to inform both credit risk management and day to day credit related decision making within the business (the 'Use Test').

Both the Foundation IRB Approach and the Retail IRB Approach are used within the Group. The application of both IRB Approaches within the Group has required a large number of internal models to be built, tested and approved by the FSA prior to roll out within the relevant Division. Different models are used to cover different portfolios of business. Credit risk exposures in relation to those portfolios of business yet to roll out onto an IRB model or that have been permanently exempted from the IRB Approach are risk weighted under the Standardised Approach.

Under the IRB Approach, alternative modelling approaches can be used for specific exposure types. These include the use of the Supervisory Slotting Approach for corporate specialised lending exposures and the Simple Risk Weight Method for equity exposures. There are also specific rules for calculating credit risk capital requirements in relation to securitisation positions.

The Group currently makes use of the Supervisory Slotting Approach for certain corporate specialised lending portfolios and applies the Simple Risk Weight Method to its equity exposure to the Business Growth Fund plc in accordance with FSA guidance. Other equity exposures that are required to be risk weighted are currently subject to the Standardised Approach, in accordance with the terms of the Group's current integrated IRB waiver permission. The Group expects to move all equity exposures that are required to be risk weighted onto the Simple Risk Weight Method during 2012.

Full details of the Group's approach to managing credit risk and an analysis of credit risk exposures at year end 2011 can be found within the Credit Risk section of the document.

Counterparty Credit Risk

Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. Such transactions relate to contracts for financial instruments and may include derivative contracts and repo contracts.

Measurement of counterparty credit risk exposures must follow one of three prescribed methodologies, the standardised method, the mark-to-market method or the internal model method. Once the exposure value is determined, it is risk weighted under the appropriate credit risk approach in order to determine the counterparty credit risk capital requirement.

Within the Group, counterparty credit risk exposure values are determined under the mark-to-market method, with capital requirements calculated under the Standardised Approach or relevant IRB Approach, as appropriate.

Full details of the Group's approach to managing counterparty credit risk and an analysis of counterparty credit risk exposures at year end 2011 can be found within the Counterparty Credit Risk section of the document.

Market Risk

Market risk capital requirements can be determined under either the Standardised Approach or the Internal Models Approach. The latter involves the use of internal Value at Risk ('VaR') models to measure market risks and determine the appropriate capital requirement. Permission is required from the FSA before VaR models can be used for this purpose.

The Group is permitted by the FSA to calculate market risk capital requirements for the trading book using its VaR models. Within the trading book, positions which contain market risk factors not covered by the VaR models have these risk factors captured with additional capital charges through the Group's 'Risk not in VaR' framework. In addition the default and rating migration risk of issuers of traded instruments within the trading books using the Internal Models Approach has a specific charge called the Incremental Risk Charge ('IRC'). The IRC was introduced at the end of 2011 following the implementation of CRD 3.

Full details of the Group's approach to managing market risk and an analysis of market risk capital requirements at year end 2011 can be found within the Market Risk section of the document.

Operational Risk

The approaches available in relation to the calculation of operational risk capital requirements are summarised below:

- The Basic Indicator Approach ('BIA') determines a capital requirement based on 15% of the 'relevant indicator' as defined under BIPRU. This indicator is based on the three year average of the sum of the firm's net interest income and net non-interest income, subject to allowable adjustments.

- The Standardised Approach ('TSA') determines a capital requirement based on the three year average of the aggregate risk weighted relevant indicators of the underlying business. This requires a firm's activities to be split into a number of defined business lines with a specific risk weight applied to the relevant indicator of each business line. An Alternative Standardised Approach is also available which uses alternative indicators in relation to the defined business lines. Firms must meet certain qualifying criteria to be able to use the Standardised or Alternative Standardised Approach.

- The Advanced Measurement Approach ('AMA') determines a capital requirement through the use of internal operational risk measurement systems. Use of this approach requires approval from the FSA and can only be used where internal systems for monitoring and measuring operational risk are sufficiently robust.

Within the Group, operational risk capital requirements are determined under The Standardised Approach.

Full details of the Group's approach to managing operational risk and an analysis of operational risk capital requirements at year end 2011 can be found within the Operational Risk section of the document.

PILLAR 2 – SUPERVISORY REVIEW PROCESS

The second pillar of the Basel II Framework is designed to assess the adequacy of a firm's capital resources by considering all material risks to the business, including those not covered or adequately addressed by the first pillar, and the impact upon the capital position that is forecast to occur using stressed macroeconomic scenarios. Furthermore, requirements under Pillar 2 encourage firms to develop, operate and evolve better risk management techniques for monitoring, measuring and managing material risks.

There are two components of Pillar 2, the Internal Capital Adequacy Assessment Process ('ICAAP') and the Supervisory Review and Evaluation Process ('SREP').

The ICAAP is a firm's own internal assessment of the overall adequacy of its capital strength in light of the material risks identified and the outcome of stress testing procedures performed.

The SREP is undertaken by the FSA in order to review and assess the firm's ICAAP and to assess the quality of the firm's risk management systems and internal controls. Based on this the FSA will make its own determination of the capital adequacy of the firm, setting a minimum capital requirement for the firm through the issue of Individual Capital Guidance ('ICG') and a minimum capital buffer through the setting of a Capital Planning Buffer.

A summary of the Group's approach to the ICAAP and the material risks identified in addition to those captured under Pillar 1 can be found within the Capital Requirements section of the document.

PILLAR 3 – MARKET DISCIPLINE

The third pillar addresses the external publication of disclosures surrounding a firm's risk management practices, its approach to capital management, its capital resources and Pillar 1 capital requirements and a detailed analysis of its credit risk exposures.

The Basel Committee on Banking Supervision sees the *'purpose of Pillar 3 – market discipline* [as being one of complementing] *the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment process, and hence the capital adequacy of the institution'* (para. 809, 'International Convergence of Capital Measurement and Capital Standards - A Revised Framework', Basel Committee on Banking Supervision, Nov 2005).

The Basel II Framework sets out the minimum disclosures required under Pillar 3. Together with additional minimum disclosure requirements imposed through amendments to the Capital Requirements Directive, these form the basis of the disclosures the Group is required to make under the relevant BIPRU provisions.

In interpreting Pillar 3 disclosure requirements, the Group considers both the guidance provided under the Basel II Framework as well as the best practice guidelines established by the Pillar 3 working parties of national and international trade associations and those of European supervisory bodies. The primary aim of these working parties continues to be to drive consensus amongst reporting firms in terms of both interpretation of Pillar 3 requirements and the nature and extent of the disclosures required.

DISCLOSURE POLICY

The following sets out a summary of the disclosure policy applied to the Lloyds Banking Group plc Pillar 3 Disclosures, including the basis of preparation, frequency, media, location and verification.

BASIS OF PREPARATION

This document contains the consolidated Pillar 3 disclosures of Lloyds Banking Group plc as at 31 December 2011, prepared in accordance with the requirements of BIPRU Chapter 11 (Disclosure – Pillar 3).

In satisfaction of certain disclosure requirements, reference has been made to the 2011 Lloyds Banking Group plc Annual Report and Accounts. As such, this document should be read in conjunction with the Annual Report and Accounts. It is however important to note that a number of significant differences exist between accounting disclosures published in accordance with International Financial Reporting Standards ('IFRS') and Pillar 3 disclosures published in accordance with prudential requirements, which prevent direct comparison in a number of areas. Of particular note are the differences surrounding scope of consolidation and the definition of credit risk exposure.

Details on the scope of consolidation applied to the disclosures presented within this document are provided within the Scope of Consolidation section of the document.

Throughout this document, unless otherwise specified, credit risk exposures are defined as the exposure at default ('EAD'), prior to the application of credit risk mitigation. EAD is defined as the aggregate of drawn (on balance sheet) exposures and undrawn (off balance sheet) commitments, post application of credit conversion factors and other relevant adjustments.

FREQUENCY, MEDIA AND LOCATION

In accordance with the requirements of BIPRU Chapter 11 (Disclosure – Pillar 3), the Group will continue to make available its consolidated Pillar 3 disclosures on an annual basis.

A standalone copy of these disclosures is located on the Lloyds Banking Group plc website (http://www.lloydsbankinggroup.com/investors/financial_performance.asp).

VERIFICATION

The disclosures presented within this document are not required to be subjected to external audit. Instead, the disclosures have been verified and approved through internal governance procedures in line with the Group's disclosure policy.

SCOPE OF CONSOLIDATION

The following sets out the scope of consolidation applied to the disclosures presented within this document.

INTRODUCTION

As a banking conglomerate, Lloyds Banking Group is required to calculate consolidated capital requirements and consolidated capital resources based on the regulatory consolidation provisions applicable to banks under BIPRU Chapter 8 (Group Risk Consolidation).

REGULATORY CONSOLIDATION

The scope of regulatory consolidation for the purposes of quantifying consolidated capital requirements and consolidated capital resources extends across the banking and investment operations of the Group. All banking and investment services related undertakings included within the scope of the accounting consolidation are also included within the scope of the regulatory consolidation. There are, however, a number of differences in the methods by which certain undertakings are consolidated for regulatory purposes.

Subsidiary undertakings included within the regulatory consolidation are fully consolidated, with capital resources determined on a line-by-line (accounting) consolidation basis. Risk capital requirements are determined either on a line-by-line (accounting) consolidation basis or by aggregating individual subsidiaries' risk capital requirements.

Undertakings in which the Group or its subsidiaries hold a 'participation', where it is deemed that the Group exerts significant influence over the undertaking, are generally consolidated within the regulatory calculations on a proportional (pro-rata) basis. This follows line-by-line (accounting) consolidation based on the ownership share in the particular undertaking. Such undertakings include joint ventures and associates, as defined under IFRS accounting standards, and specified venture capital investments. In certain circumstances, participations are deducted from capital rather than proportionally consolidated.

The assets of insurance holding and operating companies within the Group are excluded from the calculation of consolidated capital requirements and consolidated capital resources. Investments in insurance undertakings are deducted from capital.

Insurance undertakings are themselves required to maintain capital adequacy under the General Prudential Sourcebook ('GENPRU') and the Prudential Sourcebook for Insurers ('INSPRU'). As at 31 December 2011 there were no such undertakings where actual capital resources were less than the regulatory minimum required.

Investments held by the Group in respect of which it does not have the ability to exert significant influence are included within the calculation of capital requirements, being treated as equity exposures. The underlying assets of these investments are neither consolidated nor deducted.

Management practice and policy ensures that capital adequacy is maintained at all levels of banking and insurance consolidation within the Group in accordance with the appropriate regulatory requirements.

The legal and regulatory structure of the Group provides a capability for the prompt transfer of surplus capital resources over and above regulatory requirements or repayment of liabilities when due throughout the Group. There are no current or foreseeable material, practical or legal impediments to such transfers or repayments, other than the constraints imposed over the available capital resources of the Group’s life assurance businesses, further details of which can be found on pages 124 to 125 of the Risk Management section of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

SUB GROUP DISCLOSURES

Limited additional disclosures surrounding the consolidated capital resources and consolidated capital requirements of Lloyds TSB Bank plc ('Lloyds TSB Bank Group') and Bank of Scotland plc ('BOS Group') have been provided within the appendices to this document in fulfilment of significant subsidiary disclosure requirements.

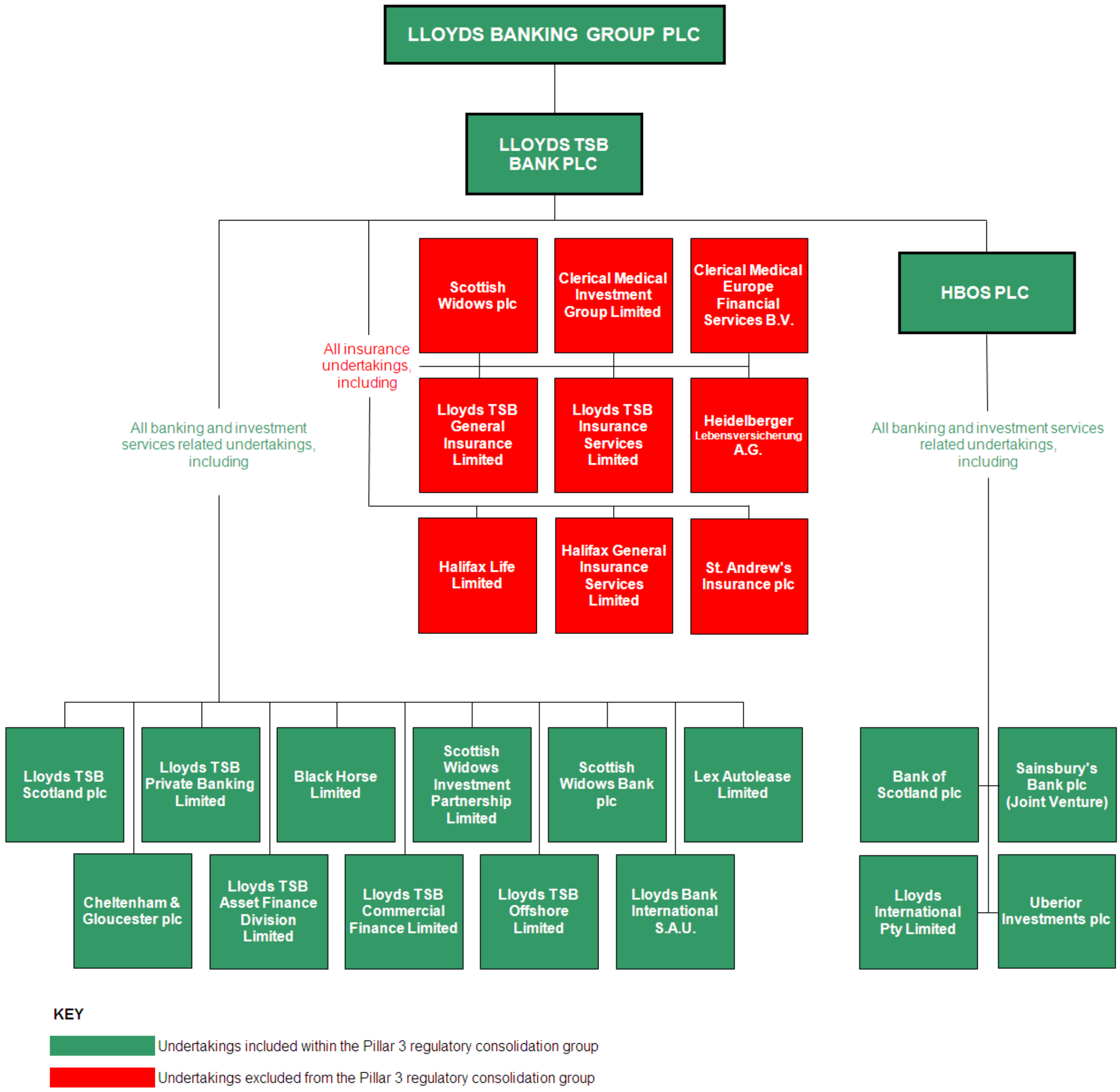
SOLO CONSOLIDATION

The Group makes use of the solo consolidation provisions set out under BIPRU Chapter 2.1 (Solo Consolidation). This allows the capital resources and capital requirements of certain specified subsidiary undertakings of Lloyds TSB Bank plc and Bank of Scotland plc to be included within the respective bank's individual capital resources and capital requirements calculations.

The application of solo consolidation provisions is subject to FSA approval and is performed in line with the terms established by the FSA for each individual bank.

REGULATORY CONSOLIDATION GROUP

A summarised diagrammatical representation (as at 31 December 2011) of the regulatory consolidation group upon which the disclosures presented within this document are based is provided below.



RISK MANAGEMENT OBJECTIVES AND POLICY

THE GROUP'S APPROACH TO RISK

Governance

- The Group’s approach to risk is founded on a robust control framework and a strong risk management culture which guides the way all employees approach their work, behave and make decisions promptly.
- Board-level engagement, coupled with the direct involvement of senior management in group wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.

Risk Appetite

- The Board takes the lead by establishing the ‘tone at the top’ and approving group risk appetite which is then cascaded throughout the Group in terms of policies, authorities and limits. The Board ensures that senior management implements policies and procedures designed to promote professional behaviour and integrity.

Culture

- The Board ensures that senior management implements risk policies and risk appetites that either limit or, where appropriate, prohibit activities, relationships, and situations that could be detrimental to the Group’s risk profile.
- The Group has a conservative business model embodied by a risk culture founded on prudence and individual accountability, where the needs of customers are paramount.
- The focus has been and remains on building and sustaining long-term relationships with customers, through good and bad economic times.

Enterprise-Wide Risk Management

- The Group uses an Enterprise-Wide Risk Management framework for the identification, assessment, measurement and management of risk.
- It seeks to maximise value for shareholders over time by aligning risk appetite with corporate strategy, assessing the impact of emerging risks and developing risk tolerances and mitigating strategies.
- The framework seeks to strengthen the Group’s ability to identify and assess risks, aggregate and report group wide risks and refine risk appetite.

Decision Making

- The Risk Committee, chaired by a Non-Executive Director, comprises other Non-Executive Directors and oversees the Group’s risk exposures. The Chief Risk Officer regularly informs the Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Risk Committee.
- The Group Risk Committee and the Group Asset and Liability Committee are chaired by the Group Chief Executive. The aggregate group wide risk profile and risk appetite are discussed at these monthly meetings.

RISK AS A STRATEGIC DIFFERENTIATOR

The Group’s strategy and risk appetite were developed together to ensure one informed the other in creating a strategy that delivered on becoming the best bank for our customers whilst creating sustainable growth over time.

Strong Control Framework

- A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.
- The Group optimises performance by allowing business units to operate within approved parameters.
- The Group’s approach to risk management ensures that business units remain accountable for risk.

Conservative Approach

- The Group has a fully embedded conservative approach to, and prudent appetite for risk.

Board Level Reporting

- The Group continues to enhance its capabilities by providing to the Board both qualitative and quantitative data including stress testing analysis on risks associated with strategic objectives.
- Taking risks which are well understood, consistent with strategy and appropriately remunerated, is a key driver of shareholder return.
- Risk analysis and reporting supports the identification of opportunities as well as risks and provide an aggregate view of the overall risk portfolio.
- The Group's key risks, management actions and performance against risk appetite are monitored and reported at Group level.

Accountability

- Risk is included as one of the five principal criteria within the Group's balanced scorecard on which business area and individual's performance is judged.
- Business executives have specified risk management objectives, and incentive schemes take account of performance against these.
- The Risk function oversees the performance assessment of business areas and senior staff to ensure adherence to the Group's risk and control frameworks, and oversees that performance has been achieved within risk appetite.

Risk Division

- During 2011 good progress has been made in creating a more agile Risk function through further delayering the management structure and simplifying the operating model.
- This reinforces the model of a strong and independent Risk function that keeps the Group safe, supports sustainable business growth and minimises losses within risk appetite.

Risk Transformation

- The Group's continued investment agenda, ensures Risk systems, processes and management information continue to meet the needs of the Group and external stakeholders.

RISK GOVERNANCE

The embedding of integrated governance, risk and control frameworks throughout the Group has continued, through a consistent approach to risk appetite, policies, delegated authorities and governance committee structures.

The risk governance structure is intended to strengthen risk evaluation and management, whilst also positioning the Group to manage the changing regulatory environment in an efficient and effective manner. The risk governance structure for Lloyds Banking Group is shown in the table on p.16.

BOARD AND BOARD COMMITTEES

The Board, assisted by Risk Committee and Audit Committee, approves the Group's overall governance, risk and control frameworks and risk appetite. The Board also reviews the Group's aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board's agreed appetite for risk. The roles of the Audit Committee, Risk Committee and further key risk oversight roles are described below.

The **Audit Committee** which comprises Non-Executive Directors, monitors and reviews the formal arrangements established by the Board in respect of the financial statements and reporting of the Group, internal controls and the risk management framework, internal audit and the Group's relationship with its external auditors. In carrying out these duties, the committee undertakes the following tasks:

- reviews the financial statements published in the name of the Board and the quality and acceptability of the related accounting policies, practices and financial reporting disclosures;
- reviews the scope of the work of the Group Audit Department, reports from that department and the adequacy of its resources;

- reviews the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations;
- approves the external auditors' terms of engagement and remuneration;
- assesses the external auditors' independence and objectivity;
- recommends the external auditors' appointment, re-appointment and removal;
- reviews the results of the external audit and its cost effectiveness;
- reviews reports from the auditors on audit planning and their findings on accounting and internal control systems; and
- reviews procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and for staff to raise concerns in confidence.

The **Risk Committee**, which comprises Non-Executive Directors, oversees and challenges the development, implementation and maintenance of the Group's risk management framework, ensuring that its strategy, principles, policies and resources are aligned internally to its risk appetite as well as externally to regulation, corporate governance and industry best practice. The Risk Committee regularly reviews the Group's risk exposures across the primary risk drivers and the detailed risk types. In addition, the Risk Committee facilitates the involvement of Non-Executive Directors in risk issues and aids their understanding of these issues, oversees adherence to Group risk policies and standards and considers any material amendments to them and reviews the work of the Group Risk Division.

The **Group Executive Committee** supports the Group Chief Executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, whilst also reviewing the Group's aggregate risk exposures and concentrations of risk. Throughout 2011 businesses provided the Group Executive Committee with regular updates on business performance, always including a review of their key risks. The Group Executive Committee is supported by other Group committees as shown in the table on p.16, and in particular by:

- The **Group Asset and Liability Committee** is responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
- The **Group Incident Executive** sets the strategic direction for the Group's response to significant incidents which could affect its ability to continue to operate, and instigates any tactical initiatives required.
- The **Group Stress Testing Committee** is responsible for reviewing, challenging and recommending to Group Executive Committee the annual stress testing of the Group's operating plan based on internal and FSA recommended scenarios, annual European Banking Authority stress tests, and other group wide macroeconomic stress tests.
- The **Group Product Governance Committee** provides strategic and senior oversight over design, launch and management of products, including new product approval, annual product reviews and management of risk in the back book.
- The **Group Risk Committee** reviews and recommends the Group's risk appetite and governance, risk and control frameworks, high-level group policies and the allocation of risk appetite. The Group Risk Committee regularly reviews risk exposures and risk / reward returns. It is also responsible for the approval of material risk models and the establishment of the risk model governance framework.

During 2011, the Group's risk committee framework has been reviewed in order to ensure more effective risk management, clearer accountabilities, and more efficient and simplified processes. A new risk committee framework has been implemented, whereby the Group Risk Committee is supported by the following Committees:

- **Credit Risk Committees**, which are responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of high-level Group credit policy, and compliance with regulatory credit requirements. Risk Committees monitor and review the Group's aggregate credit risk exposures and concentrations of risk on behalf of the Group Risk Committee.
- The **Group Market Risk Committee**, which on behalf of the Group Asset and Liability Committee, monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
- The **Insurance Risk Committee** monitors, reviews and makes recommendations on the risk management framework, risk strategy and appetite for the Insurance business, ensuring that the policy and oversight framework for insurance risk management is appropriate. The committee reviews and challenges relevant insurance reporting

and issues arising, including: the Group's aggregate portfolio of insurance risk against approved plans and risk appetite and the need and opportunity for effecting insurance risk mitigation.

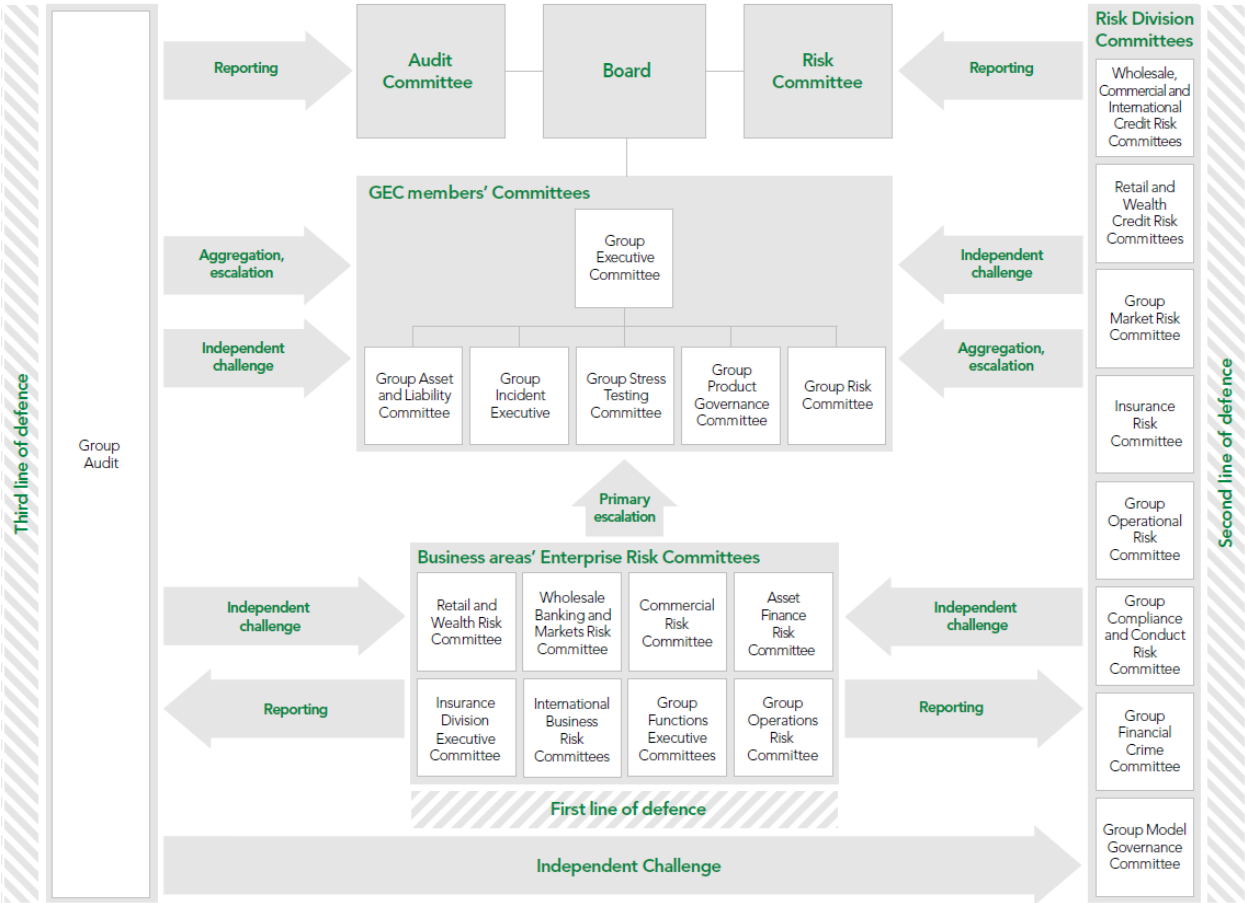
- The **Group Operational Risk Committee**, which is responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The Committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group's operational risk management framework.

- The **Group Compliance and Conduct Risk Committee** is responsible for forming a group wide view of the Group's compliance and conduct risk profile, reviewing the effectiveness of compliance and conduct risk frameworks and reviewing relevant polices and engagement with regulators.

- The **Group Financial Crime Committee** serves as the principal Group forum for reviewing and challenging the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The Committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.

The **Model Governance Committee** is responsible for monitoring the framework and standards for model governance across the Group including oversight of the Internal Ratings Based roll-out plan and Internal Ratings Based coverage. It approves risk models other than a small number defined as highly material to the Group, which are approved by the Group Risk Committee.

Risk Governance Structures



Risk Division, headed by the Chief Risk Officer, consists of eleven Risk Directors and their specialist teams. These teams provide oversight and independent challenge to business management and support the senior executive and the Board with independent reporting on risks and opportunities. Risk Directors, responsible for each risk type, meet on a regular basis under the Chairmanship of the Chief Risk Officer to review and challenge the risk profile of the Group and to ensure that mitigating actions are appropriate.

Business Unit Managing Directors / Executives have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group's policies and are within the parameters set by the Board, Group Executive Committee and

Risk Division. Compliance with policies and parameters is overseen by the Risk Committee, the Group Risk Committee, the Group Asset and Liability Committee, and Risk Division, and independently challenged by Group Audit.

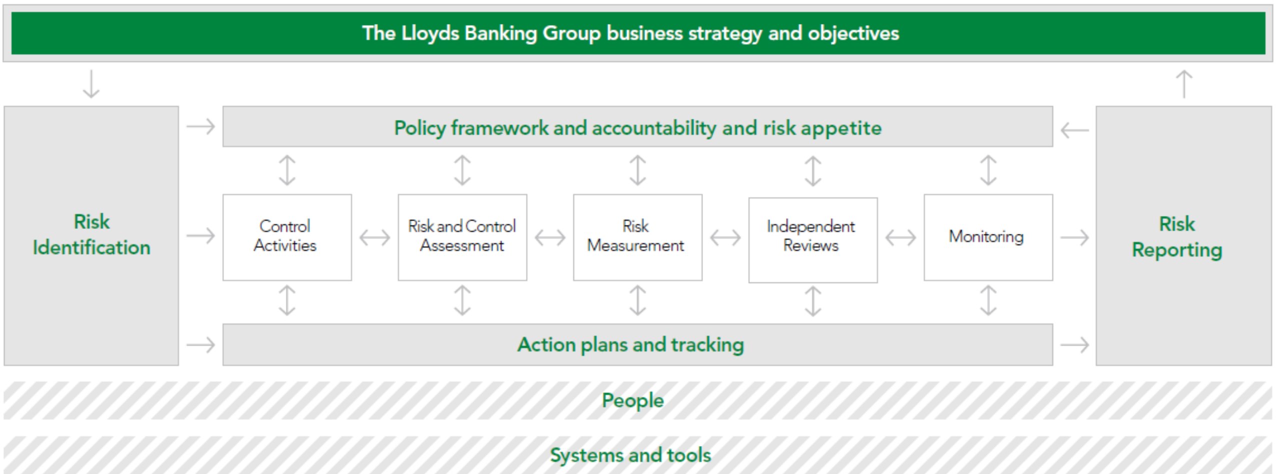
RISK MANAGEMENT OVERSIGHT

The Chief Risk Officer oversees and promotes the development and implementation of consistent group wide governance risk and control frameworks. The Chief Risk Officer, supported by the Risk Directors, provides objective challenge to the Group's senior management. The Group Executive Committee and the Board receive regular briefings and guidance from the Chief Risk Officer to ensure awareness of the overarching risk management framework and a clear understanding of their accountabilities for risk and internal control.

Risk Directors, who report directly to the Chief Risk Officer, are allocated responsibility for specific risk types and are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the risk profile across the Group. Risk Directors also support specific business areas to provide an enterprise-wide risk management perspective.

The Director of Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of Risk, seeking to ensure objective challenge to the effectiveness of the risk governance framework.

Risk Management Framework



RISK MANAGEMENT IN THE BUSINESS

Line management is directly accountable for the management of risks arising in their individual businesses. A key objective is to ensure that business decisions strike an appropriate balance between risk and reward, consistent with the Group's risk appetite.

All business areas complete a control effectiveness review annually, reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives of each business area and each Group Executive Committee member certify the accuracy of their assessment.

Risk management in the business forms part of a tiered risk management model, as shown on p.16, with Risk Division providing oversight and challenge, and the Chief Risk Officer and Group committees establishing the group wide perspective.

This approach provides the Group with an effective mechanism for developing and embedding risk policies and risk management strategies which are aligned with the risks faced by its businesses. It also seeks to facilitate effective communication on these matters across the Group.

RISK MANAGEMENT FRAMEWORK

The Group's risk management principles and framework cover all the types of risk which could impact on its banking and insurance businesses.

The Group uses an enterprise-wide risk management framework to maximise shareholder value over time by aligning risk management with the corporate strategy, assessing the impact of emerging risks, and developing tolerances and mitigating strategies. The framework ensures that policies and controls can be adapted to reflect adjustments to business strategy and risk appetite in response to changing market conditions.

The principal elements of the framework are shown in the table on p.17. These map to the components of the internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The **Lloyds Banking Group business strategy and objectives** are used to determine the Group's high level risk appetite and measures and metrics for the primary risk drivers (see table on p.19).

The risk appetite is proposed by the Group Chief Executive following review by the Group Risk Committee and Group Asset and Liability Committee, and is approved by the Board. The approved high level appetite and limits are delegated to the Group Chief Executive and then cascaded in consultation with the Group Risk Committee and Group Asset and Liability Committee to members of the Group Executive Committee and the business.

The risk appetite is executed through **Policy Framework and Accountabilities**, comprising the following levels of policy:

- Principles – Board-level statements of principle for the six primary risk drivers
- High-level Group policy – policy statements for the main risk types which align to each risk driver
- Detailed Group policy – more specific and detailed policy statements of Group policy
- Business Area policy – local policy which is produced by exception where a greater level of detail is needed by a business area than is appropriate for Group-level policy.

All policies are reviewed annually to ensure they remain fit for purpose.

During 2011, the Group's Policy Framework has been reviewed with a view to simplification, which will be implemented over the coming year.

Colleagues are expected to be aware of and to comply with the policies and procedures which apply to them and their work. Line management in each business area has primary responsibility for ensuring that they do so.

Risk Division oversees the effective implementation of policy, and Group Audit provides independent assurance to the Board about the effectiveness of the Group's internal control framework and adherence to policy.

Clear and consistent **risk identification** is undertaken using a common risk language to define and categorise risks (see table on p.19), also supporting risk aggregation and standardised reporting.

Proportionate **control activities** are in place mitigating or transferring risk where appropriate. **Risk and control assessments** including the annual control effectiveness review are undertaken assessing the effectiveness of mitigating actions and whether risk exposures are consistent with the Group's risk appetite.

The impact of risks and issues is determined through effective **risk measurement**, including modelling, stress testing and scenario analysis to assess financial, reputational and regulatory capital implications.

The outcomes of **independent reviews** (including internal and external audit and regulatory reviews) are reflected in risk management activities and action plans.

Monitoring processes are in place supporting the reporting and escalation of significant issues or losses to appropriate levels of management. Business areas monitor and report on their risk levels against risk appetite and their performance against relevant limits or policies.

Risk reporting is reviewed by the business executive sitting as a risk committee, to ensure that senior management is satisfied with the overall risk profile, risk accountabilities and progress on any necessary action plans and tracking. Information is provided to Risk Division for review and aggregation to feed into regular reporting on risk exposures and material issues.

At Group level a consolidated risk report and risk appetite dashboard are produced which are reviewed and debated by the Group Risk Committee, Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly assessment of the aggregate residual risk for the primary risk drivers, comparing the assessment with the previous periods and providing a forecast for the next twelve months and also provides an assessment of emerging risks, which could impact the Group over the next five years.

The overall effectiveness of the risk management framework depends on the **people** undertaking these activities and the quality of the supporting **systems and tools**. The risk transformation programme has initiated a significant investment in risk infrastructure to strengthen the Group's risk management capability.

PRINCIPAL RISKS AND UNCERTAINTIES

Details of the most significant risks faced by the Group, which are derived from the primary risk drivers and detailed risk types in the table below, are shown in the Risk Management section of the 2011 Lloyds Banking Group plc Annual Report and Accounts (pages 106 to 111).

RISK DRIVERS

The Group's risk language is designed to capture the Group's 'primary risk drivers'. A description of each 'primary risk driver' is included below. These are further sub-divided into 33 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in the table below.

Through the Group's risk management processes, these risks are assessed on an ongoing basis and seek to ensure optimisation of risk and reward and that, where required, appropriate mitigation is in place. Both quantitative and qualitative factors are considered in assessing the Group's current and potential future risks.

Risk Drivers

Primary risk drivers	Financial Soundness	Credit Risk	Market Risk	Operational Risk	Insurance Risk	Business Risk
Detailed risk types	Liquidity and funding Capital Financial and prudential regulatory reporting Disclosure Tax	Retail Wholesale Commercial Wealth and International	Basis risk Interest rate Foreign exchange Equity Credit spread	Regulatory Customer treatment People Supplier management Customer processes Financial crime Money laundering and sanctions Security IT systems Change Organisational Infrastructure	Mortality Longevity Morbidity Persistency Property Expenses Unemployment	Execution of strategy

Details on the Group's risk management processes in relation to credit risk, market risk and operational risk (the driver's of the Group's Pillar 1 capital requirement) and the management of capital resources are provided within these disclosures.

Further details on the Group's risk management processes in relation to business risk, insurance risk, liquidity and funding, financial and prudential regulatory reporting, disclosure and tax can be found in the Risk Management section of the 2011 Lloyds Banking Group plc Annual Report and Accounts (pages 112 to 170).

CAPITAL RESOURCES

CAPITAL RISK

Definition

Capital risk is defined as the risk of the Group having a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

Risk Appetite

Capital risk appetite is set by the Board and reported through various metrics that enable the Group to manage capital constraints and market expectations. The Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly reviews performance against risk appetite. A key metric is the Group's core tier 1 capital ratio which the Group currently aims to maintain prudently in excess of 10 per cent. This and other aspects of appetite will be kept under review in the light of further clarity of regulatory and accounting reforms.

Exposure

A capital exposure arises where the Group has insufficient regulatory capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures whilst optimising value for shareholders.

Measurement

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 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 Lloyds Banking Group, this means that the net assets of its life assurance and general insurance businesses and the non-financial entities that are held by the Group's private equity (including venture capital) businesses, are excluded from its total regulatory capital.

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 FSA requires the Group to hold sufficient regulatory capital to cover the Pillar 1 minimum of 8% of risk weighted assets and any additional requirement or buffer given to the Group by the FSA under Pillar 2 (more information is provided about Pillar 2 on p.28). In addition to the requirements for total regulatory 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.

The Group maintains its own buffer to ensure that the regulatory minimum requirements and regulatory targets and buffers are met at all times. Additionally an extensive series of stress analyses is undertaken during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements in severe economic conditions.

During the course of 2011 the EBA undertook two European wide exercises to assess the capital strength of the larger banks within the sector.

The first of these, in July 2011, sought to assess the resilience of European banks to severe shocks and their specific solvency in hypothetical stress events under certain restrictive conditions. The stress test was carried out based on common methodology and key common assumptions. The assumptions and methodology were established to assess banks' capital adequacy against a 5 per cent core tier 1 capital benchmark. As a result of the assumed shock the estimated consolidated core tier 1 ratio of the Group was 7.7 per cent at the worst point of the stress in 2012.

The second exercise, in December 2011, required banks to strengthen their capital position by building up temporary capital buffers against sovereign debt exposures to reflect market prices. In addition, it required banks to establish a buffer such that the core tier 1 ratio reaches a minimum level of 9 per cent by the end of June 2012. The Group's consolidated core tier 1 ratio from this exercise was 10.1 per cent.

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

- CRD 3 came into force on 31 December 2011 resulting in increased risk weighted assets for market and credit risk.
- The European Commission published a draft of the new Capital Requirements Directive and Regulation ('CRD 4') which will implement within the EU the so called 'Basel III' reforms for an enhanced global capital accord developed by the Basel Committee on Banking Supervision.
- Lloyds Banking Group was one of 29 banks identified by the Financial Stability Board as being of global systemic importance (G-SIFIs) and which will be subject to stronger capital adequacy requirements than Basel III. The list of G-SIFIs will be reviewed annually from a pool of around initially 70 institutions.
- In December the Government announced that it would implement the key recommendations of the UK's Independent Commission on Banking covering the ring-fencing of certain banking activities, 'bail-in' of senior unsecured debt, higher loss absorption capability and depositor preference.
- The Group is aware that there is currently a review of the endorsed ratings that may be used in Internal Ratings Based ('IRB') models and the Group is working on the assumption that no material changes to the Group's modelling approaches will result from the review.

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.

The impact of the reforms will gradually phase in as they are subject to a long transition period through to 2022. That allows time for the Group to further strengthen its capital position as necessary through business performance and mitigating actions.

Mitigation

The Group has developed procedures to ensure that compliance with both current and potential future requirements are understood and that policies are aligned to its risk appetite.

The Group is able to accumulate additional capital through profit retention, by raising equity via, for example, a rights issue or debt exchange and by raising tier 1 and tier 2 capital by issuing subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time.

The Group has in issue, as part of tier 2 capital resources, Enhanced Capital Notes which will convert to core tier 1 capital in the event that the Group's published core tier 1 ratio (as defined by the FSA in May 2009) falls below 5 per cent.

Additional measures which have been used to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises. Regulatory requirements are primarily controlled through the quality and volume of lending but are also affected through the modelling approaches used to determine risk weighted assets and expected losses.

In order to pay dividends, the Group's UK subsidiaries need to have distributable reserves. Whilst the group's direct subsidiary, Lloyds TSB Bank plc has distributable reserves, one of the Group's indirect principal subsidiaries, Bank of Scotland plc, does not and is currently unable to pay dividends. There is a risk that any profits earned by Bank of Scotland plc and its subsidiaries may be unable to be remitted to the Group holding company as dividends. This risk is mitigated by management who can elect to restructure the capital resources of a subsidiary entity.

Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's budgeting and planning processes. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those that would occur under stressed scenarios, is made to the Senior Asset and Liability Committee, the Group Asset and Liability Committee, the Group Risk Committee and the Board.

MOVEMENTS IN CAPITAL

Tier 1 Capital

Core tier 1 capital has decreased by £3,380m largely reflecting losses in the period. In addition there has been an increase in excess of expected losses over impairment losses, reflecting the reduction of legacy lending that is subject to very high provision levels and replacement with new lending.

Tier 2 Capital

Tier 2 capital has decreased in the period by £4,016m reflecting the increase in excess of expected losses over impairment, as noted above, and a reduction in eligible provisions. In addition, dated subordinated debt has also reduced in the period, partly due to amortisation and partly due to a capital restructuring exercise in December 2011, which resulted in a net overall redemption of dated subordinated debt.

Supervisory Deductions

Supervisory deductions mainly consist of investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These investments are primarily the Scottish Widows and Clerical Medical life and pensions businesses together with general insurance business. Also included within deductions for other unconsolidated investments are investments in non-financial entities that are held by the Group’s private equity (including venture capital) businesses. During the period there has been a decrease in supervisory deductions primarily due to reduced holdings in private equity businesses, and in some cases changes to the level and / or nature of investments resulting in a reclassification as material holdings.

The movements in core tier 1 and total capital in the year are shown below.

	Core Tier 1 £m	Total £m
At 1 January 2011	41,371	61,817
Loss attributable to ordinary shareholders	(2,787)	(2,787)
Decrease in regulatory post-retirement benefit adjustments	48	48
Decrease in goodwill and intangible assets deductions	80	80
Increase in excess of expected losses over impairment losses	(720)	(1,440)
Increase in material holdings deduction	-	(50)
Decrease in eligible provisions	-	(1,209)
Decrease in supervisory deductions from total capital	-	345
Decrease in dated subordinated debt	-	(1,938)
Other movements	(1)	130
At 31 December 2011	**37,991**	**54,996**

CAPITAL SECURITIES

Summary information on the terms and conditions attached to capital securities (subordinated liabilities and share capital) issued by the Group is presented on pages 284 to 292 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

The recognition, classification and valuation of these securities within the Group's regulatory capital resources are subject to the requirements of the relevant GENPRU provisions. This can lead to a different treatment from the IFRS accounting approach upon which the disclosures within the Annual Report and Accounts are based. For subordinated liabilities differences can arise in the treatment of fair value hedge accounting adjustments, accrued interest and regulatory requirements surrounding amortisation of dated securities. In addition, securities issued by the Group's insurance subsidiaries (primarily Scottish Widows plc and Clerical Medical Finance plc) are excluded from the regulatory capital resources of the banking group.

Following the implementation of the 'CRD 2' package of amendments to the Capital Requirements Directive, additional requirements surrounding hybrid capital securities were included in GENPRU. The principal changes arising out of these new requirements are that qualifying hybrid capital securities must display a greater degree of permanence and loss absorbency, have flexibility surrounding coupon or dividend payments and include the ability to write down or to convert into ordinary shares upon a trigger event. Where the requirements are satisfied, hybrid capital securities may be included within a firm's non-core tier 1 capital.

Existing non-core tier 1 securities that do not meet the new requirements surrounding hybrid capital securities can be recognised as such under the grandfathering provisions attached to the CRD 2 amendments. These provisions allow for the continued recognition of such securities within tier 1 capital over the next 29 years, subject to a reducing limit and adherence to the requirements of the provisions. GENPRU transitional provision TP 8A establishes these requirements within the UK. Future amendments to the Capital Requirements Directive as a result of the implementation of Basel III reforms are likely to result in further changes to the recognition and treatment of hybrid capital securities and related grandfathering provisions.

Under the CRD 2 grandfathering provisions, the Group has recognised its preference share capital and preferred securities as hybrid capital securities. Pages 285 and 286 of the 2011 Lloyds Banking Group plc Annual Report and Accounts provide details on the Group's preference share capital and preferred securities. These are included within the Group's non-core tier 1, subject to the regulatory adjustments required. Note that under the provisions of GENPRU TP 8.5, the 6.90% Perpetual Capital Securities (US$1,000 million) classed under preferred securities within the Annual Report and Accounts are recognised as perpetual non-cumulative preference shares for regulatory capital purposes.

All preferred securities included an incentive at issuance for the firm to redeem them, except for the 6.85% Non-cumulative Perpetual Preferred Securities (US$1,000 million) and the 6.90% Perpetual Capital Securities (US$1,000 million) noted above.

Details of the Group's tier 2 capital securities are provided on pages 287 to 289 of the 2011 Lloyds Banking Group plc Annual Report and Accounts. A list of those tier 2 capital securities disclosed that included an incentive at issuance for the firm to redeem them is provided below. Note that this excludes securities issued by insurance subsidiaries.

Undated subordinated liabilities with an incentive for the firm to redeem them included at issuance [1]	Dated subordinated liabilities with an incentive for the firm to redeem them included at issuance [1]
• 6.625% Undated Subordinated Step-up Notes (£410 million)	• Subordinated Step-up Floating Rate Notes 2016 (£300 million)
• 5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	• Subordinated Step-up Floating Rate Notes 2016 (€500 million)
• 6.5% Undated Subordinated Step-up Notes callable 2019 (£270 million)	• Callable Floating Rate Subordinated Notes 2016 (€500 million)
• 8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	• Callable Floating Rate Subordinated Notes 2016 (€500 million)
• 6.5% Undated Subordinated Step-up Notes callable 2029 (£450 million)	• Subordinated Callable Notes 2016 (US$750 million)
• 6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	• Subordinated Callable Notes 2017 callable 2012 (€1,000 million)
• 5.625% Cum. Call. Fixed to Floating Rate Undated Sub. Notes callable 2019 (£500m)	• Subordinated Callable Notes 2017 callable 2012 (US$1,000 million)
• 4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	• Subordinated Callable Floating Rate Instruments 2017 callable 2012 (Aus$400m)
• Floating Rate Undated Subordinated Notes (€500 million)	• 6.75% Sub. Call. Fixed to Floating Rate Instruments 2017 callable 2012 (Aus$200m)
• 5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	• 5.109% Callable Fixed to Floating Rate Notes 2017 callable 2012 (Can$500 million)
• 5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	• 6.305% Sub. Call. Fixed to Floating Rate Notes 2017 callable 2012 (£500 million)
• 5.75% Undated Subordinated Step-up Notes (£600 million)	• 5.625% Sub. Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)
• 6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	• 4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)
• 7.5% Undated Subordinated Step-up Notes (£300 million)	• 6.9625% Call. Sub. Fixed to Floating Rate Notes 2020 callable 2015 (£750 million)
• 8.625% Perpetual Subordinated Notes (£200 million)	• 5.75% Subordinated Fixed to Floating Rate Notes 2025 callable 2020 (£350 million)
• Floating Rate Undated Subordinated Step-up Notes (€300 million)	• 4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)
• 10.25% Subordinated Undated Instruments (£100 million)	
• 5.75% Undated Subordinated Step-up Notes (£500 million)	
• 7.375% Subordinated Undated Instruments (£150 million)	

Notes

[1] The notes provided on p.287 and p.289 of the 2011 Lloyds Banking Group plc Annual Report and Accounts provide further details on the terms and conditions attached to these securities, including conditions imposed under the state aid restructuring plan, where relevant.

In addition to the above, there are two Enhanced Capital Notes ('ECNs') with an incentive for the firm to redeem them included at issuance. These are the 8% Fixed to Floating Rate Undated Enhanced Capital Notes callable 2020 (US$1,259 million) and the 8.5% Undated Enhanced Capital Notes callable 2021 (US$277 million). Further details on Enhanced Capital Notes can found on p.288 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

LLOYDS BANKING GROUP CAPITAL RESOURCES

The capital resources of the Group as at 31 December 2011 are presented in the table below.

		2011		2010
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		45,920		46,061
Non-controlling interests per balance sheet		674		841
Regulatory adjustments to non controlling interests		(577)		(524)
Regulatory adjustments:				
Adjustment for own credit		(136)		(8)
Defined benefit pension adjustment		(1,004)		(1,052)
Unrealised reserve on AFS debt securities		(940)		747
Unrealised reserve on AFS equity investments		(386)		(462)
Cash flow hedging reserve		(325)		391
Regulatory prudent valuation adjustments		(32)		-
Other items		(4)		(3)
		43,190		45,991
Less: deductions from core tier 1				
Goodwill		(2,016)		(2,016)
Intangible assets		(2,310)		(2,390)
50% excess of expected losses over impairment		(720)		-
50% of securitisation positions		(153)		(214)
Core tier 1 capital		37,991		41,371
Non-controlling preference shares [1]		1,613		1,507
Preferred securities [1]		4,487		4,338
Less: deductions from tier 1				
50% of material holdings		(94)		(69)
Total tier 1 capital		43,997		47,147
Total tier 1 capital (excluding preferred securities) [2]	*39,510*		*42,809*	
Tier 2				
Undated subordinated debt		1,859		1,968
Dated subordinated debt		21,229		23,167
Unrealised gains on available for sale equity investments		386		462
Eligible provisions		1,259		2,468
Less: deductions from tier 2				
50% excess of expected losses over impairment		(720)		-
50% of securitisation positions		(153)		(214)
50% of material holdings		(94)		(69)
Total tier 2 capital		23,766		27,782
Total tier 2 capital (including preferred securities) [2]	*28,253*		*32,120*	
Supervisory deductions				
Unconsolidated investments – life		(10,107)		(10,042)
Unconsolidated investments – general insurance and other		(2,660)		(3,070)
Total supervisory deductions		(12,767)		(13,112)
Total Capital Resources		54,996		61,817
Risk Weighted Assets		352,341		406,372
Core tier 1 ratio (%)		10.8%		10.2%
Tier 1 capital ratio (%)		12.5%		11.6%
Total capital ratio (%)		15.6%		15.2%

Notes

[1] Non-controlling preference shares and preferred securities represent the Group's hybrid capital instruments. These are included within tier 1 capital in accordance with grandfathering provisions issued by the FSA (GENPRU TP 8A).

[2] The disclosure of tier 1 capital excluding innovative tier 1 instruments (preferred securities) and tier 2 capital including innovative tier 1 instruments (preferred securities) has been produced to meet the disclosure requirements of BIPRU Chapter 11. The ordinary presentation of preferred securities within tier 1 capital has been maintained in the second and fourth columns as this reflects the disclosure adopted within the 2011 Lloyds Banking Group plc Annual Report and Accounts and the prescribed treatment under GENPRU. Both the application of regulatory restrictions (capital resources gearing rules) and the calculation of capital ratios assume the ordinary treatment of preferred securities.

CAPITAL REQUIREMENTS

LLOYDS BANKING GROUP RISK WEIGHTED ASSETS AND PILLAR 1 CAPITAL REQUIREMENTS

The risk weighted assets and Pillar 1 capital requirements of the Group as at 31 December 2011 are presented in the table below. Notes in relation to the references below can be found on p.26.

(All figures are in £m)	2011 Risk Weighted Assets	2011 Pillar 1 Capital Requirements	2010 Risk Weighted Assets	2010 Pillar 1 Capital Requirements
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	60,405	4,832	74,720	5,978
Corporate - SME	15,168	1,213	20,285	1,623
Corporate - Specialised lending	6,683	535	7,428	594
Central governments and central banks	1,299	104	1,290	103
Institutions	2,426	194	4,371	350
Retail IRB Approach				
Retail - Residential mortgages	58,926	4,714	60,950	4,876
Retail - Qualifying revolving retail exposures	19,112	1,529	24,765	1,981
Retail - Other retail	18,479	1,478	17,690	1,415
Retail - SME	2,306	184	2,069	166
Other IRB Approaches [1]				
Corporate - Specialised lending	4,469	358	6,397	512
Equities - Exchange traded	-	-	179	14
Equities - Private equity	-	-	3,217	257
Equities - Other	57	5	2,133	171
Securitisation positions [2]	9,376	750	8,954	716
Total - IRB Approach	198,706	15,896	234,448	18,756
Exposures subject to the Standardised Approach				
Central governments and central banks	57	5	60	5
Regional governments or local authorities	8	1	14	1
Administrative bodies and non-commercial undertakings	361	29	294	24
Multilateral development banks	-	-	-	-
Institutions	399	32	292	23
Corporates	33,478	2,678	40,965	3,277
Retail	6,030	482	7,560	604
Secured on real estate property	31,473	2,518	35,582	2,847
Past due items	9,907	792	15,286	1,223
Items belonging to regulatory high risk categories	3,603	288	236	19
Securitisation positions	-	-	28	2
Short term claims on institutions or corporates	451	36	824	66
Collective investment undertakings	24	2	10	1
Other items [3]	17,734	1,419	23,341	1,867
Total - Standardised Approach	103,525	8,282	124,492	9,959
Total Credit Risk	302,231	24,178	358,940	28,715
COUNTERPARTY CREDIT RISK				
IRB Approach	6,170	494	5,207	417
Standardised Approach	6,474	518	6,358	508
Total Counterparty Credit Risk	12,644	1,012	11,565	925
MARKET RISK				
Internal Models Approach	5,096	408	2,494	200
Standardised Approach				
Interest rate position risk requirement	1,717	137	1,657	133
Foreign currency position risk requirement	40	3	61	5
Commodity position risk requirement	6	-	5	-
Specific interest rate risk of securitisation positions	18	2	-	-
Total Market Risk	6,877	550	4,217	338
OPERATIONAL RISK				
Standardised Approach	30,589	2,447	31,650	2,532
Total Operational Risk	30,589	2,447	31,650	2,532
TOTAL	352,341	28,187	406,372	32,510

DIVISIONAL RISK WEIGHTED ASSETS

The risk weighted assets of the Divisions as at 31 December 2011 are presented in the table below.

(All figures are in £m)	2011 Retail	2011 Wholesale	2011 Commercial	2011 Wealth & International	2011 Group Ops & Central Items	2011 TOTAL
CREDIT RISK						
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	-	56,413	1,590	2,311	91	60,405
Corporate - SME	-	6,823	8,345	-	-	15,168
Corporate - Specialised lending	-	5,767	882	34	-	6,683
Central governments and central banks	-	590	-	-	709	1,299
Institutions	-	2,406	-	20	-	2,426
Retail IRB Approach						
Retail - Residential mortgages	47,705	110	2,963	8,133	15	58,926
Retail - Qualifying revolving retail exposures	19,112	-	-	-	-	19,112
Retail - Other retail	15,322	3,157	-	-	-	18,479
Retail - SME	-	-	2,306	-	-	2,306
Other IRB Approaches [1]						
Corporate - Specialised lending	-	4,267	-	202	-	4,469
Equities - Exchange traded	-	-	-	-	-	-
Equities - Private equity	-	-	-	-	-	-
Equities - Other	-	-	-	-	57	57
Securitisation positions [2]	-	9,275	101	-	-	9,376
Total - IRB Approach	82,139	88,808	16,187	10,700	872	198,706
Exposures subject to the Standardised Approach						
Central governments and central banks	-	-	-	57	-	57
Regional governments or local authorities	-	5	-	3	-	8
Administrative bodies and non-commercial undertakings	-	354	3	4	-	361
Multilateral development banks	-	-	-	-	-	-
Institutions	84	67	-	132	116	399
Corporates	34	16,864	3,700	11,196	1,684	33,478
Retail	1,147	222	1,082	3,579	-	6,030
Secured on real estate property	2,553	16,711	1,701	10,508	-	31,473
Past due items	836	2,787	108	6,176	-	9,907
Items belonging to regulatory high risk categories	-	3,552	-	51	-	3,603
Securitisation positions	-	-	-	-	-	-
Short term claims on institutions or corporates	-	429	22	-	-	451
Collective investment undertakings	8	-	-	16		24
Other items [3]	981	5,496	68	1,235	9,954	17,734
Total - Standardised Approach	5,643	46,487	6,684	32,957	11,754	103,525
Total Credit Risk	87,782	135,295	22,871	43,657	12,626	302,231
COUNTERPARTY CREDIT RISK						
IRB Approach	68	6,102	-	-	-	6,170
Standardised Approach	-	5,822	-	652	-	6,474
Total Counterparty Credit Risk	68	11,924	-	652	-	12,644
MARKET RISK						
Internal Models Approach	-	5,096	-	-	-	5,096
Standardised Approach						
Interest rate position risk requirement	-	1,691	26	-	-	1,717
Foreign currency position risk requirement	-	38	-	2	-	40
Commodity position risk requirement	-	6	-	-	-	6
Specific interest rate risk of securitisation positions	-	18	-	-	-	18
Total Market Risk	-	6,849	26	2	-	6,877
OPERATIONAL RISK						
Standardised Approach	15,387	9,698	2,537	2,967	-	30,589
Total Operational Risk	15,387	9,698	2,537	2,967	-	30,589
TOTAL	103,237	163,766	25,434	47,278	12,626	352,341

Notes

[1] Credit risk exposures subject to other IRB approaches include corporate specialised lending exposures risk weighted in accordance with supervisory slotting criteria, equity exposures risk weighted in accordance with the Simple Risk Weight Method and securitisation positions risk weighted in accordance with the Internal Assessment Approach, Ratings Based Approach or Supervisory Formula Approach.

[2] Securitisation positions exclude amounts allocated to the 1,250% risk weight category. These amounts are deducted from capital, after the application of value adjustments, rather than being risk weighted at 1,250%.

[3] Other items (Standardised Approach) predominantly relate to other balance sheet assets that have no associated credit risk. These comprise various non-financial assets, including fixed assets, cash, items in the course of collection, prepayments, sundry debtors and deferred tax assets.

(All figures are in £m)	2010 Retail	2010 Wholesale	2010 Commercial	2010 Wealth & International	2010 Group Ops & Central Items	2010 TOTAL
CREDIT RISK						
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	-	70,161	1,639	2,682	238	74,720
Corporate - SME	-	9,747	10,499	39	-	20,285
Corporate - Specialised lending	-	6,440	955	33	-	7,428
Central governments and central banks	-	519	2	50	719	1,290
Institutions	-	4,351	-	20	-	4,371
Retail IRB Approach						
Retail - Residential mortgages	49,732	802	3,039	7,325	52	60,950
Retail - Qualifying revolving retail exposures	24,765	-	-	-	-	24,765
Retail - Other retail	13,077	4,543	-	70	-	17,690
Retail - SME	-	-	2,069	-	-	2,069
Other IRB Approaches [1]						
Corporate - Specialised lending	-	5,847	-	550	-	6,397
Equities - Exchange traded	-	179	-	-	-	179
Equities - Private equity	-	3,217	-	-	-	3,217
Equities - Other	-	2,133	-	-	-	2,133
Securitisation positions [2]	-	8,782	172	-	-	8,954
Total - IRB Approach	87,574	116,721	18,375	10,769	1,009	234,448
Exposures subject to the Standardised Approach						
Central governments and central banks	-	-	-	60	-	60
Regional governments or local authorities	-	7	2	5	-	14
Administrative bodies and non-commercial undertakings	-	263	17	14	-	294
Multilateral development banks	-	-	-	-	-	-
Institutions	-	74	-	116	102	292
Corporates	133	22,967	2,676	13,707	1,482	40,965
Retail	1,099	724	1,027	4,710	-	7,560
Secured on real estate property	2,105	18,898	1,927	12,652	-	35,582
Past due items	1,484	3,614	262	9,926	-	15,286
Items belonging to regulatory high risk categories	-	170	-	66	-	236
Securitisation positions	-	-	-	28	-	28
Short term claims on institutions or corporates	-	587	220	17	-	824
Collective investment undertakings	-	-	-	10	-	10
Other items [3]	885	7,788	116	1,457	13,095	23,341
Total - Standardised Approach	5,706	55,092	6,247	42,768	14,679	124,492
Total Credit Risk	93,280	171,813	24,622	53,537	15,688	358,940
COUNTERPARTY CREDIT RISK						
IRB Approach	-	5,207	-	-	-	5,207
Standardised Approach	-	6,355	-	3	-	6,358
Total Counterparty Credit Risk	-	11,562	-	3	-	11,565
MARKET RISK						
Internal Models Approach	-	2,494	-	-	-	2,494
Standardised Approach						
Interest rate position risk requirement	-	1,628	29	-	-	1,657
Foreign currency position risk requirement	-	61	-	-	-	61
Commodity position risk requirement	-	5	-	-	-	5
Specific interest rate risk of securitisation positions	-	-	-	-	-	-
Total Market Risk	-	4,188	29	-	-	4,217
OPERATIONAL RISK						
Standardised Approach	15,974	8,601	1,901	5,174	-	31,650
Total Operational Risk	15,974	8,601	1,901	5,174	-	31,650
TOTAL	109,254	196,164	26,552	58,714	15,688	406,372

Notes

[1] Credit risk exposures subject to other IRB approaches include corporate specialised lending exposures risk weighted in accordance with supervisory slotting criteria, equity exposures risk weighted in accordance with the Simple Risk Weight Method and securitisation positions risk weighted in accordance with the Internal Assessment Approach, Ratings Based Approach or Supervisory Formula Approach.

[2] Securitisation positions exclude amounts allocated to the 1,250% risk weight category. These amounts are deducted from capital, after the application of value adjustments, rather than being risk weighted at 1,250%.

[3] Other items (Standardised Approach) predominantly relate to other balance sheet assets that have no associated credit risk. These comprise various non-financial assets, including fixed assets, cash, items in the course of collection, prepayments, sundry debtors and deferred tax assets.

LLOYDS BANKING GROUP PILLAR 2 CAPITAL REQUIREMENT

The Capital Resources Requirement ('CRR') is 8 per cent of risk weighted assets and represents the total capital required under Pillar 1 of the Basel II Framework.

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 bank specific Individual Capital Guidance ('ICG'). A key input into the FSA's ICG setting process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process ('ICAAP'). The Group has been given an ICG by the FSA and maintains capital at a level which exceeds this requirement. The FSA has made it clear that each ICG remains a confidential matter between a bank and the FSA.

The LBG ICAAP supplements the Pillar 1 capital requirements for Credit Risk, Operational Risk and Market Risk (Trading Book) by assessments of the material risks not fully captured under Pillar 1. This not only has the advantage of consistency with Pillar 1 but also allows the Group to leverage the considerable investment it has made in developing the component Pillar 1 models. This includes a detailed internal review of the models, their embedding in business use and an external review of these models by the FSA.

Some of the key risks assessed within the ICAAP include:

Risks not fully captured under Pillar 1

- Concentration Risk – greater loss volatility arising from a higher level of loan default correlation than is assumed by the Pillar 1 assessment.

- Underestimation Risk – where it is considered that the Pillar 1 capital assessment underestimates the risk as a result of factors other than loan default correlation.

Risks not covered by Pillar 1

- Pension Obligation Risk - the potential for additional unplanned costs that the Group would incur in the event of a significant deterioration in the funding position of the Group's defined benefit pension schemes.

- Interest Rate Risk in the Banking Book - the potential losses in the non-trading book resulting from interest rate changes or widening of the spread between Bank Base Rate and LIBOR rates.

As part of the capital planning process, forecast capital positions are subjected to an extensive stress analysis to determine the adequacy of the Group's capital resources against the minimum requirements including ICG over the forecast period. The output from these stress analyses is used, in conjunction with discussions with the FSA, to determine the appropriate level of capital buffers, over and above the minimum regulatory requirements, that should be maintained now as mitigation against potential future periods of stress.

The detailed ICAAP document is subject to a robust review process, approved by the LBG Board and submitted to the FSA.

CREDIT RISK

DEFINITION

The risk of reductions in earnings and / or value, through financial or reputational loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

RISK APPETITE

Credit risk appetite is set at Board level and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio performance measures, which include the use of various credit risk rating systems as inputs. These metrics are supported by more detailed appetite metrics at Divisional and business level and by a comprehensive suite of policies, sector caps, product and country limits to manage concentration risk and exposures within the Group's approved risk appetite.

This statement of the Group's overall appetite for credit risk is reviewed and approved annually. With the support of the Group Risk Committee, the Group Chief Executive allocates this risk appetite across the Group.

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions, sovereigns and corporate clients. Credit risk exposures are categorised as 'retail', arising primarily in the Retail and Wealth and International Divisions, 'commercial' and 'corporate', 'financial institutions' or 'sovereigns' arising in the Wholesale, Commercial and Wealth and International Divisions.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially also exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail term commitments to extend credit can be cancelled without notice and the creditworthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are monitored regularly.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers. A significant proportion of the investments are held in unit-linked and with-profits funds where the shareholder risk is limited, subject to any guarantees given.

Under the Basel II Framework credit risk exposures are classified into broad categories, as defined under the IRB Approach and Standardised Approach exposure categorisations of the Framework. The methodology used for assigning exposures to different categories ('exposure classes') is consistently applied to all new exposures arising.

The IRB exposure classes applying to the business are described below. Exposures allocated to the equivalent Standardised exposure classes follow similar definitions.

Corporate Exposures - General

In general, this relates to exposures generated through lending and corporate financing activities in respect of servicing the needs of corporate and commercial clients ('Main') and small and medium enterprises ('SME'). Exposures also arise in relation to business conducted through specialised lending.

Corporate Exposures – Specialised Lending

The FSA requires that specialised lending exposures arising through the Group's business streams are separately identified from general corporate exposures.

There are four sub-classes of specialised lending recognised by the FSA. These are project finance, object finance, commodities finance and income-producing real estate ('IPRE'). Each of these sub-classes is defined under the Basel II Framework.

Specialised lending exposures are those possessing all the following characteristics, either in legal form or economic substance:

- the exposure is typically to an entity – often a special purpose entity ('SPE') which was created specifically to finance and / or operate physical assets;

- the borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;
- the terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates; and
- as a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.

The Group's specialised lending exposures predominantly comprise property investment and development portfolios (IPRE), major asset financing transactions such as shipping, trains and aircraft (object finance) and energy and infrastructure financing transactions (project finance).

Retail Exposures

The following exposures are generally considered to be retail exposures under the Basel II Framework:

- Retail exposures secured by real estate collateral (i.e. residential mortgages)
- Qualifying revolving retail exposures (i.e. overdrafts and credit cards)
- Exposures to retail SMEs (i.e. retail business banking)
- Other retail exposures (i.e. unsecured personal lending)

Retail SME exposures relate to the provision of business banking to sole traders, small partnerships and small businesses that do not meet the regulatory threshold for recognition as corporate SME exposures and which are generally managed as retail exposures within Retail business streams.

Exposures to Central Governments and Central Banks

Exposures to central governments and central banks are also referred to as sovereign exposures. Certain public sector entities and Multilateral Development Banks are also included within this exposure class where they meet the relevant criteria under the BIPRU provisions.

Exposures to Institutions

This relates to exposures to other banking and financial institutions. It also includes exposures to certain domestic public sector entities and Multilateral Development Banks that do not meet the criteria for recognition as exposures to central governments and central banks, but are considered to be equivalent to an exposure to an institution.

Equity Exposures

An equity interest, held either directly or indirectly, in a corporate undertaking that does not form part of the Group is considered to be an equity exposure if it meets certain additional criteria including the requirement to be irredeemable and provide entitlement to the Group to have a residual claim on the assets of the third party. Additionally, debt claims designed to mimic the features of equity interest (e.g. interest payments linked to dividends or profits) will be treated as equity exposures to capture the true economic risk of that exposure.

Securitisation Positions

Securitisation positions are defined and explained within the Securitisations section of the document.

MEASUREMENT

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the ‘probability of default’ by the counterparty on its contractual obligations; (ii) 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’).

For regulatory capital purposes the Group’s rating systems assess probability of default and if permitted, exposure at default and loss given default, in order to derive an expected loss. If not permitted, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Lloyds Banking Group models, is delegated to the Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a Retail Master Scale and a Wholesale Master Scale.

The quality definition of both retail and non-retail counterparties / exposures is largely based on the outcomes of credit risk (probability of default – PD) models. The Group operates a significant number of different rating models, typically developed internally using statistical analysis and may use management judgement – retail models rely more on the former; non-retail models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data in model development, where appropriate.

The models vary, inter alia, in the extent to which they are Point-in-Time versus Through-the-Cycle. The models are subject to rigorous validation and oversight / governance, including where appropriate, benchmarking to external information.

In non-retail portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties / exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' to a (non-retail) master scale which enables the consolidation of credit risk information, and it is this that forms the basis for the IFRS credit quality characterisation.

In retail, for reporting purposes, counterparties are also segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes.

The nature, construction and calibration of retail and non-retail models are very different and so too are their respective master scales (not least in their graduality). The distribution of probabilities of default is also different, which precludes reportage on a single consolidated basis.

MONITORING

In conjunction with Risk, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Risk Division in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the Group Risk Committee and the Board Risk Committee.

The performance of all rating models is monitored on a regular basis, in order to seek to ensure that models provide appropriate risk differentiation capability, the generated ratings remain as accurate and robust as practical, and the models assign appropriate risk estimates to grades / pools. All models are monitored against a series of agreed key performance indicators. In the event that the monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated in accordance with the governance framework set by the Model Governance Committee.

CREDIT RISK EXPOSURE: ANALYSIS BY EXPOSURE CLASS

As at 31 December 2011 the total credit risk exposures of the Group amounted to £807.6bn (2010: £878.5bn).

Credit risk exposures by exposure class are provided in the table below, together with the associated RWA, average risk weight and average credit risk exposure.

Exposure Class	2011 Credit Risk Exposure £m	2011 Risk Weighted Assets £m	2011 Average Risk Weight %	2011 Average Credit Risk Exposure [4] £m
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	100,796	60,405	60%	100,190
Corporate - SME	23,162	15,168	65%	25,631
Corporate - Specialised lending	8,028	6,683	83%	8,351
Central governments and central banks	17,714	1,299	7%	13,766
Institutions	11,892	2,426	20%	16,456
Retail IRB Approach				
Retail - Residential mortgages	361,121	58,926	16%	365,115
Retail - Qualifying revolving retail exposures	38,614	19,112	49%	40,449
Retail - Other retail	16,642	18,479	111%	18,366
Retail - SME	2,642	2,306	87%	2,593
Other IRB Approaches [1]				
Corporate - Specialised lending	5,961	4,469	75%	6,006
Equities - Exchange traded	-	-	-	-
Equities - Private equity	-	-	-	-
Equities - Other	15	57	370%	8
Securitisation positions [2]	31,027	9,376	30%	36,112
Total - IRB Approach	617,614	198,706	32%	633,043
Exposures subject to the Standardised Approach				
Central governments and central banks	72,442	57	0%	71,471
Regional governments or local authorities	41	8	20%	53
Administrative bodies and non-commercial undertakings	371	361	97%	360
Multilateral development banks	83	-	-	28
Institutions	1,177	399	34%	1,163
Corporates	34,805	33,478	96%	38,823
Retail	8,032	6,030	75%	10,013
Secured on real estate property	38,037	31,473	83%	40,729
Past due items	8,678	9,907	114%	13,195
Items belonging to regulatory high risk categories	2,433	3,603	148%	2,367
Securitisation positions	-	-	-	9
Short term claims on institutions or corporates	456	451	99%	976
Collective investment undertakings	113	24	21%	77
Other items [3]	23,330	17,734	76%	25,764
Total - Standardised Approach	189,998	103,525	54%	205,028
TOTAL	807,612	302,231	37%	838,071

Notes

[1] Credit risk exposures subject to other IRB approaches include corporate specialised lending exposures risk weighted in accordance with supervisory slotting criteria, equity exposures risk weighted in accordance with the Simple Risk Weight Method and securitisation positions risk weighted in accordance with the Internal Assessment Approach, Ratings Based Approach or Supervisory Formula Approach.

[2] Securitisation positions exclude amounts allocated to the 1,250% risk weight category. These amounts are deducted from capital, after the application of value adjustments, rather than being risk weighted at 1,250%.

[3] Other items (Standardised Approach) predominantly relate to other balance sheet assets that have no associated credit risk. These comprise various non-financial assets, including fixed assets, cash, items in the course of collection, prepayments, sundry debtors and deferred tax assets.

[4] Average credit risk exposure represents the average exposure across the year to 31 December.

Key Movements

- Foundation IRB corporate and institutions exposures reduced during the year, primarily reflecting further deleveraging by customers, the continued active de-risking of the non-core balance sheet and a reduction in loans and advances to banks. Loans and advances to corporate customers reduced significantly as demand for new corporate lending and refinancing of existing facilities was more than offset by maturities, reflecting a continued trend of subdued corporate demand for lending, customer deleveraging and asset sales in non-core sectors. Foundation IRB RWAs reduced overall as a result of both the reduction in exposures and the impact of changes in risk profile. Average risk weights for corporate main and corporate SME exposures reduced from 69% and 74% to 60% and 65% respectively, reflecting both risk profile changes and a reduction in non-core assets that typically carried a higher risk weighting.

- Corporate specialised lending exposures subject to the IRB Supervisory Slotting Approach reduced significantly during the year following the transition of the remaining Irish property development portfolio to the Standardised Approach. As a result, the average risk weight of the remaining portfolios subject to the Slotting Approach has increased from 51% to 75%, reflecting the absence of the dilutive effect caused by the defaulted Irish property development portfolio exposures (which were assigned a risk weight of 0% under the approach). Average credit risk exposures have been adjusted to reflect the transition of the portfolio to the Standardised Approach.

Notes in relation to the references below can be found on p.32.

Exposure Class	2010 Credit Risk Exposure £m	2010 Risk Weighted Assets £m	2010 Average Risk Weight %	2010 Average Credit Risk Exposure [4] £m
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	108,074	74,720	69%	114,049
Corporate - SME	27,528	20,285	74%	25,815
Corporate - Specialised lending	8,737	7,428	85%	8,810
Central governments and central banks	22,920	1,290	6%	27,670
Institutions	23,927	4,371	18%	27,029
Retail IRB Approach				
Retail - Residential mortgages	369,473	60,950	16%	368,778
Retail - Qualifying revolving retail exposures	43,049	24,765	58%	44,213
Retail - Other retail	20,550	17,690	86%	23,125
Retail - SME	2,249	2,069	92%	2,869
Other IRB Approaches [1]				
Corporate - Specialised lending	12,539	6,397	51%	11,989
Equities - Exchange traded	62	179	290%	103
Equities - Private equity	1,693	3,217	190%	1,514
Equities - Other	576	2,133	370%	589
Securitisation positions [2]	56,392	8,954	16%	60,934
Total - IRB Approach	697,769	234,448	34%	717,487
Exposures subject to the Standardised Approach				
Central governments and central banks	40,168	60	0%	45,687
Regional governments or local authorities	65	14	22%	73
Administrative bodies and non-commercial undertakings	347	294	85%	353
Multilateral development banks	-	-	-	-
Institutions	825	292	35%	709
Corporates	44,386	40,965	92%	49,537
Retail	10,103	7,560	75%	10,268
Secured on real estate property	42,925	35,582	83%	45,167
Past due items	12,641	15,286	121%	12,403
Items belonging to regulatory high risk categories	170	236	139%	1,420
Securitisation positions	8	28	350%	124
Short term claims on institutions or corporates	901	824	91%	758
Collective investment undertakings	40	10	25%	59
Other items [3]	28,154	23,341	83%	30,843
Total - Standardised Approach	180,733	124,492	69%	197,401
TOTAL	878,502	358,940	41%	914,888

Key Movements – cont.

- Equity exposures previously subject to the IRB Simple Risk Weight Method were transitioned to the Standardised Approach during the year following finalisation of the Group's integrated IRB waiver permission. Amounts remaining subject to the Simple Risk Weight Method relate to the Group's exposure to the Business Growth Fund plc. Average credit risk exposures have been adjusted to reflect the transition of the relevant equity exposures to the Standardised Approach.

- Securitisation positions subject to the IRB Approach reduced markedly during the year as a result of major disposal programmes, sell downs and the non-replenishment of holdings after amortisations or maturities. The increase in average risk weight from 16% to 30% primarily reflects the impact of higher risk weights applied to re-securitisation positions following the implementation of CRD 3 requirements.

- Retail IRB exposures reduced during the year following a reduction in loans and advances to customers, primarily as a result of subdued customer demand for new credit, existing customers continuing to reduce their personal indebtedness, non-core lending run off and Retail Division maintaining a conservative approach to risk. Related RWAs reduced overall as a result of both the reduction in exposure and the implementation of new credit cards models, as reflected in the average risk weight reduction for qualifying revolving retail exposures from 58% to 49%. The overall reduction in Retail IRB RWAs was partly mitigated by the increase in the other retail average risk weight from 86% to 111% - a result of the implementation of new, more conservative, personal loans models.

- The significant increase in exposures to central governments and central banks (Standardised Approach) reflects a combination of increased deposits with the Bank of England, further investment in UK Government securities and the transitioning of remaining EEA central bank exposures from the Foundation IRB Approach to the Standardised Approach.

- Standardised corporates, secured on real estate property and past due items exposures reduced during the year for reasons similar to those behind the reduction in Foundation IRB corporate exposures. Customer repayments and asset sales through Wholesale Division were the primary drivers. In addition, reductions in related portfolios within Wealth and International Division also contributed to the overall reduction as a result of the continued focus on de-risking the Wealth and International balance sheet and the impact of net repayments (including asset sales), additional impairment provisions and foreign exchange movements.

CREDIT RISK EXPOSURE: ANALYSIS BY DIVISION

An analysis of total credit risk exposures by Division is provided below.

Division	Risk Weight Approach	2011 Credit Risk Exposure £m	2010 Credit Risk Exposure £m
Retail	IRB	397,083	412,665
	Standardised	11,016	9,813
Wholesale	IRB	175,042	232,598
	Standardised	92,384	83,841
Commercial	IRB	26,695	26,229
	Standardised	7,177	6,247
Wealth & International	IRB	10,829	17,378
	Standardised	41,957	50,347
Group Ops & Central Items	IRB	7,965	8,899
	Standardised	37,464	30,485
Total		807,612	878,502

CREDIT RISK EXPOSURE: ANALYSIS BY INDUSTRY

Credit risk exposures as at 31 December 2011, analysed by major industrial sector, are provided in the table below.

(All figures are in £m)	2011 Agriculture, Forestry and Fishing	2011 Energy and Water Supply	2011 Manufacturing	2011 Construction	2011 Transport, Distribution and Hotels	2011 Postal and Comms	2011 Property Companies	2011 Financial, Business and Other Services	2011 Personal: Mortgages	2011 Personal: Other	2011 Lease Financing	2011 Hire Purchase	2011 TOTAL
Exposures subject to the IRB Approach													
Foundation IRB Approach													
Corporate - Main	356	2,293	13,552	5,137	14,798	2,455	16,533	41,731	-	126	3,211	604	100,796
Corporate - SME	956	13	1,736	1,315	3,210	361	8,819	6,509	-	10	16	217	23,162
Corporate - Specialised lending	7	-	-	153	66	-	7,036	766	-	-	-	-	8,028
Central governments and central banks	-	-	-	-	-	-	-	17,714	-	-	-	-	17,714
Institutions	-	30	-	-	-	-	-	11,141	-	-	721	-	11,892
Retail IRB Approach													
Retail - Residential mortgages	1,152	3	261	356	1,445	27	3,450	1,413	353,012	2	-	-	361,121
Retail - Qualifying revolving retail exposures	-	-	-	-	-	-	-	-	-	38,614	-	-	38,614
Retail - Other retail	-	-	-	-	-	-	-	-	-	13,247	-	3,395	16,642
Retail - SME	249	1	226	412	706	22	251	769	-	6	-	-	2,642
Other IRB Approaches													
Corporate - Specialised lending	-	834	60	208	1,840	10	438	1,724	-	-	847	-	5,961
Equities - Exchange traded	-	-	-	-	-	-	-	-	-	-	-	-	-
Equities - Private equity	-	-	-	-	-	-	-	-	-	-	-	-	-
Equities - Other	-	-	-	-	-	-	-	15	-	-	-	-	15
Securitisation positions	203	-	82	77	823	14	576	29,252	-	-	-	-	31,027
Total – IRB Approach	2,923	3,174	15,917	7,658	22,888	2,889	37,103	111,034	353,012	52,005	4,795	4,216	617,614
Exposures subject to the Standardised Approach													
Central governments and central banks	-	-	-	-	-	-	-	72,431	-	-	11	-	72,442
Regional governments or local authorities	-	-	-	-	-	-	-	8	-	-	15	18	41
Administrative bodies and non-commercial undertakings	-	1	-	-	-	-	-	353	-	-	12	5	371
Multilateral development banks	-	-	-	-	-	-	-	83	-	-	-	-	83
Institutions	-	-	-	-	-	-	-	1,177	-	-	-	-	1,177
Corporates	1,821	1,474	1,948	1,227	7,356	2,202	3,508	9,736	29	1,738	3,229	537	34,805
Retail	1,404	8	67	93	68	53	30	504	39	4,804	389	573	8,032
Secured on real estate property	3	-	34	177	526	23	18,024	1,834	17,360	56	-	-	38,037
Past due items	28	60	319	281	1,944	106	3,886	464	976	368	235	11	8,678
Items belonging to regulatory high risk categories	-	-	32	16	-	-	100	2,285	-	-	-	-	2,433
Securitisation positions	-	-	-	-	-	-	-	-	-	-	-	-	-
Short term claims on institutions or corporates	17	1	21	54	13	-	14	333	-	-	3	-	456
Collective investment undertakings	-	-	-	-	-	-	-	113	-	-	-	-	113
Total – Standardised Approach	3,273	1,544	2,421	1,848	9,907	2,384	25,562	89,321	18,404	6,966	3,894	1,144	166,668
Total	6,196	4,718	18,338	9,506	32,795	5,273	62,665	200,355	371,416	58,971	8,689	5,360	784,282
Other items													23,330
Total Credit Risk Exposure													807,612

(All figures are in £m)	2010 Agriculture, Forestry and Fishing	2010 Energy and Water Supply	2010 Manufacturing	2010 Construction	2010 Transport, Distribution and Hotels	2010 Postal and Comms	2010 Property Companies	2010 Financial, Business and Other Services	2010 Personal: Mortgages	2010 Personal: Other	2010 Lease Financing	2010 Hire Purchase	2010 TOTAL
Exposures subject to the IRB Approach													
Foundation IRB Approach													
Corporate - Main	644	2,492	12,680	6,940	15,302	1,658	16,989	47,870	271	-	2,710	518	108,074
Corporate - SME	857	11	2,063	1,464	4,285	368	10,212	7,274	27	-	637	330	27,528
Corporate - Specialised lending	19	-	-	187	75	-	7,679	777	-	-	-	-	8,737
Central governments and central banks	-	-	-	-	-	-	-	22,920	-	-	-	-	22,920
Institutions	-	-	-	-	-	-	18	23,419	-	-	490	-	23,927
Retail IRB Approach													
Retail - Residential mortgages	901	2	207	314	1,202	23	2,939	1,164	362,720	1	-	-	369,473
Retail - Qualifying revolving retail exposures	-	-	-	-	-	-	-	-	-	43,049	-	-	43,049
Retail - Other retail	1	-	1	1	6	1	1	6	-	15,793	2	4,738	20,550
Retail - SME	223	1	237	443	721	22	252	345	-	5	-	-	2,249
Other IRB Approaches													
Corporate - Specialised lending	1	722	89	594	2,375	45	5,850	2,015	-	-	848	-	12,539
Equities - Exchange traded	-	-	-	-	-	-	3	59	-	-	-	-	62
Equities - Private equity	-	-	-	-	-	-	73	1,620	-	-	-	-	1,693
Equities - Other	-	-	39	-	3	-	111	423	-	-	-	-	576
Securitisation positions	250	-	111	112	1,012	17	651	54,239	-	-	-	-	56,392
Total – IRB Approach	2,896	3,228	15,427	10,055	24,981	2,134	44,778	162,131	363,018	58,848	4,687	5,586	697,769
Exposures subject to the Standardised Approach													
Central governments and central banks	-	-	-	-	-	-	-	40,160	-	-	8	-	40,168
Regional governments or local authorities	-	-	-	-	-	-	-	43	-	-	22	-	65
Administrative bodies and non-commercial undertakings	-	67	-	-	-	-	-	267	-	-	12	1	347
Multilateral development banks	-	-	-	-	-	-	-	-	-	-	-	-	-
Institutions	-	-	-	-	-	-	16	808	-	-	1	-	825
Corporates	1,541	1,370	2,579	2,476	12,052	2,048	4,295	15,103	2	1,410	1,295	215	44,386
Retail	1,346	8	171	246	144	68	134	1,230	-	5,613	467	676	10,103
Secured on real estate property	4	-	67	384	632	27	24,317	1,444	15,204	1	751	94	42,925
Past due items	158	61	383	351	2,598	179	5,672	968	1,512	605	121	33	12,641
Items belonging to regulatory high risk categories	-	-	-	-	7	-	6	157	-	-	-	-	170
Securitisation positions	-	-	-	-	-	-	-	-	8	-	-	-	8
Short term claims on institutions or corporates	132	2	17	18	66	1	33	595	-	-	33	4	901
Collective investment undertakings	-	-	-	-	-	-	-	40	-	-	-	-	40
Total – Standardised Approach	3,181	1,508	3,217	3,475	15,499	2,323	34,473	60,815	16,726	7,629	2,710	1,023	152,579
Total	6,077	4,736	18,644	13,530	40,480	4,457	79,251	222,946	379,744	66,477	7,397	6,609	850,348
Other items													28,154
Total Credit Risk Exposure													878,502

CREDIT RISK EXPOSURE: ANALYSIS BY GEOGRAPHY

Credit risk exposures as at 31 December 2011, analysed by geographical area based on the country of residence of the customer, are provided in the table below.

(All figures are in £m)	2011 United Kingdom	2011 Rest of Europe	2011 United States of America	2011 Asia-Pacific	2011 Other	2011 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	74,491	12,314	10,743	778	2,470	100,796
Corporate - SME	22,865	168	50	-	79	23,162
Corporate - Specialised lending	6,390	1,100	89	47	402	8,028
Central governments and central banks	-	310	17,066	13	325	17,714
Institutions	3,509	2,539	4,445	1,016	383	11,892
Retail IRB Approach						
Retail - Residential mortgages	355,200	5,921	-	-	-	361,121
Retail - Qualifying revolving retail exposures	38,614	-	-	-	-	38,614
Retail - Other retail	16,576	66	-	-	-	16,642
Retail - SME	2,642	-	-	-	-	2,642
Other IRB Approaches						
Corporate - Specialised lending	2,612	755	1,635	326	633	5,961
Equities - Exchange traded	-	-	-	-	-	-
Equities - Private equity	-	-	-	-	-	-
Equities - Other	15	-	-	-	-	15
Securitisation positions [1]	18,010	4,843	7,321	-	853	31,027
Total – IRB Approach	540,924	28,016	41,349	2,180	5,145	617,614
Exposures subject to the Standardised Approach						
Central governments and central banks	61,089	10,776	-	414	163	72,442
Regional governments or local authorities	26	-	-	15	-	41
Administrative bodies and non-commercial undertakings	358	-	-	12	1	371
Multilateral development banks	-	83	-	-	-	83
Institutions	771	120	166	43	77	1,177
Corporates	17,174	8,193	2,178	5,389	1,871	34,805
Retail	4,470	322	21	3,114	105	8,032
Secured on real estate property	20,231	14,676	373	1,797	960	38,037
Past due items	1,893	4,711	182	1,632	260	8,678
Items belonging to regulatory high risk categories	1,939	301	177	-	16	2,433
Securitisation positions	-	-	-	-	-	-
Short term claims on institutions or corporates	154	290	12	-	-	456
Collective investment undertakings	113	-	-	-	-	113
Total – Standardised Approach	108,218	39,472	3,109	12,416	3,453	166,668
Total	649,142	67,488	44,458	14,596	8,598	784,282
Other items						23,330
Total Credit Risk Exposure						807,612

Notes

[1] Securitisation positions (IRB Approach) have been analysed on a country of risk basis as this better reflects the profile of exposures held.

(All figures are in £m)	2010 United Kingdom	2010 Rest of Europe	2010 United States of America	2010 Asia-Pacific	2010 Other	2010 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	81,139	11,376	12,225	699	2,635	108,074
Corporate - SME	27,147	131	133	44	73	27,528
Corporate - Specialised lending	6,757	1,380	85	5	510	8,737
Central governments and central banks	6	11,613	10,900	78	323	22,920
Institutions	5,167	11,536	4,389	1,659	1,176	23,927
Retail IRB Approach						
Retail - Residential mortgages	363,189	6,284	-	-	-	369,473
Retail - Qualifying revolving retail exposures	43,049	-	-	-	-	43,049
Retail - Other retail	20,319	230	-	-	1	20,550
Retail - SME	2,249	-	-	-	-	2,249
Other IRB Approaches						
Corporate - Specialised lending	3,657	5,761	2,133	322	666	12,539
Equities - Exchange traded	29	-	-	1	32	62
Equities - Private equity	1,209	311	173	-	-	1,693
Equities - Other	509	30	30	-	7	576
Securitisation positions [1]	17,983	10,861	20,466	376	6,706	56,392
Total – IRB Approach	572,409	59,513	50,534	3,184	12,129	697,769
Exposures subject to the Standardised Approach						
Central governments and central banks	36,337	3,301	-	473	57	40,168
Regional governments or local authorities	44	-	-	20	1	65
Administrative bodies and non-commercial undertakings	280	1	-	65	1	347
Multilateral development banks	-	-	-	-	-	-
Institutions	397	149	177	66	36	825
Corporates	21,036	11,153	2,975	7,417	1,805	44,386
Retail	5,323	813	145	3,395	427	10,103
Secured on real estate property	23,962	14,457	191	3,420	895	42,925
Past due items	3,301	5,417	504	3,114	305	12,641
Items belonging to regulatory high risk categories	36	40	2	-	92	170
Securitisation positions	-	8	-	-	-	8
Short term claims on institutions or corporates	785	82	1	18	15	901
Collective investment undertakings	40	-	-	-	-	40
Total – Standardised Approach	91,541	35,421	3,995	17,988	3,634	152,579
Total	663,950	94,934	54,529	21,172	15,763	850,348
Other items						28,154
Total Credit Risk Exposure						878,502

Notes

[1] Securitisation positions (IRB Approach) have been analysed on a country of risk basis as this better reflects the profile of exposures held.

CREDIT RISK EXPOSURE: ANALYSIS BY RESIDUAL MATURITY

Credit risk exposures as at 31 December 2011, analysed by residual contractual maturity, are provided in the table below.

(All figures are in £m)	2011 On demand	2011 Repayable in 3 months or less	2011 Repayable between 3 months and 1 year	2011 Repayable between 1 and 5 years	2011 Repayable over 5 years or undated	2011 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	7,001	6,178	15,612	51,338	20,667	100,796
Corporate - SME	2,318	1,913	2,342	9,107	7,482	23,162
Corporate - Specialised lending	175	526	1,428	4,731	1,168	8,028
Central governments and central banks	-	9,812	83	953	6,866	17,714
Institutions	1,001	1,188	981	6,859	1,863	11,892
Retail IRB Approach						
Retail - Residential mortgages	2,325	489	4,682	19,098	334,527	361,121
Retail - Qualifying revolving retail exposures	38,614	-	-	-	-	38,614
Retail - Other retail	298	527	1,670	11,777	2,370	16,642
Retail - SME	1,779	6	27	316	514	2,642
Other IRB Approaches						
Corporate - Specialised lending	2	217	425	2,219	3,098	5,961
Equities - Exchange traded	-	-	-	-	-	-
Equities - Private equity	-	-	-	-	-	-
Equities - Other	-	-	-	-	15	15
Securitisation positions	103	1,740	5,849	3,588	19,747	31,027
Total – IRB Approach	53,616	22,596	33,099	109,986	398,317	617,614
Exposures subject to the Standardised Approach						
Central governments and central banks	36,829	13,245	670	5,016	16,682	72,442
Regional governments or local authorities	-	-	1	36	4	41
Administrative bodies and non-commercial undertakings	-	-	1	136	234	371
Multilateral development banks	-	-	-	-	83	83
Institutions	415	391	112	96	163	1,177
Corporates	1,400	1,157	3,908	16,761	11,579	34,805
Retail	593	166	390	3,817	3,066	8,032
Secured on real estate property	438	1,893	3,603	11,409	20,694	38,037
Past due items	237	699	856	3,981	2,905	8,678
Items belonging to regulatory high risk categories	287	68	3	287	1,788	2,433
Securitisation positions	-	-	-	-	-	-
Short term claims on institutions or corporates	112	344	-	-	-	456
Collective investment undertakings	113	-	-	-	-	113
Total – Standardised Approach	40,424	17,963	9,544	41,539	57,198	166,668
Total	94,040	40,559	42,643	151,525	455,515	784,282
Other items						23,330
Total Credit Risk Exposure						807,612

(All figures are in £m)	2010 On demand	2010 Repayable in 3 months or less	2010 Repayable between 3 months and 1 year	2010 Repayable between 1 and 5 years	2010 Repayable over 5 years or undated	2010 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	7,726	9,778	14,967	54,953	20,650	108,074
Corporate - SME	3,020	2,544	3,216	9,596	9,152	27,528
Corporate - Specialised lending	221	445	1,228	5,129	1,714	8,737
Central governments and central banks	401	14,291	56	2,489	5,683	22,920
Institutions	281	7,604	2,635	7,753	5,654	23,927
Retail IRB Approach						
Retail - Residential mortgages	2,099	499	4,296	18,693	343,886	369,473
Retail - Qualifying revolving retail exposures	43,049	-	-	-	-	43,049
Retail - Other retail	307	919	2,296	13,718	3,310	20,550
Retail - SME	1,476	6	26	331	410	2,249
Other IRB Approaches						
Corporate - Specialised lending	336	515	1,215	6,416	4,057	12,539
Equities - Exchange traded	-	-	-	32	30	62
Equities - Private equity	-	-	5	34	1,654	1,693
Equities - Other	-	-	-	2	574	576
Securitisation positions	139	902	11,514	8,061	35,776	56,392
Total – IRB Approach	59,055	37,503	41,454	127,207	432,550	697,769
Exposures subject to the Standardised Approach						
Central governments and central banks	23,107	2,056	1,091	176	13,738	40,168
Regional governments or local authorities	-	-	2	59	4	65
Administrative bodies and non-commercial undertakings	-	2	65	136	144	347
Multilateral development banks	-	-	-	-	-	-
Institutions	84	507	52	92	90	825
Corporates	2,005	1,481	4,149	21,864	14,887	44,386
Retail	1,138	398	577	5,174	2,816	10,103
Secured on real estate property	1,105	3,426	3,394	14,126	20,874	42,925
Past due items	870	1,326	1,693	4,723	4,029	12,641
Items belonging to regulatory high risk categories	-	-	-	161	9	170
Securitisation positions	-	-	-	-	8	8
Short term claims on institutions or corporates	266	635	-	-	-	901
Collective investment undertakings	40	-	-	-	-	40
Total – Standardised Approach	28,615	9,831	11,023	46,511	56,599	152,579
Total	87,670	47,334	52,477	173,718	489,149	850,348
Other items						28,154
Total Credit Risk Exposure						878,502

PAST DUE EXPOSURES, IMPAIRED EXPOSURES AND IMPAIRMENT PROVISIONS

DEFINITION

For accounting purposes, past due but not impaired exposures, impaired exposures and impairment provisions are defined as follows:

- **Past due but not impaired exposures:** An exposure is past due when a counterparty has failed to make a payment when contractually due.
- **Impaired exposures:** An exposure where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
- **Impairment provisions:** Impairment provisions are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.

ACCOUNTING POLICY

The Group's accounting policy in respect of impaired exposures ('financial assets') and impairment provisions raised in respect of loans and receivables is detailed below.

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 Wholesale, Commercial and Wealth 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 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.

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, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

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

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

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

Incurred but not yet identified impairment

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

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. There are a number of different types of loan renegotiation, including the capitalisation of arrears, payment holidays, interest rate adjustments and extensions of the due date of payment. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

Write Offs

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

Debt for Equity Exchanges

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

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.

MANAGING IMPAIRED EXPOSURES AND IMPAIRMENT PROVISIONS

Group Provisioning Policy

The high level principles and policies of the Group in respect of the management of impaired exposures, the setting of impairment provisions and the write-off of impaired exposures are contained within the Group Credit Impairment Policy, approved by the Chief Risk Officer and reviewed annually.

The policy for the treatment of impaired assets has been developed and is maintained by Risk Division who formulate and agree the policy in conjunction with Group Finance.

Adequacy Reviews

All assets whether impaired or unimpaired, are considered for impairment on a quarterly basis. The process followed is exactly the same as that used in determining whether or not an asset is impaired and if it is, whether it should fall within the individually assessed or collectively assessed category.

Any assessment of impairment must be based on the information and events that have already occurred as at the review, reporting or balance sheet date. Events that occur after such date may be taken into account only where they inform the position at that date.

The process for estimating impairment must consider all credit exposures and not only those in default or low credit quality.

Assets previously identified as impaired are reviewed to ensure that the objective evidence of impairment remains valid, that cashflow projections (including any potential net proceeds from realisation of collateral) remain appropriate and that the impairment loss recorded in the bank's books continues to reflect the difference between the net present value and the carrying value of the asset. In the event that the future expected cashflow has changed from the previous assessment, an adjustment to the level of loss allowance is made as appropriate.

Where these impaired assets are within a pool of similar assets and are assessed collectively, the relevance of the pool within which the asset has been placed and the assumptions regarding cashflow emanating from the pool is considered.

Upon review, if it can be evidenced that the impairment event has passed without detriment to the future expected cashflow and the net present value is greater than the carrying value of the asset, the asset can be re-categorised as unimpaired and the loss allowance released.

Loss allowances are raised in the same currency as the pool of impaired assets to which they relate.

Reporting

The Credit Risk Committees and Risk Division monitor impairment provisions on a continuous basis throughout the year. All significant new impaired asset exposures are reported by their respective group business area as soon as they arise.

On a regular basis, an analysis of significant impaired exposures (including levels and trends in impaired exposures) is provided to the Impairment Committee, Group Risk Committee and the Board Risk Committee.

A consolidated risk report is produced on a monthly basis for the Group Risk Committee. This report includes comparison of actual performance against budget for the main balance sheet and income statement metrics, including asset balances, impaired assets, income statement impairment charge and balance sheet provisions.

In addition, comprehensive monthly reporting packs are produced by the Global Business Support Unit, which actively manages distressed wholesale assets and by Collections and Recoveries units within Retail Division.

The Group reviews regularly, but at least annually, its provision forecast against actual experience to identify whether its policies resulted in over or under provisioning across the economic cycle. The responsibility for the review rests with Risk Division who report their findings and recommendations to the Group Risk Committee and Audit Committee.

Intensive Care of Customers in Difficulty

Retail Assets

The Group's aim in offering forbearance and other assistance to retail customers in financial distress is to benefit both the customer and the Group by: discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests; and bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes.

The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework; controls around the execution of policy; regular review of the different treatments to confirm that they remain appropriate; monitoring of customers' performance and the level of payments received; and management visibility of the nature and extent of assistance provided and the associated risk.

Assistance is provided through trained colleagues in branches and dedicated telephony units, and via online guidance material. For those customers requiring more intensive help, assistance is provided through dedicated support units where tailored repayment programmes can be agreed. Customers are actively supported and referred to free money advice agencies when they have multiple credit facilities, including those at other lenders, that require restructuring. Within the Collections and Recoveries functions, the sharing of best practice and alignment of policies across the Group has helped to drive more effective customer outcomes and achieve operational efficiencies.

One component of the Group's relationship management approach is to contact customers showing signs of financial difficulty, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears.

The specific tools available to assist customers vary by territory and product and the customer's status. In defining the treatments offered to customers who have experienced financial distress, the Group distinguishes between the following three categories:

- Forbearance – a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments such as a temporary capital payment break.

- Financial distress assistance – an account change for customers in financial distress where arrears accrue at the contractual monthly payment such as a short-term arrangement to pay.

- Repair – an account change used to repair a customer's position when they have emerged from financial difficulty, such as capitalisation of arrears when a payment track record has been re-established.

To assist customers in financial distress, the Group also participates in or benefits from the following UK Government ('Government') sponsored programmes for households:

- Income Support for Mortgage Interest: this is a Government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the Government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the Government. Payments are made directly to the Group by the appropriate Government department.

- Homeowner Mortgage Support Scheme: This is a Government medium-term initiative that enables borrowers affected by temporary reductions in income to access reduced payments for a period of up to two years. The Government provides a partial guarantee to the Group whilst a customer participates in the plan. Decisions on eligibility, principally whether the Group expects the borrower's earnings to recover fully, initially rest with the Group and must be made on the basis of detailed information received from an independent fee-free advisor. After a year, the customer must undergo a further full assessment made by the advice agency. The customer must pay at least 30 per cent of the interest due. Any shortfall in payments made during the period covered by the scheme is collected through increased payments over the remaining term. The scheme was closed to new customer applications in April 2011 by the Department of Communities and Local Government.

- Mortgage Rescue Scheme: This is a Government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

Wholesale Assets (including Commercial)

In order to support wholesale customers that encounter difficulties during the current economic downturn, the Group increased the size of its dedicated business support unit (BSU) to cover all its UK and International portfolios.

Wholesale credit facilities are reviewed on a regular basis and more frequently where required. When financial stress is exhibited, the customer would be transferred at an early stage to the Group's specialist BSU and Customer Support teams.

The over-arching aim of BSU is to work with each customer to try and resolve the issues, to restore the business to a financially viable position and facilitate a business turnaround. This could be through a number of channels, including providing advice on how to develop and implement turnaround strategies, and considering potential restructuring of debt and forbearance. This may involve using turnaround professionals, for example accountants and valuers.

BSU Relationship Managers are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and ongoing close scrutiny by senior management. Exposure is minimised through a combination of appropriate forbearance, asset sales, restructuring and work-out strategies.

Customer Support provides intensive care and support to Commercial SME customers in difficulty. Whilst the customer relationship remains with the Relationship Manager, they are supported by a Customer Support Manager (CSM) to oversee and manage identified risk.

The main types of forbearance for wholesale customers in financial distress could include:

- Covenant resets and breach of covenant waivers
- Extension of facilities outside of agreed terms
- Capital repayment holidays
- Debt for equity swaps
- Partial debt write off

Forbearance alone is not necessarily an indicator of impairment but will always be a trigger point for the Bank to review the customer's credit and assess whether the risk has changed.

Multiple types of forbearance concessions often occur on the more distressed cases managed in BSU or Customer Support. Each case is treated depending on its own specific circumstances and the Group's strategy and offer of forbearance is largely dependent on the individual situation. Early identification, control and monitoring are key.

One of the components of wholesale's approach to forbearance and early identification of issues is the Group's Credit Risk Classification policy, which is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. This policy includes the Group's good book / mainstream early warning process identifying "Special Mention" and "Sub Standard" cases. This process seeks to ensure that Relationship Managers act promptly to identify, and highlight to senior management, customers that have the possibility to become higher risk in the future. Customers classified as Special Mention / Sub Standard are subject to additional controls and regular monitoring routines, including oversight by BSU and the independent Credit Sanctioning function.

Concessions granted under forbearance would be classified in the Group's Credit Risk Classification system according to the severity of the customer's financial distress. Management information is produced which gives a high level view of asset quality, with clearly defined parameters and features. Trends and warning signs are reported and advised to senior management promptly; which include issues not yet identified by rating models. A robust review and challenge process is applied to each credit if asset quality declines, initiating an appropriate and measured response. As the financial stress of a credit deteriorates the Credit Risk Classification helps to determine the route and management of the customer.

Repeat transgressions of forbearance would be reflected in the strategy to manage the customer and an objective reassessment of any impairment will be undertaken on a regular basis. This is subject to independent review and sanctioning.

In addition, the Group, through its banking businesses, participates in a number of initiatives designed to assist small and medium-sized enterprises. These include:

- The Lending Code: Introduced by the British Bankers' Association in November 2009, the Lending Code is a voluntary set of commitments and standards of good practice to ensure that lenders act fairly and reasonably in all dealings with customers. This has been reviewed and updated in March 2011, not only to incorporate the key elements of the Statement of Principles, a previously issued brochure which outlined an agreed approach to working with micro-enterprise customers (entities with fewer than 10 employees and having a turnover of less than €2 million), but also to introduce key elements of the work of the Business Finance Taskforce (see below). A leaflet 'A guide to the Lending Code for Micro-enterprises' provides an introduction to the standards customers should expect from the banks, building societies and credit-card providers who follow the Lending Code.

- Business Finance Taskforce: The Group through its banking businesses has taken a leading role in the Business Finance Taskforce, which committed to a number of key actions in three broad areas: (i) improving customer relationships; (ii) ensuring better access to finance and (iii) providing better information and promoting customer understanding. Key elements of this include:

  - The lending appeals process: if a lending application is declined, customers have the right to appeal that decision. We have committed to respond to 90 per cent of appeals with a decision, within 15 working days.
  - The finance application checklist: Details of the type of information we may ask customers to provide in order to support their lending application.
  - Business mentoring: Businesses may benefit from the support of a business mentor. www.mentorsme.co.uk is a free online service that enables businesses to locate local independent mentoring organisations that suit their specific business needs.

- 2012 SME Charter: The Group's 2012 SME Charter details the Group's commitment to supporting UK business and incorporates the Group's pledge to support any viable business through temporary difficulties and into recovery. As part of the Group's commitment to this, we issue a Letter of Concern to customers when we have concerns about their business or the Group's relationship with them. This aims to generate early dialogue between the customer and the Group, so that a joint approach to the situation can be agreed with them.

Further information on the treatment of customers experiencing financial difficulty can be found on pages 332 to 335 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

ANALYSIS OF PAST DUE AND IMPAIRED LOANS AND ADVANCES TO CUSTOMERS

The analysis provided within this section has been presented on an accounting consolidation basis rather than a regulatory consolidation basis.

As at 31 December 2011, past due but not impaired exposures in respect of loans and advances to customers amounted to £16.3bn (2010: £17.9bn). Impaired exposures in respect of loans and advances to customers amounted to £60.3bn (2010: £64.6bn), of which £6.5bn (2010: £7.9bn) were classified as 'impaired – no provision required' and the remaining £53.8bn (2010: £56.7bn) as 'impaired – provision held'.

Analysis by Industry

An analysis of past due but not impaired loans and advances to customers and impaired loans and advances to customers as at 31 December 2011, by major industrial sector, is provided in the table below.

	Past due but not impaired		Impaired	
	2011 £m	2011 As a % of Credit Risk Exposure	2011 £m	2011 As a % of Credit Risk Exposure
Agriculture, forestry and fishing	99	1.60%	173	2.79%
Energy and water supply	2	0.04%	86	1.82%
Manufacturing	86	0.47%	1,556	8.49%
Construction	203	2.14%	3,752	39.47%
Transport, distribution and hotels	526	1.60%	8,623	26.29%
Postal and communications	1	0.02%	102	1.93%
Property companies	950	1.52%	24,952	39.82%
Financial, business and other services	782	0.39%	8,883	4.43%
Personal: Mortgages	12,742	3.43%	8,065	2.17%
Personal: Other	720	1.22%	3,503	5.94%
Lease financing	87	1.00%	190	2.19%
Hire purchase	146	2.72%	384	7.16%
Total	**16,344**	**2.02%**	**60,269**	**7.46%**

	Past due but not impaired		Impaired	
	2010 £m	2010 As a % of Credit Risk Exposure	2010 £m	2010 As a % of Credit Risk Exposure
Agriculture, forestry and fishing	96	1.58%	257	4.23%
Energy and water supply	15	0.32%	241	5.09%
Manufacturing	239	1.28%	2,412	12.94%
Construction	101	0.75%	2,811	20.78%
Transport, distribution and hotels	500	1.24%	7,704	19.03%
Postal and communications	18	0.40%	59	1.32%
Property companies	1,708	2.16%	29,459	37.17%
Financial, business and other services	743	0.33%	8,401	3.77%
Personal: Mortgages	13,215	3.48%	7,780	2.05%
Personal: Other	927	1.40%	4,595	6.91%
Lease financing	122	1.65%	302	4.08%
Hire purchase	247	3.74%	585	8.85%
Total	17,931	2.04%	64,606	7.35%

Analysis by Geography

An analysis of past due but not impaired loans and advances to customers and impaired loans and advances to customers as at 31 December 2011, by country of residence of the customer, is provided in the table below.

	Past due but not impaired		Impaired	
	2011 £m	**2011 As a % of Credit Risk Exposure**	**2011 £m**	**2011 As a % of Credit Risk Exposure**
United Kingdom	14,442	2.22%	37,589	5.79%
Rest of Europe	1,379	2.04%	17,906	26.53%
United States of America	-	-	711	1.60%
Asia-Pacific	426	2.92%	3,037	20.81%
Other	97	1.13%	1,026	11.93%
Total	**16,344**	**2.02%**	**60,269**	**7.46%**

	Past due but not impaired		Impaired	
	2010 £m	2010 As a % of Credit Risk Exposure	2010 £m	2010 As a % of Credit Risk Exposure
United Kingdom	15,745	2.37%	41,499	6.25%
Rest of Europe	1,669	1.76%	16,125	16.99%
United States of America	9	0.02%	1,902	3.49%
Asia-Pacific	420	1.98%	4,696	22.18%
Other	88	0.56%	384	2.44%
Total	17,931	2.04%	64,606	7.35%

ANALYSIS OF IMPAIRMENT PROVISIONS IN RESPECT OF LOANS AND ADVANCES TO CUSTOMERS

The analysis provided within this section has been presented on an accounting consolidation basis rather than a regulatory consolidation basis.

The movement in impairment provisions, from 31 December 2010 to 31 December 2011, in respect of loans and advances to customers is provided below.

	£m
At 31 December 2010	18,373
Exchange and other adjustments	(369)
Advances written off	(7,487)
Recoveries of advances written off in previous years	421
Unwinding of discount	(226)
Charge to the income statement	8,020
At 31 December 2011	**18,732**

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

	£m
At 31 December 2009	14,801
Exchange and other adjustments	(2)
Advances written off	(6,966)
Recoveries of advances written off in previous years	216
Unwinding of discount	(403)
Charge to the income statement	10,727
At 31 December 2010	18,373

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

Analysis by Industry

An analysis of closing impairment provisions, the net charge to the income statement and advances written off in respect of loans and advances to customers, by major industrial sector, is provided in the table below [1].

	2011 Impairment Provisions £m	2011 Net Charge £m	2011 Advances Written Off £m
Agriculture, forestry and fishing	51	27	11
Energy and water supply	165	105	48
Manufacturing	475	206	137
Construction	898	350	92
Transport, distribution and hotels	2,117	884	329
Postal and communications	62	15	1
Property companies	8,710	2,776	2,630
Financial, business and other services	3,075	1,464	1,120
Personal: Mortgages	948	444	86
Personal: Other	1,895	1,669	2,617
Lease financing	92	60	224
Hire purchase	244	20	192
Total	**18,732**	**8,020**	**7,487**

	2010 Impairment Provisions £m	2010 Net Charge £m	2010 Advances Written Off £m
Agriculture, forestry and fishing	16	20	47
Energy and water supply	108	17	36
Manufacturing	540	203	385
Construction	588	463	365
Transport, distribution and hotels	1,400	800	742
Postal and communications	50	32	-
Property companies	8,546	4,114	846
Financial, business and other services	2,451	1,293	881
Personal: Mortgages	526	196	145
Personal: Other	3,541	3,431	3,344
Lease financing	287	57	15
Hire purchase	320	101	160
Total	18,373	10,727	6,966

Notes

[1] Extracted from the 'Summary of Loan Loss Experience' analysis presented on pages 112 to 115 of the 2011 Form 20-F.

Analysis by Geography

An analysis of closing impairment provisions, the net charge to the income statement and advances written off in respect of loans and advances to customers, by country of residence of the customer, is provided in the table below.

	2011 Impairment Provisions £m	2011 Net Charge £m	2011 Advances Written Off £m
United Kingdom	15,117	5,439	7,111
Rest of Europe	10,497	2,949	403
United States of America	63	49	-
Asia-Pacific	1,774	1,040	1,875
Other	267	235	89
	27,718	9,712	9,478
Fair value and other adjustments [1]	(8,986)	(1,692)	(1,991)
Total	**18,732**	**8,020**	**7,487**

	2010 Impairment Provisions £m	2010 Net Charge £m	2010 Advances Written Off £m
United Kingdom	18,626	6,771	8,784
Rest of Europe	7,705	4,531	95
United States of America	779	120	666
Asia-Pacific	2,513	1,428	557
Other	12	108	-
	29,635	12,958	10,102
Fair value and other adjustments [1]	(11,262)	(2,231)	(3,136)
Total	18,373	10,727	6,966

Notes

[1] Analysis of closing impairment provisions, the net charge to the income statement and advances written off in respect of loans and advances to customers, by country of residence of the customer, has been presented prior to the application of fair value and other adjustments. Such adjustments are not analysed on a geographical basis within the business. Further details on the fair value and other adjustments applied in respect of impairment provisions can be found on p.324 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

IMPAIRED LOANS AND ADVANCES TO BANKS

As at 31 December 2011, loans and advances to banks amounting to £111m (2010: £20m) were deemed to be impaired. Impairment provisions held in respect of these impaired balances amounted to £14m (2010: £20m). An analysis of the movement in impairment provisions, from 31 December 2010 to 31 December 2011, is provided below.

	£m
At 31 December 2010	20
Exchange and other adjustments	-
Advances written off	(6)
Recoveries of advances written off in previous years	-
Unwinding of discount	-
Charge to the income statement	-
At 31 December 2011	**14**

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

	£m
At 31 December 2009	149
Exchange and other adjustments	(5)
Advances written off	(111)
Recoveries of advances written off in previous years	-
Unwinding of discount	-
Release to the income statement	(13)
At 31 December 2010	20

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

IMPAIRED DEBT SECURITIES CLASSIFIED AS LOANS AND RECEIVABLES

As at 31 December 2011, impairment provisions held in respect of debt securities classified as loans and receivables amounted to £276m (2010: £558m). An analysis of the movement in impairment provisions, from 31 December 2010 to 31 December 2011, is provided below.

	£m
At 31 December 2010	558
Exchange and other adjustments	2
Advances written off	(341)
Recoveries of advances written off in previous years	8
Unwinding of discount	-
Charge to the income statement	49
At 31 December 2011	**276**

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

	£m
At 31 December 2009	430
Exchange and other adjustments	119
Advances written off	(48)
Recoveries of advances written off in previous years	-
Unwinding of discount	-
Charge to the income statement	57
At 31 December 2010	558

(Lloyds Banking Group plc Annual Report and Accounts 2011, p.258)

FACTORS IMPACTING LOSS EXPERIENCE

The Group continued to see reductions in the impairment charge in 2011, with lower charges seen across all divisions. These lower charges were principally supported by the continued application of the Group's prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK retail and commercial property prices, partly offset by weakening UK economic growth and rising unemployment.

Impaired loans decreased by 7 per cent compared to December 2010 to £60.3bn, driven by a decrease in Retail and Wholesale as a result of asset sales, repayments, and write-offs, partially offset by an increase in impaired loans in Ireland.

Retail's impairment charge reduced by 28 per cent, with a reduction in the unsecured charge more than offsetting an increase in the secured charge. Credit performance remained strong with fewer assets entering arrears compared to 2010, in both the secured and unsecured portfolios.

During 2011, Retail's secured impairment charge was in line with expectations, with the increase on 2010 largely reflecting a less certain outlook for house prices, and provisioning against existing credit risks which have longer emergence periods due to current low interest rates. These factors were partially offset by an improvement in the quality of the secured portfolio. Secured asset quality remained good and the number of customers entering arrears reduced through 2011 compared to 2010. The stock of properties in repossession remained stable and the sales prices of repossessed properties continued to be at expected values. The proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100 per cent has decreased to 12 per cent benefitting from the regional mix of lending. The value of the portfolio with an indexed loan-to-value of greater than 100 per cent and more than three months in arrears has been stable at just over £3bn.

Retail's unsecured impairment charge for 2011 decreased by 39 per cent, compared to the same period in 2010. This reflected continued improving new business quality and portfolio trends as a result of the Group's conservative risk appetite, with a focus on lending to existing customers. This focus on improving business quality has resulted in the level of early arrears for accounts acquired since 2009 being at pre-recession levels. Unsecured impaired loans decreased to £2.4bn from £3.0bn at 31 December 2010 as a result of tighter credit policy across the lifecycle, including stronger controls on customer affordability.

The Wholesale impairment charge decreased in 2011. The reduction was primarily driven by lower impairment from the corporate real estate and real estate related asset portfolios partly offset by higher impairment on leveraged acquisition finance exposures. The continued low interest rate environment helped to maintain defaults at a reduced level. In addition, newly impaired assets, being generally of better quality, are requiring a lower level of provisions once impaired than previously impaired assets.

In Commercial, the impairment charge decreased in 2011 reflecting the benefits of the low interest rate environment, which has helped maintain defaults at a lower level, and the continued application of the Group's prudent credit risk appetite. Portfolio metrics including delinquencies and assets under close monitoring remain above benign environment levels.

In Wealth and International, impairment charges decreased by 23 per cent. The reduction predominantly reflects lower impairment charges in the Group's Irish portfolio where the rate of impaired loan migration has slowed. Impaired loans increased by £0.4 billion with an increase of £1.9 billion in Ireland partly offset by a reduction in the Australasian book as a result of write-offs and disposals, resulting in 42.8 per cent of the International portfolios (66.0 per cent of the Irish portfolio) being classified as impaired compared with 35.1 per cent in 2010. Impaired loans accounted for 84.3 per cent of the Irish wholesale portfolio. Further provisioning has been necessary in the Group's Australasian portfolio primarily reflecting geographical real estate concentrations where market conditions and asset valuations have remained weak in 2011.

EXPOSURES SUBJECT TO THE INTERNAL RATINGS BASED APPROACH

The Group operates a range of IRB models for IRB Pillar 1 credit risk calculations. The Group uses both Foundation IRB and Retail IRB approaches. The extent to which these approaches are applied to credit portfolios within the Group is set out in the analysis of credit risk exposures that precedes this section.

Irrespective of regulatory approach, implementation of Foundation IRB models or Retail IRB models is rigorously controlled through consistent development, validation and governance standards. IRB models are put through a stringent internal assessment process and material models, together with material model changes are subject to additional FSA scrutiny and approval before they are allowed to go live for regulatory capital calculation purposes.

SCOPE OF THE IRB PERMISSION

The Foundation IRB approach is applied to wholesale portfolios and the Retail IRB approach is applied to retail portfolios.

Model roll out has been partially completed. The timing and intended regulatory approach for models yet to roll out is targeted for completion in 2013.

Portfolios whose associated models have yet to roll out, or where no model roll out is planned, are risk weighted under the Standardised Approach. The latter includes portfolios that are permanently exempt from the IRB approach, remaining subject to the Standardised Approach. Existing permanent exemptions comprise small / immaterial portfolios and portfolios that are closed to new business or are in run-off, where it is impractical to apply an IRB approach. The Group's permanent exemption list is currently being revisited, to ensure it reflects the outcome of the Group's Strategic Review and any further changes proposed to the IRB roll out plan. An updated IRB roll out plan will be submitted to the FSA during 2012.

Certain credit risk exposures categorised under the specialised lending and equity exposure classes are subject to alternative approaches that fall under the BIPRU provisions governing the IRB Approach. These include the Supervisory Slotting Approach for specialised lending exposures and the Simple Risk Weight Method for equity exposures.

Securitisation positions are subject to a range of risk weighting methodologies, including the Internal Assessment Approach, the Ratings Based Approach, the Supervisory Formula Approach and the Standardised Approach. Further details can be found in the Securitisations section of the document.

INTERNAL DEVELOPMENT AND MONITORING OF IRB MODELS

Throughout 2011 the Group operated with a structure of risk model governance that placed responsibility for the Group wide model governance framework with the Group Model Governance Committee ('GMGC') and model approval with divisional Model Governance Committees. GMGC Committee members comprised the Chief Risk Officer, Group Finance Director, Group Analytics and Risk Modelling Director and a representative from each of the Divisional Risk teams. Divisional MGC's included Board representation for the approval of the Group's most material risk models.

In September 2011, the Board agreed that with effect from 1 December 2011 the Group Risk Committee ('GRC') should be designated as having direct responsibility both for the establishment and review of the risk model governance framework and for the approval of Level 1 risk models categorised as material to the Group. This replaced the previous risk model governance structure and removed approval authorities from the divisional MGCs which, with the exception of the Insurance business, have now been replaced by non-approving fora. The GRC includes the Group Chief Executive, Chief Risk Officer and Group Finance Director. GRC has delegated approval responsibility for all non-Level 1 models to a newly formed Model Governance Committee (MGC) situated within the Risk Division. This MGC comprises the Risk Modelling Director, Chief Credit Officer - Retail and Wealth, Chief Credit Officer - Wholesale and International and the Market & Liquidity Risk Director together with representatives from Risk Division, Finance and, as appropriate, Business MD / CEO (or equivalent).

Group Risk Model Governance Policy and a set of Mandatory Group Manuals ('MGM') set out the risk model control framework. Group Risk Model Governance Policy prescribes the overarching approval and governance framework that applies to risk models. MGMs provide mandatory principles and baseline guidance for all risk models and all risk model related activity covering; data integrity, model implementation, development and validation, forecasting and stress testing, usage of IRB credit models and model review and approval.

Model review must be undertaken annually and independently of the development process, covering the following aspects; design, validation, conservatism, calibration, sensitivity analysis / stress testing, operational aspects, usage, governance, independence, regulatory compliance and performance monitoring and reporting.

Independent, ongoing assessments of adherence to the risk model governance framework and processes are undertaken through a combination of the second line assurance teams in the Risk Division and internal audit.

INTERNAL APPLICATION OF THE IRB APPROACH

The Group not only utilises IRB models in the regulatory capital calculation process, the models are also widely used in the business.

Credit Approval

The Risk Division sets out the Group credit principles and policy according to which credit risk is taken and managed. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Specific credit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions at business unit levels. IRB models are strongly linked with the credit approval process, although the precise nature differs between asset classes. For retail exposures the underlying application and behavioural scorecards, used to make retail credit approval decisions, generate the PD component of the IRB model. For wholesale exposures the PD model ascribes a credit risk grade to each exposure and this grade is used as a key input into the credit approval process.

Credit Limits

Prudent sanctioning and control procedures lie at the heart of the Group's credit regime with a variety of approaches appropriate to the product line, with the fundamental structure built upon:

- A risk differentiated, hierarchical approach to control, driven by size of exposure, credit risk grade, nature of risk and where appropriate lifetime expected losses ('LEL') measures, which are aligned with IRB models;
- Approvals provided through: individual delegated sanctioning authorities or dual sanctioning or specific credit committees or approved automated credit decisioning systems (incorporating credit scorecards and / or behavioural scorecards and / or affordability models);
- Separate authorities for different types of credit risk including sovereigns, banks, non bank and retail;
- Authorities based on business need, and on the credit competence of the individuals concerned, rather than position within the Group hierarchy;
- Tight control procedures that govern review frequency and account management responsibility; and
- Noting and reporting protocols that ensure significant exposures, within the Group, are subject to additional monitoring and review.

Pricing

The relative value inherent in the extension of credit risk exposure is considered in establishing the price appropriate to such exposure to ensure that the return is commensurate with the risks of the transaction proposed, taking account of the Board’s Credit Risk Appetite.

- Irrespective of market, budgetary or competitor influences, there exists a base price below which the Group's limited capital may not be utilised for new business. Such base price will constitute the minimum acceptable, as established in the strategy of each Group business;
- Each Group business has established guidelines for its range of products that reflect upside revenue potential and opportunities as well as downside procedural / control aspects.
- Pricing reflects the principle of risk / reward and the Risk Appetite defined by the Board, whilst recognising that no reward can justify the acceptance of excessive risk.

For Retail Division, pricing and decision making are intrinsically linked. The LELs are fed into the profit model, along with other costs, to allow target exposure levels to be set that generate the required return. Associated decisions have been assessed using the LEL to ensure that current pricing passes the required hurdle rates dependant on the risk involved.

For Wholesale Division, a number of pricing models are in place to support the relationship manager’s determination of price. Credit risk grade is a key driver in such models.

Portfolio Reporting

Credit Risk reporting is conducted at both Group and Divisional levels, embedding IRB parameters into management information. This includes analysis of the core model outputs, being PD, LGD, EAD and EL measures. Model performance and parameter assessment are also presented.

Impairment Forecasting

The calculation of impairment levels within each portfolio is subject to rigorous challenge and oversight from both Finance and Risk. IRB model outputs are used to inform the impairment forecasting process and where appropriate may be used as inputs to impairment models.

MODEL CONSTRUCTION

The calculation of PD, LGD and EAD varies by wholesale and retail customers reflecting differences in portfolio types, customer segments as well as the lending product. The methodology and approach to the construction of the models used within the calculations is highly dependent upon the availability of data, the history of the portfolio and the perceived sensitivity to the economic environment. This results in a suite of models that fall to some extent into one of the following three categories:

- Statistical models - include quantitative tools or default probability models, which can include both quantitative (e.g. financial ratios) and qualitative but standardised (e.g. payment history) information. The modelling techniques can range across differing techniques with a varying degrees of complexity, most prominently being logistic regression.

- Constrained expert judgement - a type of expert judgement, where the analyst is provided with some qualitative or quantitative rules about assessing individual factors. Often points will be assigned to particular values of variables (e.g. History of arrears: Yes =1; No =0) and these variables may be given specific weightings relative to each other. However, the points and weights are themselves determined by expert judgement (e.g. a panel of experts) rather than through a statistical process.

- Hybrid models - defined as models that combine elements of expert judgement and statistical models other than through the application of a judgemental overlay. For example, this would include rating systems that take into account a number of financial ratios, some qualitative factors and, if applicable, other external inputs and assign a rating based on a combination of these elements in a predetermined way.

For capital calculation purposes, except where directed otherwise by the regulator, the PDs assigned to grades must reflect the long-run average PD of that grade over a full economic cycle i.e. over an economic cycle, the PD model outputs should have the same average as the actual default rate over the same period. However, models and rating systems vary between two extremes of Point-in-Time ('PiT') and Through-the-Cycle ('TTC') with most representing a hybrid position. Within LBG the PD models used in the regulatory capital calculation seek to be through-the-cycle calibrated or hybrid models, and as a result, whilst having the same average over a full economic cycle as the actual default rates, have lower variability.

For certain portfolios PiT PDs are used for business purposes as they best represent the credit risk arising from prevailing economic conditions. In these cases the Group have established appropriate mechanisms by which the PiT PDs are converted into TTC PDs for the purpose of calculating regulatory capital. These conversions follow a process of segmenting the portfolio into homogeneous risk groups and for each segment calculating a forward-looking long-run average default rate over a full economic cycle. The underlying PD model outputs are then calibrated by segment to these long-run averages to form the regulatory PD outputs. This approach aids capital management by ensuring the regulatory PD (and therefore the resultant regulatory capital requirements) fluctuates mainly due to changes in the credit quality mix (i.e. segment mix) of the portfolio, rather than changes in the economy.

Wholesale Ratings

The PD rating tools for sovereigns and financial institutions place reliance on the history of external data and in particular the application of external ratings. The internal models seek to replicate the characteristics utilised by ECAIs and then apply this approach to all counterparties across the given portfolio.

For corporates the LBG internal models are developed to take account of elements that are quantitative i.e. financial ratio analysis; qualitative i.e. internal assessment of business management; and behavioural i.e. history of arrears. The specific measures and weighting of these components varies in relation to the particular scope of the model and portfolio to which it is being applied.

In certain circumstances there are portfolios where the observed number of defaults is low and in these cases the bank has followed appropriate steps to ensure the resulting model and calibration includes specific conservatism to reflect the degree of uncertainty in the available information. Where other weaknesses have been identified further suitable conservatism has been adopted to ensure the final calculation remains cautious.

Retail Ratings

There is extensive experience throughout the retail banking portfolio in the development, use and operation of credit models. Application scorecards are built to assist the identification of new customers by reflecting on the historical performance observations. These scorecards are statistically developed using customer financial and demographic data supported by credit bureau information where available. Behavioural scorecards are similarly derived from historically observed performance using similar information as above with the addition of payment history. These tools further assist in the management of the existing portfolio.

The PD for retail customers is produced by mapping the score, whether application or behavioural, and reflecting the known default history of the portfolio in question along with the given risk appetite and current economic conditions. Where appropriate and allowed this output is converted into a long run average position.

The EAD models predict the balance at default by assessing historical balance migration along side behavioural elements specific to the operation of the product. Credit conversion factors are derived as necessary for reporting.

The LGD models take account of the differing recovery processes and procedures associated with the different product lines. These include assessments of any underlying security, its variation in value over time and the ability to realise the collateral in an efficient manner. This is supplemented by the historic information available to cash collections, losses and write offs. These factors are discounted to reflect the opportunity cost for holding such assets over the period of the collection process.

Within the capital calculation the EAD and LGD output are adjusted to reflect the regulatory requirement to utilise values associated with an economic downturn. Where known weaknesses have been identified, either through a lack of available data or through changes to business activity (thus weakening the ability to use the past to predict the future), conservative assumptions have been used to support robust and stable outcomes.

INTERNAL RATING SCALES

Within the Group, probability of default ('PD') internal rating scales are used in assessing the credit quality of the Foundation IRB and Retail IRB portfolios. Two separate scales exist within the business – a Wholesale Master Scale which covers all relevant corporate, central government and central bank and institution portfolios and a Retail Master Scale which covers all relevant retail portfolios.

PD Master Scales

Wholesale Master Scale

PD Grade	Range		
	Lower	Mid	Upper
1	0.000%	0.005%	0.010%
2	0.011%	0.018%	0.025%
3	0.026%	0.063%	0.100%
4	0.101%	0.311%	0.510%
5	0.511%	1.751%	3.000%
6	3.001%	11.501%	20.000%
7	20.001%	60.000%	99.999%
Default	100.000%	-	-

Retail Master Scale

PD Grade	Range		
	Lower	Mid	Upper
0	0.000%	0.050%	0.100%
1	0.101%	0.251%	0.400%
2	0.401%	0.601%	0.800%
3	0.801%	1.001%	1.200%
4	1.201%	1.851%	2.500%
5	2.501%	3.501%	4.500%
6	4.501%	6.001%	7.500%
7	7.501%	8.751%	10.000%
8	10.001%	12.001%	14.000%
9	14.001%	17.001%	20.000%
10	20.001%	25.001%	30.000%
11	30.001%	37.501%	45.000%
12	45.001%	72.500%	99.999%
Default	100.000%	-	-

The Group's internal rating scales contain a similar number of rating grades to major external rating agency scales. However, the bases of the underlying rating philosophies differ and as such it is not appropriate to map internal rating scales directly to external rating agency scales.

A detailed analysis, by PD Grade, of credit risk exposures subject to the Foundation IRB and Retail IRB approaches is provided in the sections that follow.

ANALYSIS OF EXPOSURES SUBJECT TO THE FOUNDATION IRB APPROACH

This section provides a detailed analysis, by PD Grade, of wholesale credit risk exposures subject to the Foundation IRB Approach.

Disclosures provided in the tables below take into account PD floors specified by regulators in respect of the calculation of regulatory capital requirements.

Corporate Exposures

As at 31 December 2011, corporate exposures subject to the Foundation IRB Approach totalled £132.0bn (2010: £144.3bn).

Corporate Main exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	2,391	0.03%	10.91%	2,876	0.03%	8.77%
2	3,453	0.03%	16.83%	4,579	0.03%	17.62%
3	19,833	0.05%	25.24%	20,271	0.04%	23.95%
4	32,916	0.24%	48.11%	30,390	0.25%	44.02%
5	19,895	1.36%	99.68%	20,595	1.50%	100.69%
6	8,634	6.66%	159.40%	14,707	8.60%	167.94%
7	2,142	30.66%	239.46%	4,062	31.58%	246.02%
Default	11,532	100.00%	-	10,594	100.00%	-
Total	100,796	13.02%	59.93%	108,074	12.53%	69.14%

Corporate SME exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	23	0.03%	20.36%	4	0.03%	32.71%
2	28	0.03%	20.19%	7	0.03%	20.01%
3	1,102	0.06%	27.57%	1,513	0.06%	31.84%
4	2,674	0.24%	48.01%	2,802	0.23%	46.91%
5	7,776	1.30%	78.05%	8,071	1.46%	86.51%
6	4,942	6.92%	121.37%	6,897	7.47%	127.07%
7	788	29.19%	189.43%	1,400	29.50%	195.84%
Default	5,829	100.00%	-	6,834	100.00%	-
Total	23,162	28.11%	65.48%	27,528	28.65%	73.70%

Specialised Lending exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	64	0.06%	27.75%	226	0.06%	17.16%
4	2,750	0.30%	61.58%	2,904	0.29%	64.10%
5	3,946	1.31%	102.20%	3,992	1.39%	110.92%
6	584	4.87%	160.71%	709	5.35%	155.11%
7	-	-	-	-	-	-
Default	684	100.00%	-	906	100.00%	-
Total	8,028	9.62%	83.24%	8,737	11.54%	85.02%

Key Movements

- Average risk weights for corporate main and corporate SME exposures reduced from 69.14% and 73.70% to 59.93% and 65.48% respectively, reflecting both risk profile changes and a reduction in non-core assets that typically carried a higher risk weighting.

Central Government and Central Bank Exposures

As at 31 December 2011, central government and central bank exposures subject to the Foundation IRB Approach totalled £17.7bn (2010: £22.9bn).

Central Governments and Central Banks exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	7,544	0.01%	10.54%	22,718	0.01%	5.54%
2	10,154	0.02%	4.92%	105	0.01%	8.87%
3	12	0.07%	19.59%	59	0.04%	13.10%
4	-	-	-	32	0.11%	21.17%
5	3	1.24%	85.00%	3	0.90%	74.87%
6	-	-	-	-	-	-
7	-	-	-	2	56.88%	201.96%
Default	1	100.00%	-	1	100.00%	-
Total	17,714	0.02%	7.34%	22,920	0.02%	5.63%

Institution Exposures

As at 31 December 2011, institution exposures subject to the Foundation IRB Approach totalled £11.9bn (2010: £23.9bn).

Institutions exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	13	0.03%	8.04%	-	-	-
2	137	0.03%	10.66%	317	0.03%	5.94%
3	7,607	0.04%	13.34%	16,922	0.04%	9.92%
4	3,631	0.18%	30.48%	5,898	0.20%	34.20%
5	420	0.85%	65.22%	586	1.36%	96.14%
6	5	6.75%	173.77%	77	3.41%	119.75%
7	3	30.14%	250.37%	-	-	-
Default	76	100.00%	-	127	100.00%	-
Total	11,892	0.76%	20.40%	23,927	0.65%	18.26%

ANALYSIS OF EXPOSURES SUBJECT TO THE RETAIL IRB APPROACH

This section provides a detailed analysis, by PD Grade, of retail credit risk exposures subject to the Retail IRB Approach.

Disclosures provided in the tables below take into account PD floors and LGD floors specified by regulators in respect of the calculation of regulatory capital requirements.

As at 31 December 2011, retail exposures subject to the Retail IRB Approach totalled £419.0bn (2010: £435.3bn).

Residential Mortgage exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Exposure Weighted Average LGD [1] %	2011 Average Risk Weight %	2011 Undrawn Commitments (Gross) [2] £m	2011 Undrawn Commitments (Post Credit Conversion Factor) £m
0	143,489	0.09%	10.07%	2.19%	2,217	1,115
1	97,938	0.33%	12.13%	7.42%	346	73
2	36,233	0.70%	12.95%	13.17%	690	448
3	17,745	1.11%	14.52%	20.56%	215	167
4	21,311	2.04%	14.79%	30.00%	119	86
5	13,868	3.55%	14.98%	41.19%	4,110	2,271
6	5,399	6.90%	17.69%	69.31%	47	44
7	2,432	11.34%	19.74%	93.49%	11	7
8	3,038	13.62%	22.85%	118.38%	28	25
9	3,009	18.74%	18.39%	105.31%	13	11
10	2,446	27.64%	17.55%	105.97%	1	-
11	2,119	40.12%	16.62%	96.49%	13	12
12	4,453	69.09%	18.72%	62.79%	3	1
Default	7,641	100.00%	19.07%	101.83%	11	4
Total	361,121	4.35%	12.35%	16.32%	7,824	4,264

PD Grade	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Exposure Weighted Average LGD [1] %	2010 Average Risk Weight %	2010 Undrawn Commitments (Gross) [2] £m	2010 Undrawn Commitments (Post Credit Conversion Factor) £m
0	134,911	0.07%	9.79%	1.80%	2,089	894
1	107,385	0.29%	11.78%	6.57%	774	437
2	38,610	0.70%	13.42%	13.81%	525	234
3	15,281	0.99%	14.62%	19.18%	258	152
4	26,214	2.45%	14.40%	32.13%	135	78
5	15,429	3.55%	14.62%	40.01%	4,368	2,266
6	5,358	5.84%	21.09%	79.80%	26	17
7	3,601	11.67%	17.45%	84.47%	15	7
8	3,162	11.49%	18.41%	93.50%	45	37
9	2,725	16.95%	19.73%	112.90%	10	9
10	2,794	25.14%	18.53%	112.76%	8	6
11	2,301	38.39%	16.96%	100.48%	1	-
12	4,305	69.43%	16.68%	55.81%	4	-
Default	7,397	100.00%	18.08%	99.90%	8	-
Total	369,473	4.21%	12.20%	16.50%	8,266	4,137

Notes

[1] The 10% LGD floor that applies to residential mortgage exposures is applied at sub-portfolio level rather than at account level. The prior year exposure weighted average LGD disclosed for PD Grade 0 falls below the floor as a result of the underlying accounts within the relevant sub-portfolios being allocated across the PD Grades. The accounts residing within PD Grade 0 represent the highest quality accounts within these sub-portfolios and may individually receive an LGD of less than 10%. However, the LGD for the entire sub-portfolio in which these accounts reside is floored at 10%.

[2] Undrawn commitments disclosed under PD Grade 5 relate to pipeline mortgage applications which are risk weighted in accordance with average parameters under the appropriate model.

Qualifying Revolving Retail Exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Exposure Weighted Average LGD %	2011 Average Risk Weight %	2011 Undrawn Commitments (Gross) £m	2011 Undrawn Commitments (Post Credit Conversion Factor) [1] £m
0	8,629	0.05%	77.12%	2.73%	10,682	8,346
1	7,208	0.22%	78.91%	9.47%	7,974	6,770
2	5,247	0.57%	76.42%	20.03%	11,186	4,208
3	2,384	0.98%	77.20%	30.88%	3,082	1,595
4	3,880	1.77%	77.77%	48.15%	3,633	2,226
5	3,048	3.46%	77.96%	78.03%	1,975	1,302
6	2,542	5.94%	77.64%	111.52%	1,288	789
7	1,281	8.71%	77.31%	140.79%	348	303
8	1,037	11.53%	77.82%	166.11%	235	231
9	878	17.25%	79.10%	205.77%	177	272
10	514	24.38%	78.77%	234.01%	79	118
11	358	36.17%	78.57%	252.99%	45	75
12	368	63.66%	78.57%	199.75%	32	67
Default	1,240	100.00%	58.45%	92.89%	47	-
Total	38,614	6.50%	77.05%	49.49%	40,783	26,302

PD Grade	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Exposure Weighted Average LGD %	2010 Average Risk Weight %	2010 Undrawn Commitments (Gross) £m	2010 Undrawn Commitments (Post Credit Conversion Factor) [1] £m
0	5,174	0.06%	86.88%	3.53%	3,489	4,761
1	11,993	0.24%	74.95%	9.87%	19,293	10,175
2	4,431	0.54%	77.02%	19.31%	8,626	3,674
3	3,345	1.05%	72.92%	30.71%	3,555	2,106
4	3,222	1.88%	75.85%	49.03%	2,666	1,580
5	4,899	3.69%	68.17%	71.16%	2,249	2,138
6	1,258	6.06%	81.81%	118.59%	453	307
7	2,185	8.15%	65.82%	116.06%	584	655
8	1,454	11.97%	76.76%	167.71%	327	234
9	964	16.48%	65.40%	167.26%	145	185
10	1,617	26.48%	67.70%	182.35%	405	279
11	388	36.34%	70.57%	212.19%	33	31
12	425	64.37%	74.44%	184.71%	13	12
Default	1,694	100.00%	69.12%	225.33%	61	-
Total	43,049	8.03%	74.77%	57.53%	41,899	26,137

Notes

[1] Undrawn commitments post credit conversion can exceed the gross undrawn equivalents where there is an assumption that future drawings will be higher than the current limit.

Key Movements

- The reduction in the overall average risk weight from 57.53% to 49.49% reflects the impact of new credit cards models implemented during the year.

Other Retail exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Exposure Weighted Average LGD %	2011 Average Risk Weight %	2011 Undrawn Commitments (Gross) £m	2011 Undrawn Commitments (Post Credit Conversion Factor) £m
0	1	0.10%	83.01%	21.56%	-	-
1	516	0.32%	56.22%	31.61%	10	7
2	1,132	0.67%	65.42%	57.32%	20	14
3	805	1.01%	84.28%	91.02%	18	13
4	4,827	1.75%	73.78%	96.87%	43	31
5	3,365	3.35%	87.41%	130.74%	32	23
6	2,343	5.90%	81.35%	129.50%	17	12
7	626	8.62%	89.67%	152.95%	6	4
8	524	11.35%	86.54%	161.24%	4	3
9	247	17.18%	90.71%	200.53%	5	4
10	294	22.08%	69.55%	171.29%	1	1
11	210	39.57%	69.63%	189.43%	7	4
12	347	65.43%	82.21%	175.23%	4	3
Default	1,405	100.00%	60.85%	72.44%	-	-
Total	16,642	13.75%	77.20%	111.04%	167	119

PD Grade	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Exposure Weighted Average LGD %	2010 Average Risk Weight %	2010 Undrawn Commitments (Gross) £m	2010 Undrawn Commitments (Post Credit Conversion Factor) £m
0	11	0.09%	85.02%	20.07%	-	-
1	618	0.31%	66.36%	36.09%	-	-
2	2,906	0.69%	57.77%	51.74%	17	3
3	562	1.00%	84.36%	90.53%	-	-
4	4,660	1.69%	61.77%	80.45%	17	4
5	3,214	3.22%	64.82%	96.75%	15	3
6	2,798	5.66%	65.47%	103.78%	12	2
7	906	9.05%	64.87%	111.96%	6	1
8	1,028	11.77%	62.00%	117.05%	1	-
9	202	17.33%	68.18%	151.20%	1	-
10	564	22.33%	67.35%	162.69%	14	6
11	490	35.05%	64.37%	168.70%	10	3
12	416	71.23%	69.54%	133.08%	-	-
Default	2,175	100.00%	64.35%	39.92%	-	-
Total	20,550	16.42%	63.81%	86.08%	93	22

Key Movements

- The increase in exposure weighted average LGDs and resultant increase in the overall average risk weight from 86.08% to 111.04% reflects the impact of new, more conservative personal loans models implemented during the year.

Retail SME exposures by PD Grade

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Exposure Weighted Average LGD %	2011 Average Risk Weight %	2011 Undrawn Commitments (Gross) £m	2011 Undrawn Commitments (Post Credit Conversion Factor) £m
0	-	-	-	-	-	-
1	-	-	-	-	-	-
2	728	0.61%	53.73%	54.97%	524	493
3	422	1.12%	58.11%	81.02%	205	199
4	228	1.67%	64.45%	122.25%	105	103
5	291	2.62%	63.10%	122.74%	100	98
6	211	5.67%	61.65%	107.36%	54	53
7	71	8.04%	59.05%	105.79%	12	12
8	142	10.61%	71.53%	161.71%	42	41
9	83	18.02%	72.50%	178.54%	13	13
10	-	-	-	-	-	-
11	36	34.10%	84.25%	280.34%	5	5
12	20	78.18%	74.91%	137.10%	4	2
Default	410	100.00%	2.86%	29.25%	2	1
Total	2,642	19.19%	51.39%	87.27%	1,066	1,020

PD Grade	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Exposure Weighted Average LGD %	2010 Average Risk Weight %	2010 Undrawn Commitments (Gross) £m	2010 Undrawn Commitments (Post Credit Conversion Factor) £m
0	-	-	-	-	-	-
1	-	-	-	-	-	-
2	408	0.60%	64.87%	50.85%	357	337
3	280	1.12%	73.25%	75.79%	189	184
4	191	1.67%	77.38%	92.86%	113	111
5	489	2.62%	60.62%	85.89%	159	160
6	105	5.67%	80.21%	118.94%	37	38
7	35	8.04%	110.27%	165.04%	15	14
8	230	10.61%	89.48%	152.61%	83	90
9	65	18.01%	97.27%	209.99%	18	21
10	-	-	-	-	-	-
11	81	34.09%	108.83%	289.93%	19	21
12	18	78.17%	123.70%	194.01%	6	7
Default	347	100.00%	4.63%	31.84%	2	-
Total	2,249	20.24%	63.70%	91.97%	998	983

ANALYSIS OF EXPOSURES SUBJECT TO SUPERVISORY SLOTTING AND THE SIMPLE RISK WEIGHT METHOD

Specialised Lending Exposures Subject to Supervisory Slotting

Specialised lending exposures subject to supervisory slotting are assigned to a grade, the determination of which takes into account the following factors:

- financial strength e.g. market conditions, financial ratios, stress analysis, financial structure, cash flow predictability, market liquidity and degree of over-collateralisation of trade;
- political and legal environment e.g. political risks, country risks, force majeure risks, government support, stability of legal and regulatory environment, enforceability of contracts and collateral and security;
- transaction and / or asset characteristics e.g. location, design and technology risks, construction risks, completion guarantees, financial strength of contractors and reliability, operating risks, off-take risks, supply risks, financing terms, resale values, value sensitivities and susceptibility to damage;
- strength of the sponsor and developer including any public private partnership income stream e.g. sponsor's financial strength, quality of financial disclosure, sponsor's support, reputation and track record, trading controls and hedging policies; and
- security package e.g. assignment of contracts and accounts, pledge of assets, lender's control over cash flow, covenant package, reserve funds, nature of lien, quality of insurance coverage, asset control and inspection rights.

The detailed criteria applying to each of the factors above is set out within BIPRU. Differing criteria apply to each of the main specialised lending categories i.e. project finance, income-producing real estate, object finance and commodities finance.

Once assigned to a grade, the exposure is risk weighted in accordance with the risk weight applicable to that grade and remaining maturity banding.

As at 31 December 2011, total credit risk exposures in respect of specialised lending subject to supervisory slotting criteria amounted to £6.0bn (2010: £12.5bn). Risk weighted assets arising from this amounted to £4.5bn (2010: £6.4bn) as analysed in the table below.

	Remaining Maturity <2.5 years		Remaining Maturity >2.5 years	
Grade	2011 Exposure £m	2011 Risk Weighted Assets £m	2011 Exposure £m	2011 Risk Weighted Assets £m
1) Strong	78	39	1,431	591
2) Good	363	248	2,563	2,088
3) Satisfactory	389	448	339	390
4) Weak	253	633	13	32
5) Default [1]	490	-	42	-
Total	1,573	1,368	4,388	3,101

	Remaining Maturity <2.5 years		Remaining Maturity >2.5 years	
Grade	2010 Exposure £m	2010 Risk Weighted Assets £m	2010 Exposure £m	2010 Risk Weighted Assets £m
1) Strong	208	104	2,316	1,512
2) Good	443	325	2,232	1,938
3) Satisfactory	755	865	464	534
4) Weak	307	767	141	352
5) Default [1]	5,233	-	440	-
Total	6,946	2,061	5,593	4,336

Notes

[1] Exposures categorised as 'default' do not attract a risk weighting but are instead treated as expected loss deductions at a rate of 50% of the exposure value.

Key Movements

- The overall reduction in exposure is primarily a result of the transitioning of the remaining Irish property development portfolio to the Standardised Approach.

Equity Exposures Subject to the Simple Risk Weight Method

The Simple Risk Weight Method is used for calculating risk weighted asset positions in respect of equity exposures.

As at 31 December 2011, total credit risk exposures in respect of equities subject to the Simple Risk Weight Method amounted to £15m (2010: £2.3bn). Risk weighted assets arising from this also amounted to £57m (2010: £5.5bn).

An analysis of equity exposures categorised and risk weighted under the Simple Risk Weight Method is provided in the table below.

	2011 Credit Risk Exposure £m	2011 Risk Weighted Asset £m	2010 Credit Risk Exposure £m	2010 Risk Weighted Asset £m
Privately traded equity exposures – 190% [1]	-	-	1,693	3,217
Publicly traded equity exposures – 290%	-	-	62	179
Other equity exposures – 370%	15	57	576	2,133
Total	15	57	2,331	5,529

Notes

[1] Where privately traded equity exposures are in sufficiently diversified portfolios.

Key Movements

- Equity exposures previously subject to the IRB Simple Risk Weight Method were transitioned to the Standardised Approach during the year following finalisation of the Group's integrated IRB waiver permission. Amounts remaining subject to the Simple Risk Weight Method relate to the Group's exposure to the Business Growth Fund plc.

Further information on equity exposures is provided on pages 74 to 75.

COMPARISON OF EXPECTED LOSSES TO ACCOUNTING IMPAIRMENT LOSSES

The table below provides a comparison of gross expected losses as at 31 December 2010 to the net charge to the income statement (impairment losses) for the year to 31 December 2011, in respect of credit risk exposures subject to the IRB Approach. Expected losses in relation to the Group's IRB portfolios are derived from the underlying IRB models, being a function of the associated PD, LGD and EAD estimates, and represent the potential loss on a portfolio over a 12 month period, subject to downturns and regulatory floors. Where expected losses for the Group exceed the current impairment provisions raised, the 'excess' is deducted from capital, split equally between core tier 1 and tier 2 capital.

As IRB models are developed to meet precise regulatory requirements under the Basel II Framework, the expected losses generated by these models are not directly comparable to impairment losses derived under IFRS accounting standards. In particular;

- IFRS accounting impairment losses seek to measure loss on the basis of the economic conditions at the balance sheet date. However expected loss calculations are predicated on loss estimates that are based on economic downturn conditions.

- Expected loss calculations forecast potential losses arising from all accounts including those that currently exhibit no indication of impairment. However IFRS accounting impairment losses specifically exclude any customers that are currently operating within the terms of the credit agreement.

- Expected losses in relation to portfolios that are based on through-the-cycle ('TTC') PD estimates utilise historic default experience, whereas IFRS accounting impairment losses are based on the loss incurred at a point-in-time ('PIT').

- Expected loss calculations anticipate additional drawings made by customers who are yet to default (EAD estimate). IFRS accounting impairment losses reflect exposures value and conditions at the balance sheet date.

In addition, expected losses in relation to credit portfolios that have rolled out onto IRB models during the year will not be reflected in the expected losses total at the start of the year as these portfolios were, at the time, subject to the Standardised Approach. Impairment losses for the year will reflect losses in relation to all portfolios that were subject to the IRB Approach during the year. In comparing expected losses to accounting impairment losses, consideration of the above should be taken into account.

	Expected Losses as at 31 December 2010	Impairment Losses for the year to 31 December 2011	Expected Losses as at 31 December 2009	Impairment Losses for the year to 31 December 2010
	£m	£m	£m	£m
Foundation IRB Approach				
Corporate (Main, SME and Specialised lending)	9,541	2,386	10,244	2,209
Central governments and central banks	1	-	1	-
Institutions	69	68	115	87
Retail IRB Approach				
Retail - Residential mortgages	2,136	799	2,020	549
Retail - Qualifying revolving retail exposures	1,884	806	2,026	1,531
Retail - Other retail	1,881	798	2,376	1,178
Retail - SME	124	71	137	-
Other IRB Approaches				
Corporate - Specialised lending [1]	2,931	462	2,684	1,958
Equities	35	-	27	-
Total	18,602	5,390	19,630	7,512
Impairment losses on standardised portfolios		4,322		5,433
Fair value and other adjustments to loans and advances		(1,692)		(2,231)
Impairment losses on debt securities (loans and receivables)		49		57
Impairment of available-for-sale financial assets		80		106
Other credit risk provisions		(55)		75
Total Impairment Charged to the Income Statement		8,094		10,952

Notes

[1] For corporate specialised lending portfolios subject to the supervisory slotting approach, exposures categorised as 'default' do not attract a risk weighting but are instead treated as expected loss deductions at a rate of 50% of the exposure value.

Key Movements

- Factors leading to the reduction in impairment losses during 2011 are explained on pages 50 to 51.

Accounting policies in respect of the impairment of loans and receivables are provided within the Past Due Exposures, Impaired Exposures and Impairment Provisions section of the document (pages 41 to 43).

MODEL PERFORMANCE

This section provides an analysis of the performance of IRB models over 2011.

The table below compares the estimated and actual Probability of Default ('PD') and Loss Given Default ('LGD'), and Exposure at Default ('EAD') ratio by exposure class. The values are taken from the Group's regulatory capital calculation models, including regulatory floors. For the purposes of comparison, EAD weighting has been used throughout.

Validation of model parameters and outputs forms part of the control framework surrounding the development and monitoring of Foundation IRB and Retail IRB models described on pages 52 to 55.

IRB Exposure Class	Probability of Default		Loss Given Default of Defaulted Assets		EAD of Defaulted Assets
	Estimated Dec 10 %	Actual Dec 11 %	Estimated Dec 10 %	Actual Dec 11 %	Ratio of Predicted to Actual %
Wholesale Business					
Central governments and central banks	0.02%	0.00%			
Institutions	0.10%	0.00%			
Corporates	3.17%	5.27%			
Retail Business					
Residential mortgages	2.29%	1.35%	16.34%	8.51%	1.02
Qualifying revolving retail exposures	3.79%	3.48%	79.41%	69.95%	1.09
Other retail	6.79%	6.16%	86.89%	69.89%	1.07
Retail SME	6.73%	4.47%	62.68%	74.72%	1.06

IRB Exposure Class	Probability of Default		Loss Given Default of Defaulted Assets		EAD of Defaulted Assets
	Estimated Dec 09 %	Actual Dec 10 %	Estimated Dec 09 %	Actual Dec 10 %	Ratio of Predicted to Actual %
Wholesale Business					
Central governments and central banks	0.02%	0.00%			
Institutions	0.18%	0.00%			
Corporates	3.22%	4.68%			
Retail Business					
Residential mortgages	1.77%	1.33%	18.78%	7.09%	1.02
Qualifying revolving retail exposures	5.58%	4.69%	65.25%	68.70%	1.19
Other retail	6.28%	6.78%	60.18%	69.80%	2.10
Retail SME	6.16%	4.70%	65.00%	71.00%	0.47

Each exposure class consists of a number of IRB models. For capital calculation purposes, except where directed otherwise by the regulator, the PDs assigned to grades must reflect the long-run average PD of that grade over a full economic cycle i.e. over an economic cycle, the PD model outputs should have the same average as the actual default rate over the same period.

However, models and rating systems vary between two extremes of Point-in-Time ('PiT') and Through-the-Cycle ('TTC') with most representing a hybrid position. Within the Group, PD models used in the regulatory capital calculation seek to be through-the-cycle calibrated or hybrid models, and as a result, whilst having the same average over a full economic cycle as the actual default rates, have lower variability. The gap between Estimated and Actual Default Rates will therefore narrow or widen to reflect the cyclical nature of defaults. In addition, the EAD weighted default metric is subject to volatility due to a small number of large value defaults in the Wholesale Business exposure classes which can result in an apparently higher actual default rate. However a large default will not necessarily result in a large loss, and capital requirements are calculated for each asset using the regulatory EAD and LGD parameters. This ensures that sufficient capital is held for all assets in line with the regulatory requirements that apply.

The LGD models are downturn calibrated. Determination of actual LGD also includes the use of downturn calibrated model estimates for those assets where losses are not yet realised. The impact of model updates also therefore contributes to the difference between estimated and actual LGD.

The EAD ratio is provided as a proxy for the regulatory requirement to disclosure information about credit conversion factors. The ratio is provided as it allows a consistent measurement to be produced across all parts of the Group, and the Group believes this to be a more useful measure. Where the predicted EAD was greater than the actual exposure on the date of default, the ratio will be greater than one.

Model performance metrics for each exposure class will be influenced over time by a number of factors, such as changes to the underlying portfolio and suite of models in use. The Group operates an ongoing programme to regularly refresh models either through recalibration or replacement. During 2011 the process to integrate or align models across the two heritage Banks has continued to make significant progress. In addition the risk profile of some portfolios have moved, and there have been significant volume reductions over the year.

No LGD or EAD information is provided for central governments and central banks, institutions or corporates, as these parameters are not modelled under the Foundation IRB Approach.

EXPOSURES SUBJECT TO THE STANDARDISED APPROACH

As at 31 December 2011, credit risk exposures risk weighted under the Standardised Approach amounted to £190.0bn (2010: £180.7bn), generating risk weighted assets of £103.5bn (2010: £124.5bn) and a capital requirement of £8.3bn (2010: £10.0bn).

The Group makes limited use of credit assessments by external credit assessment institutions ('ECAIs') to assign risk weights to credit risk exposures under the Standardised Approach. This typically applies in the case of certain central government and central bank and institution exposures. Where available, credit assessments can also be used to assign risk weights to exposures to corporates and collective investment undertakings.

Where a credit assessment is used this must be provided by an eligible ECAI from the FSA's approved list. The appropriate risk weight to apply to the credit risk exposure is determined by assigning the exposure to the relevant credit quality step under BIPRU Chapter 3 (Standardised Credit Risk), based on the FSA's mapping of credit assessments to credit quality steps. A table containing the current mappings is published on the FSA's website. Where appropriate, the Group makes use of credit assessments provided by Standard & Poor's, Moody's and Fitch.

The majority of the Group's Standardised credit risk exposures are deemed to be unrated as there are no available credit assessments to utilise. Risk weights are assigned to these exposures in accordance with BIPRU Chapter 3 requirements prescribing the treatment of unrated exposures.

The following tables indicate the risk weights applied to credit risk exposures subject to the Standardised Approach, by Standardised exposure class, together with the associated RWA. The appropriate risk weight is applied to the exposure after consideration of any eligible forms of credit risk mitigation.

Key movements in Standardised credit risk exposures are explained on p.33.

Central Governments and Central Banks

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	72,385	-	72,385	-
100%	57	-	57	57
150%	-	-	-	-
Total	72,442	-	72,442	57

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	40,110	-	40,110	-
100%	53	-	53	53
150%	5	-	5	7
Total	40,168	-	40,168	60

Regional Governments and Local Authorities

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
20%	41	-	41	8
100%	-	-	-	-
Total	41	-	41	8

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
20%	64	-	64	13
100%	1	-	1	1
Total	65	-	65	14

Administrative Bodies and Non-Commercial Undertakings

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
20%	12	-	12	2
100%	359	-	359	359
Total	371	-	371	361

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
20%	66	-	66	13
100%	281	-	281	281
Total	347	-	347	294

Multilateral Development Banks

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	83	-	83	-
Total	83	-	83	-

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	-	-	-	-
Total	-	-	-	-

Institutions

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	66	-	66	-
20%	722	-	722	144
50%	267	-	267	133
100%	122	-	122	122
150%	-	-	-	-
Total	1,177	-	1,177	399

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	76	-	76	-
20%	480	-	480	96
50%	154	(1)	153	77
100%	106	-	106	106
150%	9	-	9	13
Total	825	(1)	824	292

Corporates

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	48	-	48	-
20%	132	-	132	26
50%	-	-	-	-
100%	13,158	(287)	12,871	12,871
150%	11	-	11	17
Other [1]	21,456	(157)	21,299	20,564
Total	**34,805**	**(444)**	**34,361**	**33,478**

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	2,999	-	2,999	-
20%	201	-	201	40
50%	68	-	68	34
100%	41,086	(243)	40,843	40,843
150%	32	-	32	48
Total	44,386	(243)	44,143	40,965

Notes

[1] This category includes Wholesale Division and Commercial Division exposures to corporates. Risk weighted asset amounts at 31 December 2011 have been determined in accordance with Standardised Approach requirements, supplemented by additional conservative estimates. The equivalent exposure at 31 December 2010 amounted to £28,496m, generating a total risk weighted asset amount of £25,643m.

Exposures to corporates amounting to £898m (2010: £1,610m) are covered by eligible financial collateral, allowing a reduced risk weight to be applied. This collateral has not been used to reduce the exposures recognised for risk weighting purposes.

Exposures to corporates amounting to £48m (2010: £183m) are covered by an export credits guarantee from the UK Export Finance, Export Credit Guarantee Department ('ECGD'). A risk weight of 0% has been applied to these exposures. A further £2m (2010: £8m) of exposures to corporates are covered by guarantees that allow a reduced risk weight to be applied.

Exposures to corporates amounting to £109m (2010: £112m) are covered by credit derivatives, allowing a risk weight of 20% to be applied.

Retail

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	32	-	32	-
20%	-	-	-	-
35%	62	-	62	22
75%	7,554	(60)	7,494	5,620
100%	375	-	375	375
150%	9	-	9	13
Total	**8,032**	**(60)**	**7,972**	**6,030**

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	18	-	18	-
20%	8	-	8	2
35%	-	-	-	-
75%	9,476	(75)	9,401	7,052
100%	593	(99)	494	494
150%	8	-	8	12
Total	10,103	(174)	9,929	7,560

Secured on Real Estate Property

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	481	-	481	-
20%	1	-	1	-
35%	11,603	-	11,603	4,061
50%	774	-	774	387
75%	3,404	-	3,404	2,553
100%	5,847	-	5,847	5,847
150%	-	-	-	-
Other [1], [2]	15,927	-	15,927	18,625
Total	38,037	-	38,037	31,473

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	558	-	558	-
20%	5	-	5	1
35%	9,971	-	9,971	3,490
50%	1,678	-	1,678	839
75%	2,832	-	2,832	2,124
100%	25,297	(46)	25,251	25,251
150%	2,584	-	2,584	3,877
Total	42,925	(46)	42,879	35,582

Notes

[1] This category includes Wholesale Division and Commercial Division real estate property exposures amounting to £15,576m. Risk weighted asset amounts at 31 December 2011 (totalling £18,412m) have been determined in accordance with Standardised Approach requirements, supplemented by additional conservative estimates. The equivalent exposure at 31 December 2010 amounted to £19,639m, generating a total risk weighted asset amount of £20,825m.

[2] In addition to the real estate property exposures noted above, this category also includes lifetime mortgage exposures amounting to £351m that are subject to non-standard risk weights. A risk weighted asset amount of £213m was generated at 31 December 2011.

Exposures secured on real estate property amounting to £481m (2010: £500m) are covered by a guarantee provided through a Dutch Government scheme. A risk weight of 0% has been applied to these exposures. In addition, exposures secured on real estate property amounting to £nil (2010: £5m) are subject to an insurance arrangement which allows a reduced risk weight of 20% to be applied.

Past Due Items

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	-	-	-	-
20%	1	-	1	-
35%	4	-	4	2
50%	30	-	30	15
75%	-	-	-	-
100%	6,016	(67)	5,949	5,949
150%	2,627	-	2,627	3,941
Total	8,678	(67)	8,611	9,907

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	23	-	23	-
20%	2	-	2	1
35%	-	-	-	-
50%	36	(1)	35	17
75%	194	-	194	145
100%	6,911	-	6,911	6,911
150%	5,475	-	5,475	8,212
Total	12,641	(1)	12,640	15,286

Notes

Past due items amounting to £nil (2010: £1m) are subject to an insurance arrangement which allows a reduced risk weight of 20% to be applied. A further £1m (2010: £1m) of past due items are covered by guarantees that allow a reduced risk weight of 20% to be applied.

Items Belonging to Regulatory High Risk Categories

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
100%	92	-	92	92
150%	2,341	-	2,341	3,511
Total	2,433	-	2,433	3,603

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
100%	39	-	39	39
150%	131	-	131	197
Total	170	-	170	236

Short Term Claims on Institutions or Corporates

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
50%	10	-	10	5
100%	446	-	446	446
Total	456	-	456	451

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
50%	154	-	154	77
100%	747	-	747	747
Total	901	-	901	824

Collective Investment Undertakings

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
20%	111	-	111	22
100%	2	-	2	2
Total	113	-	113	24

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
20%	38	-	38	8
100%	2	-	2	2
Total	40	-	40	10

Other Items

Risk Weight	2011 Credit Risk Exposure (Pre CRM) £m	2011 Credit Risk Mitigation £m	2011 Credit Risk Exposure (Post CRM) £m	2011 Risk Weighted Asset £m
0%	3,936	-	3,936	-
20%	1,947	-	1,947	389
50%	180	-	180	90
75%	50	-	50	38
100%	17,217	-	17,217	17,217
		-		
Total	23,330	-	23,330	17,734

Risk Weight	2010 Credit Risk Exposure (Pre CRM) £m	2010 Credit Risk Mitigation £m	2010 Credit Risk Exposure (Post CRM) £m	2010 Risk Weighted Asset £m
0%	3,438	-	3,438	-
20%	1,645	-	1,645	329
50%	65	-	65	33
75%	108	-	108	81
100%	22,898	-	22,898	22,898
Total	28,154	-	28,154	23,341

Further details on securitisation positions subject to the Standardised Approach can be found within the Securitisations section of the document.

NON-TRADING BOOK EXPOSURES IN EQUITIES

Non-trading book exposures in equities held by the Group primarily arise within Wholesale Division from individual transactions in the private equity market and as a result of debt for equity swaps. These are generally medium term investments, held for gain and include limited partnership stakes and listed and unlisted equity shares.

Private equity investments are managed, and evaluated, in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The accounting techniques and valuation methodologies applied are set out within the Group's accounting policies, an extract of which is provided below for reference.

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.

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.

Accounting policies in relation to the recognition of impairment losses on available-for-sale financial assets are set out on p.43.

The balance sheet value of non-trading book exposures in equities, as at 31 December 2011, is presented in the table below. There was no difference between the balance sheet value and the fair value of these exposures.

Equity Grouping	2011 Balance Sheet Value £m	2010 Balance Sheet Value £m
Publicly quoted equities	27	67
Privately held equities	1,953	2,404
Total	**1,980**	2,471

Realised gains recognised in the year to 31 December 2011 in respect of the sale and liquidation of non-trading book exposures in equities amounted to £183m (2010: £356m).

As at 31 December 2011, net unrealised gains on available-for-sale equities amounted to £386m (2010: £462m). This gain has been included within tier 2 capital.

NON-TRADING BOOK SECURITISATIONS

The Group is an active participant in the securitisation market, operating as an originator, a sponsor of asset backed commercial paper conduits and as an arranger of and an investor in third party securitisations. The Group also provides liquidity facilities to both own originated and sponsored securitisations as well as to third parties.

Securitisation Strategy and Roles

The Group undertakes securitisation activities for a number of reasons, including to manage risk concentrations in its balance sheet, to support relationships with customers and to manage its funding requirements and capital position.

As an originator, the Group makes use of securitisation as a means of actively managing its balance sheet. Origination activities mainly extend around the Group's retail and commercial lending portfolios where the primary objective is funding, although certain synthetic commercial loan securitisations, involving the use of credit default swaps, are used for capital efficiency purposes. Further details on the Group's originated securitisations are provided on pages 77 to 82.

Through its sponsoring activities, the Group has established three asset backed commercial paper conduits which it manages and supports, where relevant, through the provision of liquidity facilities. The purpose of each of the conduits is explained more fully on p.83.

As an investor, the Group invests directly in third party asset backed securities and provides liquidity facilities to other third party securitisations.

Summary Analysis

As at 31 December 2011, credit risk exposures classed as securitisation positions amounted to £31.0bn (2010: £56.4bn). An analysis of these exposures by type and risk weight approach, together with the associated capital requirement, is provided in the table below. In addition, the table provides an analysis of securitisation positions that have been deducted from capital.

Securitisation type and risk weight approach	2011 Credit Risk Exposure [1] £m	2011 Risk Weighted Assets [2] £m	2011 Capital Requirement £m	2011 Deduction from Capital [3] £m
Originated:				
Ratings Based Approach	7,427	2,838	227	156
Standardised Approach	-	-	-	-
Supervisory Formula Approach	-	-	-	-
	7,427	2,838	227	156
Sponsored and Invested:				
Internal Assessment Approach	4,855	738	59	-
Ratings Based Approach	18,745	5,800	464	150
	23,600	6,538	523	150
TOTAL	31,027	9,376	750	306

Securitisation type and risk weight approach	2010 Credit Risk Exposure [1] £m	2010 Risk Weighted Assets [2] £m	2010 Capital Requirement £m	2010 Deduction from Capital [3] £m
Originated:				
Ratings Based Approach	9,256	1,891	151	123
Standardised Approach	8	28	2	10
Supervisory Formula Approach	106	8	1	18
	9,370	1,927	154	151
Sponsored and Invested:				
Internal Assessment Approach	9,296	767	61	-
Ratings Based Approach	37,734	6,288	503	286
	47,030	7,055	564	286
TOTAL	56,400	8,982	718	437

Notes

[1] Credit risk exposure is defined as the aggregate of the Group's gross retained or purchased positions, excluding those positions rated below BB- or that are unrated and therefore deducted from capital.

[2] Risk weighted assets are stated net of value adjustments, where applicable. These adjustments represent a combination of impairment writedowns, acquisition related fair value adjustments and other fair value adjustments.

[3] Retained or purchased positions rated below BB- or that are unrated are deducted from capital. The amount deducted is stated net of value adjustments, as defined above.

ORIGINATED SECURITISATIONS

Overview of Originated Securitisation Structures

Traditional originated securitisation transactions typically involve the sale of a group or portfolio of ring fenced loans to another entity, often known as a special purpose entity ('SPE'). An SPE is a purposely created company within a group of companies where the ultimate holding company of the group is unrelated to the originator and is usually held by a trust, meaning Lloyds Banking Group does not legally own the SPE. The Group does, however, administer the SPE and the originating Group company receives fees from the SPE for continuing to service the loans.

To raise funds for the purchase (being initially equal to the face value of the assets) fixed and floating rate notes are issued to investors in the financial market from the issuing company within the SPE group of companies. Interest and principal received from the underlying assets is used to fund the payment of the loan note interest and principal. Any residual income after paying the interest and principal on the notes and any fees and other operating costs is generally retained within the structure as additional reserve funds or distributed to the originating entity.

Notes issued are divided into separate tranches depending upon their level of subordination. Typically there will be senior, mezzanine and junior notes. In its most basic form, if a shortfall in income were to exist there would be no recourse to the originator. The shortfall would firstly be borne by any reserve funds within the structure and would then be borne as losses by the noteholders in the order of their subordination. In this way the most senior notes can achieve a high credit rating.

Investors who subscribe for the notes have the advantage of choosing the tranche that best meets their risk / return needs. In funding driven transactions, often the most junior tranches are retained by the Group so that there is effectively no significant risk transfer of credit risk away from the Group. Instead the vehicle serves as a diverse source of funding for the securitised assets.

Where there is deemed to be a significant transfer of risk then the Group benefits from lower regulatory capital requirements in respect of the securitised assets.

A synthetic securitisation transaction works in a similar way to the traditional version discussed above, except that the legal ownership of the underlying assets remains with the bank and the economic risk of the assets is transferred instead using credit default swaps. In certain cases the Group will retain the risk on the senior tranches.

Re-securitisation transactions undertaken by the Group involve securitisations where the risk associated with the underlying pool of assets is tranched and at least one of the underlying assets is a securitisation position.

Summary of Accounting Policies

From an accounting perspective, the treatment of SPEs is assessed in accordance with the Standing Interpretations Committee's interpretation (SIC 12) of International Accounting Standard (IAS) 27. This requires SPEs to be consolidated where the substance of the relationship between the Group and the SPE indicates that the SPE is controlled by the Group.

Where the transfer of the Group's assets to the SPE fails the 'derecognition' accounting tests under IAS 39, a deemed loan is reflected in both the Group and SPE accounts for the consideration paid. The transferred assets remain on the Group's balance sheet for accounting purposes. These assets are classified as loans and receivables on the balance sheet and the notes issued (excluding those held by the Group) classified as debt securities in issue. The assets and notes issued are held at amortised cost.

Securitised assets are only derecognised where the following conditions are met:

- substantially all of the risks and rewards associated with the assets have been transferred in which case they are derecognised in full; or

- a significant proportion but not all of the risks and rewards have been transferred, in which case the assets are either derecognised in full where the transferee has the ability to sell the assets, or continue to be recognised by the Group but only to the extent of its continuing involvement; or

- a fully proportional share of all or of specifically identified cash flows have been transferred, in which case that proportion of the assets are derecognised.

A securitisation transaction is recognised as a sale or partial sale where derecognition is achieved. The difference between the carrying amount and the consideration received is recorded in the income statement. Securitisation transactions that do not achieve derecognition are treated as financings.

The Group's securitised residential mortgage assets are not derecognised because the Group retains substantially all the risks and rewards associated with the underlying portfolios of assets. In addition securitised commercial banking loans are not derecognised because the Group has not transferred the contractual rights to receive the cash flows from those loans nor has it assumed a contractual obligation to pay the cash flows from those loans to a third party.

Synthetic securitisations, where credit derivatives are used to transfer the economic risk of the underlying assets but the Group retains legal ownership of the assets, are accounted for under similar accounting policies to those summarised above, with the associated credit derivatives accounted for under the requirements of IAS 39.

Liquidity lines provided to the conduits are accounted for in accordance with the accounting policies set out in the 2011 Lloyds Banking Group plc Annual Report and Accounts.

The Group's retained and purchased securitisation and re-securitisation positions are valued for accounting purposes in accordance with the Group's accounting policies as outlined on pages 218 to 220 (Financial Assets and Liabilities) of the 2011 Lloyds Banking Group plc Annual Report and Accounts. For those positions measured at fair value, further details on the valuation methodologies applied are outlined on pages 311 to 318 (Fair Values of Financial Assets and Liabilities) of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

Securitisation Programmes and Activity

On an accounting basis, the Group's principal originated securitisation programmes, together with the balances of the advances subject to securitisation and the carrying value of the notes in issue at 31 December, are noted in the table below.

Securitisation Programmes [1]	2011 Gross Assets Securitised £m	2010 Gross Assets Securitised £m	Movement £m	2011 Notes in Issue £m	2010 Notes in Issue £m	Movement £m
UK residential mortgages	129,764	146,200	(16,436)	94,080	114,428	(20,348)
US residential mortgage-backed securities	398	-	398	398	-	398
Commercial loans	13,313	11,860	1,453	11,342	8,936	2,406
Irish residential mortgages	5,497	6,007	(510)	5,661	6,191	(530)
Credit card receivables	6,763	7,327	(564)	4,810	3,856	954
Dutch residential mortgages	4,933	4,526	407	4,777	4,316	461
Personal loans	-	3,012	(3,012)	-	2,011	(2,011)
PFI / PPP and project finance loans	767	776	(9)	110	110	-
Motor vehicle loans	3,124	926	2,198	2,871	975	1,896
	164,559	180,634	(16,075)	124,049	140,823	(16,774)
Less notes held by the Group				(86,637)	(100,081)	13,444
Total				37,412	40,742	(3,330)

Notes

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

Gross assets securitised decreased by £16.1bn during the year, primarily as a result of amortisation of the pools within the UK residential mortgage programmes and the closure of the personal loans programme. The increase in gross assets securitised in relation to motor vehicle loans of £2.2bn reflects the inclusion of further assets originated from the Group's balance sheet during the year.

No securitisation transactions undertaken during the year were recognised as sales.

Risks Inherent in Securitised Assets

The Group's securitisation programmes extend primarily around residential mortgage portfolios, credit card portfolios and commercial loan portfolios. In each case credit risk is the primary risk driver attached to the underlying asset pool. Assets securitised are predominantly originated from the Group's UK operations, other than for the Group's Dutch and Irish residential mortgage securitisation programmes, the motor vehicle loans originated from the Group's Australian operations (which represent a proportion of the overall securitised motor vehicles loans pool) and various assets within the Group's wholesale securitisations, including certain PFI / PPP portfolios which are internationally diverse.

The performance of the securitised assets is largely dependent on prevailing economic conditions, and in the case of residential mortgage assets, the health of the housing market. The likelihood of defaults in the underlying asset pool and the amounts that may be recovered in the event of default are related to a number of factors and may vary according to characteristics, product type, security, collateral and customer support initiatives. Significant changes in the national or international economic climate, regional economic or housing conditions, changes in tax laws, interest rates, inflation, the availability of financing, yields on alternative investments, political developments and government policies or in the health of a particular geographic zone that represents a concentration in the securitised assets, could also affect the cashflows from the underlying asset pool.

The underlying assets of the Group's re-securitisation transactions primarily relate to US residential mortgage backed securities, the performance of which will be impacted by similar factors to those described above.

Liquidity risk arises where insufficient funds are received by the SPE to service payments to the noteholders as they fall due. The receipt of funds is in part dependent on the level of repayment on the underlying asset pool. In general, where such a situation arises noteholders may not be paid in full and amounts may be deferred to subsequent periods. Such deferred amounts will be due but not payable until funds become available in accordance with the relevant priority of payments as set out in the programme documentation. Variations in the rate of prepayment of principal on the underlying loans may affect each series and class of notes differently.

In addition, both the notes in issue and the underlying asset pool are exposed to interest rate risk and, in certain cases, can be subject to foreign exchange risk.

Where the Group holds notes in a securitisation it is exposed to the credit performance of the underlying asset pool, the impact of interest rate and, in some cases, foreign exchange volatility on the value of the notes, and to the seniority of the notes held, the latter of which determines the extent to which the Group would suffer any loss as a result of a shortfall in funds received by the SPE.

Liquidity risk in the context of the Group's conduits is covered in more detail on pages 83 to 86.

Regulatory Treatment

In deriving credit risk exposures associated with originated securitisations, the Group takes into account that certain securitised assets, whilst held on the balance sheet for accounting purposes, are deemed to have met the prudential significant risk transfer tests when securitised and therefore the retained positions in the securitisations are included within regulatory calculations rather than the underlying assets. Where the minimum requirements for recognition of significant risk transfer are not met, the underlying assets remain part of the relevant exposure class and are risk weighted accordingly. This mainly applies in the case of funding transactions.

Capital requirements in relation to originated securitisation positions are determined under one of the relevant IRB Approach methodologies or under the Standardised Approach. Where appropriate, the Group utilises the ratings services of several ECAIs ('External Credit Assessment Institutions'), being Standard & Poor's, Moody's and Fitch, to rate securitisation transactions and retained or purchased positions for risk weight allocation purposes.

Gross Securitised Exposure

On a regulatory basis, the gross securitised exposures in relation to originated securitisations where significant risk transfer has been achieved amounted to £11.6bn (2010: £15.2bn) comprising both traditional and synthetic originated securitisations. An analysis is provided in the table below together with the amount of impaired exposures, past due but not impaired exposures and value adjustments.

	Gross Securitised Exposure				
	2011 Traditional £m	2011 Synthetic £m	2011 Impaired Exposures £m	2011 Past Due but not Impaired Exposures £m	2011 Value Adjustments [1] £m
Dutch residential mortgages	-	-	-	-	-
Commercial, PFI / PPP and project finance loans	235	3,951	547	25	-
Re-securitisations	7,422	-	-	-	3,010
Total	**7,657**	**3,951**	**547**	**25**	**3,010**

	Gross Securitised Exposure				
	2010 Traditional £m	2010 Synthetic £m	2010 Impaired Exposures £m	2010 Past Due but not Impaired Exposures £m	2010 Value Adjustments [1] £m
Dutch residential mortgages	2,139	-	16	77	-
Commercial, PFI / PPP and project finance loans	444	5,056	93	43	-
Re-securitisations	7,597	-	-	-	2,569
Total	10,180	5,056	109	120	2,569

Notes

[1] Value adjustments applied to re-securitisation exposures refer to impairment writedowns, acquisition related fair value adjustments and other fair value adjustments. At year end, £2,176m (2010: £2,295m) of these value adjustments applied against positions rated below BB- or that were unrated.

The net charge to the income statement for the year to 31 December 2011 in respect of losses attributed to the gross securitised exposures noted above amounted to £55m (2010: £32m).

Monitoring Changes in the Credit Risk of Securitised Exposures

The Group employs a range of measures to monitor changes in the credit risk of securitised commercial banking, PFI / PPP and project finance loans. These include monitoring on a monthly basis of current exposures in the underlying pool (including credit events, default history and disposals), together with data tracking collateral cover and loan repayments which are tracked from the original amount advanced.

The process for monitoring changes in the credit risk of re-securitisation positions is similar to the process applied in respect of the Group's ABS portfolios and is discussed further on p.86.

Use of Credit Default Swaps

The Group uses credit default swaps to securitise, in combination with external funding, commercial banking, PFI / PPP and project finance loans. The credit default swaps offer a level of credit protection to the Group over the positions retained in the synthetic securitisation programmes. The major swap counterparties include multilateral development banks (such as the European Investment Fund) and other institutions.

The Group's synthetic securitisations are legacy programmes and were established as synthetics, involving the use of credit default swaps, to reduce set up costs and to adopt a more simplified structure.

The Group does not use credit default swaps nor any forms of hedging in relation to mitigating the risk of retaining positions in re-securitisation transactions.

Assets Awaiting Securitisation

As at 31 December 2011, the Group had no assets awaiting securitisation through warehousing or pipeline activities. The Group does not currently partake in originate-to-distribute activities.

Originated Securitisations Subject to the Ratings Based Approach

The Ratings Based Approach utilises a set of defined risk weights prescribed by the FSA. The appropriate risk weight is dependent on the rating of the position, its classification as a securitisation position or a re-securitisation position, the maturity and the seniority of the position and the granularity of the asset pool backing the position. As at 31 December 2011, securitisation and re-securitisation positions arising from origination activities and risk weighted under the Ratings Based Approach amounted to £9.9bn (2010: £11.7bn), generating a capital requirement of £227m (2010: £151m). An analysis of these positions, by risk weight category, is provided in the table below.

S&P Equivalent Rating and RBA Risk Weight [1]		**Securitisation Positions 2011**						**Re-securitisation Positions 2011**				**TOTAL 2011**		TOTAL 2010 [4]	
		Senior		**Non-Senior**		**Tranches Backed by Non Granular Pools**		**Senior**		**Non-Senior**					
		Exposure	**Cap Req**	**Exposure**	**Cap Req**	**Exposure**	**Cap Req**	**Exposure**	**Cap Req**	**Exposure**	**Cap Req**	**Exposure**	**Cap Req**	Exposure	Cap Req
AAA	(7%, 12%, 20%, 20%, 30%)	1,285	8	28	-	-	-	1,439	24	-	-	2,752	32	3,847	
AA	(8%, 15%, 25%, 25%, 40%)	1,725	11	101	2	-	-	-	-	909	31	2,735	44	3,108	
A+	(10%, 18%, 35%, 35%, 50%)	-	-	61	1	-	-	-	-	223	10	284	11	306	
A	(12%, 20%, 35%, 40%, 65%)	-	-	-	-	-	-	-	-	231	13	231	13	238	
A-	(20%, 35%, 35%, 60%, 100%)	-	-	-	-	-	-	27	-	174	15	201	15	229	
BBB+	(35%, 50%, 50%, 100%, 150%)	-	-	-	-	-	-	81	-	44	5	125	5	228	
BBB	(60%, 75%, 75%, 150%, 225%)	-	-	46	2	-	-	52	-	103	13	201	15	310	
BBB-	(100%, 100%, 100%, 200%, 350%)	-	-	-	-	-	-	39	-	110	15	149	15	229	
BB+	(250%, 250%, 250%, 300%, 500%)	-	-	21	2	-	-	-	-	331	74	352	76	264	
BB	(425%, 425%, 425%, 500%, 650%)	-	-	-	-	-	-	-	-	185	1	185	1	238	
BB-	(650%, 650%, 650%, 750%, 850%)	-	-	12	-	-	-	-	-	200	-	212	-	259	
Below BB- or unrated	Deduction	44	-	207	-	-	-	-	-	2,247	-	2,498	-	2,418	
Total		3,054	19	476	7	-	-	1,638	24	4,757	177	9,925	227	11,674	151
Value adjustments taken to reserves [2]												(2,342)	-	(2,295)	-
Deduction from capital												(156)	-	(123)	-
Total Credit Risk Exposure / Cap Req [3]												7,427	227	9,256	151

Notes

[1] The Ratings Based Approach risk weights for each rating are listed in the following order: senior securitisation positions, non-senior securitisation positions, tranches backed by non-granular pools, senior re-securitisation positions and non-senior re-securitisation positions. Positions rated below BB- or that are unrated are deducted from capital, net of value adjustments applied.

[2] Value adjustments taken to reserves refer to impairment writedowns, acquisition related fair value adjustments and other fair value adjustments applied against gross positions rated below BB- or that are unrated. The net result is deducted from capital.

[3] Total credit risk exposure is defined as the aggregate of the Group's gross retained or purchased positions, excluding those positions rated below BB- or that are unrated and therefore deducted from capital. Capital requirements are stated net of value adjustments, where applicable. All retained or purchased positions are held on-balance sheet.

[4] Amendments were made to the application of the Ratings Based Approach at the end of 2011, as a result of the implementation of CRD 3. These amendments include the application of higher risk weights to re-securitisation positions. Prior to this no distinction was made between securitisation and re-securitisation positions under the Ratings Based Approach. As a result the prior year exposure comparatives for 2010 are disclosed in aggregate by rating grade and the resultant capital requirement in total as these are not directly comparable to the current year analysis and results.

Re-securitisation Positions

In relation to the Group's re-securitisation positions arising from origination activities, the underlying securitisation positions are predominantly senior positions. The assets underlying these positions relate to US Residential Mortgage Backed Securities.

Originated Securitisations Subject to the Standardised Approach

At 31 December 2011, credit risk exposures relating to retained positions risk weighted under the Standardised Approach amounted to £nil (2010: £8m), generating an RWA of £nil (2010: £28m) and a capital requirement of £nil (2010: £2m).

An analysis of these exposures by risk weight category is provided in the table below.

Risk Weight %	2011 Credit Risk Exposure £m	2011 Risk Weighted Assets £m	2011 Capital Requirement £m	2011 Deduction from Capital £m
350%	-	-	-	-
Deduction	-	-	-	-
Total	-	-	-	-

Risk Weight %	2010 Credit Risk Exposure £m	2010 Risk Weighted Assets £m	2010 Capital Requirement £m	2010 Deduction from Capital £m
350%	8	28	2	-
Deduction	-	-	-	10
Total	8	28	2	10

Originated Securitisations Subject to the Supervisory Formula Approach

At 31 December 2011, aggregate retained positions risk weighted under the Supervisory Formula Approach amounted to £nil (2010: £106m), generating an RWA of £nil (2010: £8m). In addition aggregate retained positions relating to reserve accounts of £nil (2010: £18m) were deducted from capital.

SPONSORED AND INVESTED SECURITISATIONS

The Group sponsors three asset backed commercial paper ('ABCP') conduits, Cancara, Argento and Grampian which invest in debt securities and client receivables. Within these conduits there are a series of bankruptcy remote SPEs that purchase receivables or asset backed securities and are funded by the issue of asset backed commercial paper or, in the event of market disruption, through liquidity facilities. The structures generate fee income and net interest income for the Group. Further details are provided in the table below.

Details	Cancara	Argento	Grampian
General description	Cancara was established in 2002 by Lloyds TSB Bank. It provides financing facilities to the Group's core corporate and financial institution clients, funded by asset backed commercial paper.	Argento was established in 2010 by Lloyds Banking Group to provide an additional source of funding for the Group through the issuance of asset backed commercial paper. It provides funding for third party originated asset backed securities as well as LBG originated assets.	Grampian was established in 2002 by HBOS. It funds a diverse portfolio of asset backed securities through the issuance of asset backed commercial paper. It represents an incremental funding source for the Group.
Programme limit / CP outstanding as at 31 December 2011	\$33.0bn / \$6.2bn (£21.4bn / £4.0bn)	\$10.0bn / \$6.0bn (£6.5bn / £3.9bn)	\$26.0bn / \$8.6bn (£16.8bn / £5.6bn)
Conduit structure	Partially supported multi-seller [1]	Hybrid, fully supported multi-seller	Securities arbitrage, fully supported
Credit enhancement	Programme Wide Letter of Credit	Fully supported	Programme Wide Letter of Credit
Liquidity provider	Lloyds Banking Group	Lloyds Banking Group	Lloyds Banking Group

Notes

[1] If a default occurs within the portfolio then liquidity facilities cannot be used to fund the defaulted asset.

All the external assets in these conduits are consolidated for accounting purposes in the Group's financial statements, following similar accounting policies to those established for originated securitisations. The total consolidated assets in the conduits are set out in the table below.

	2011 Cancara £m	2011 Argento £m	2011 Grampian £m	2011 TOTAL £m
Loans and advances	3,962	130	73	4,165
Debt securities classified as loans and receivables:				
Asset backed securities	-	1,022	2,004	3,026
Corporate and other debt securities	-	-	-	-
Debt securities classified as available-for-sale financial assets:				
Asset backed securities	21	733	796	1,550
Corporate and other debt securities	-	73	-	73
Total assets	3,983	1,958	2,873	8,814

	2010 Cancara £m	2010 Argento £m	2010 Grampian £m	2010 TOTAL £m
Loans and advances	3,957	-	-	3,957
Debt securities classified as loans and receivables:				
Asset backed securities	-	1,448	6,957	8,405
Corporate and other debt securities	-	202	-	202
Debt securities classified as available-for-sale financial assets:				
Asset backed securities	2,587	1,436	-	4,023
Corporate and other debt securities	-	463	-	463
Total assets	6,544	3,549	6,957	17,050

Total consolidated assets decreased by £8.2bn during the year as a result of significant reductions in the underlying asset backed securities portfolios of all three conduits, mainly as a result of disposals.

Cancara

Structure and liquidity facilities

Cancara Asset Securitisation Limited is an asset backed commercial paper conduit that buys assets from different sources via advances made to various purchasing companies. The conduit funds the purchase of the assets by issuing

ABCP. Cancara Asset Securitisation LLC is a separate bankruptcy remote, special purpose limited liability company established to co-issue US Dollar domestic commercial paper from Cancara Asset Securitisation Limited.

Assets purchased relate to pools of third party receivables. During the year the remaining securities portfolio was reduced down through selective disposals.

There are a number of intermediary special purpose entities within the conduit structure that are used to purchase the assets. Each purchasing company enters into a purchasing agreement with the issuer, which then advances funds to the purchasing company to buy the assets. The purchasing company issues a purchaser demand note to the issuer which benefits from security over the assets.

The Group provides support to the programme in its roles as sponsor, administrator and programme wide credit enhancement / liquidity provider.

For each new asset purchase, Cancara enters into a liquidity facility with the Group. The liquidity is used to cover any mismatch between available income and any shortfall in repaying the ABCP notes. In the absence of market disruption the conduit will look to fund through issuing ABCP and therefore the liquidity facility should not require to be drawn down upon under normal circumstances. The liquidity facility cannot be used to fund defaulted assets.

At 31 December 2011, liquidity facilities provided by the Group to Cancara amounted to £4.9bn, none of which had been drawn down.

Capital assessment

For Cancara, the Group has approval to utilise the ABCP Internal Assessment Approach for calculating capital requirements on the basis of the liquidity facilities provided to the conduit.

The Group's ABCP Internal Assessment Approach model is a proprietary credit rating system for rating liquidity facilities to entities that have been set up to issue asset backed commercial paper, such as Cancara, as well as third-party conduits.

Unlike the Group's Foundation and Retail IRB models, the ABCP Internal Assessment Approach model does not estimate the probability of default for the exposure, but instead is used to determine a model rating grade equivalent to an ECAI (rating agency) grade, where the internal rating methodology must reflect the ECAI's methodology. The equivalent ECAI rating is then assigned a risk weight percentage by mapping it to the relevant BIPRU Credit Quality Step (CQS). The risk weight is then applied to the risk position in order to derive an RWA and ultimately the capital requirement. The model itself consists of a number of scorecards, one for each asset class.

It is a requirement under BIPRU 9.12.20 that the rating methodology used is aligned to the rating criteria published by ECAIs. Periodically, ECAIs publish updates to their methodologies relating to different asset classes. The Conduit Management Team in the Group monitors rating agency updates and ensure that the Structuring Team is aware of any relevant updates on an ongoing basis. The Structuring Team undertake regular reviews of the model and confirm with the Conduit Management Team that all changes to rating methodologies have been reflected in the modelling and the model itself.

Stress factor inputs play an important part in determining the rating of a transaction. Depending on the level of credit enhancement, the stress factor will determine the final rating a transaction would receive from an ECAI taking into account 'stressed scenarios' on the level of cash-flows generated by the underlying pool of assets.

Cancara receivables facilities are modelled using a stress factor input which reflects the ability of the transaction to withstand a deterioration in the asset quality and is a through-the-cycle measure that is applied to a base case default rate. To determine the base case default rate historic loss data is used. In its approach, S&P incorporates additional analysis into historic loss data to mitigate any effects of recent changes with the result that in many cases the base case loss rate assumed is above the historical average.

The model is subject to a robust governance framework. In line with the Rating Model Validation Framework, the Group undertakes an Annual Credit Rating Model Validation exercise to ensure that the model remains compliant with the requirements of BIPRU 9.12.20 which establishes the critieria that must be met in order to apply the ABCP Internal Assessment Approach to exposures arising from ABCP programmes such as liquidity facilities. A Risk Model Decision Forum ensures that re-approval of the model is conducted systematically, with appropriate peer challenge and review. Re-approval documentation is subject to the internal model approval processes in place within the Group.

As at 31 December 2011, the total credit risk exposure of the Group in respect of the liquidity facilities provided to Cancara amounted to £4.9bn (2010: £9.3bn). An analysis of this exposure, by underlying exposure type, is provided in the table below.

Exposure Type	2011 Exposure £m	2010 Exposure £m
Mortgage Backed Securities:		
Non-US RMBS	-	3,425
CMBS	-	584
Collateralised Debt Obligations:		
CLO	-	154
Personal Sector:		
Auto Loans	1,405	1,063
Credit Cards	480	421
FFELP Student Loans	-	-
Trade receivables	1,045	1,751
Other ABS [1]	1,925	1,898
Total Credit Risk Exposure	4,855	9,296

Notes

[1] Other ABS exposures relate predominantly to Insurance Premium Funding Loans and Capital Calls.

An analysis of the total credit risk exposure and associated capital requirement by risk weight category under the ABCP Internal Assessment Approach is provided in the table below.

S&P Equivalent Rating and IAA Risk Weight	2011 Exposure £m	2011 Capital Req £m	2010 Exposure £m	2010 Capital Req £m
AAA: 7%	2,482	15	5,641	32
AA: 8%	714	5	1,766	12
A+: 10%	633	5	1,424	12
A: 12%	-	-	367	4
A-: 20%	718	12	98	1
BBB+ 35%	66	2	-	-
BBB: 60%	15	1	-	-
BBB-: 100%	227	19	-	-
Total Credit Risk Exposure / Capital Requirement	4,855	59	9,296	61

Argento

Structure and liquidity facilities

Argento replicates many of the features of Cancara. It can purchase and manage pools of rated and unrated assets. The initial transfer of assets to the conduit consisted of rated ABS purchased from subsidiaries of the Group.

There are two issuing entities within the conduit structure – Argento Variable Funding Company Limited (‘AVF Limited’) and Argento Variable Funding Company LLC (‘AVF LLC’), the latter of which is the co-issuer for US Dollar commercial paper and operates under the instruction of AVF Limited.

Argento has a number of purchasing vehicles within its structure. Liquidity facilities are provided to the purchasing vehicles and this includes cover for defaulted assets. New purchasing vehicles accede to the programme by signing purchasing commissioning agreements with AVF Limited. The purchasing vehicles fund purchases via the issuance of purchaser notes, discount notes, or alternative financing instruments in favour of AVF Limited. The purchasing companies grant security over their assets in favour of the purchaser collateral agents to secure their obligations to the issuer and other secured parties.

The Group provides support to the programme in its roles as sponsor, administrator and full support liquidity facility provider.

At 31 December 2011, liquidity facilities provided by the Group to Argento amounted to £4.5bn, none of which had been drawn down.

Capital assessment

For Argento, capital requirements are assessed by looking through to the underlying asset portfolios held. As a result the liquidity facilities do not attract capital. Risk positions attached to the underlying asset portfolios are treated in a similar way to risk positions arising from invested securitisation activities, with capital requirements calculated under the Ratings Based Approach.

Grampian

Structure and liquidity facilities

Grampian Funding Limited is a limited-purpose, bankruptcy remote entity. Its purpose is to issue discounted or interest bearing commercial paper, make loans to the purchasing companies within the conduit structure and to acquire and to hold securities rated investment grade by at least one agency at purchase.

Grampian Funding LLC is a bankruptcy remote, special purpose limited liability company. Its sole purpose is to co-issue US Dollar commercial paper from Grampian Funding Limited.

The are a number of purchasing companies within the conduit structure. These companies purchase securities in the same manner as Grampian Funding Limited. The companies fund these purchases through loans from Grampian Funding Limited. Each purchasing company benefits from its own liquidity support and hedging agreement.

The Group provides support to the programme in its roles as sponsor, administrator and liquidity facility provider. The Group also provides programme wide credit support through the provision of an irrevocable letter of credit (LOC).

Liquidity support provided by the Group is sized to cover the principal amount of outstanding commercial paper, including that co-issued by Grampian Funding LLC. The liquidity facility may be drawn to cover defaulted assets.

At 31 December 2011, liquidity facilities provided by the Group to Grampian amounted to £6.7bn, none of which had been drawn down. In addition Grampian has a repurchase facility with the Group, equal in size to the liquidity facilities provided. This facility allows Grampian to repo asset backed securities at par with the Group. In turn the Group is able to repo the assets with central banks and other market counterparties subject to certain eligibility criteria. At 31 December 2011, £0.7bn of repo funding was drawn by Grampian.

The Group has previously announced that it is in the process of winding down the Grampian conduit.

Capital assessment

For Grampian, capital requirements are assessed by looking through to the underlying asset portfolios held. As a result the liquidity facilities do not attract capital. Risk positions attached to the underlying asset portfolios are treated in a similar way to risk positions arising from invested securitisation activities, with capital requirements calculated under the Ratings Based Approach.

Direct Investments

In addition to sponsoring asset backed commercial paper conduits, the Group invests directly in third party asset backed securities and is a provider of liquidity facilities to other third party securitisations. Investments in asset backed securities are primarily used as part of the Group's liquidity asset portfolio.

The majority of these investments are accounted for as loans and receivables on the balance sheet and held at amortised cost, with the remainder held as available-for-sale or at fair value through the income statement. At year end the Group's net exposure to direct investments in asset backed securities amounted to £10.7bn (2010: £22.3bn), further details on which are presented on p.335 of the 2011 Lloyds Banking Group plc Annual Report and Accounts. The reduction during the year of £11.6bn reflects a combination of disposal of positions and non-replenishment of holdings after amortisations and maturities.

Monitoring Changes in the Credit Risk of Asset Backed Securities Portfolios

The monitoring of changes in the credit risk of Asset Backed Securities ('ABS') portfolios is undertaken by the Structured Credit Investment ('SCI') team and the ABS Bond Management team. Credit reviews are produced at least annually for a particular sector or for a specific bond (or both) as well as for third party ABS liquidity facilities. A credit review process will also be triggered where an ECAI applies a significant downgrade to a bond.

The Securitised Assets Credit team provide an independent risk oversight of the SCI credit reviews by providing each ABS transaction with a Credit Risk Classification (ranging from Good Book to Substandard), as well as sanctioning credit limits either locally or by referral to the Credit Committee.

Additional risk measures covering the ABS portfolios include: monthly Watch List meetings (which include a review of downgraded bonds), quarterly preparation of IAS39 reports and stress testing of portfolios and a quarterly Portfolio Risk Review Forum ('PRRF') between Risk Division representatives and the business teams.

Similar processes are used to monitor changes in credit risk associated with re-securitisation positions.

Analysis of Argento, Grampian and Direct Investment Credit Risk Exposures

As at 31 December 2011, the total credit risk exposure arising in respect of the risk positions attached to the underlying asset portfolios of Argento and Grampian amounted to £7.6bn (2010: £15.3bn).

The total credit risk exposure relating to direct investments in third party asset backed securities amounted to £11.1bn (2010: £22.4bn).

An analysis of these exposures, by exposure type, is provided in the table below.

Exposure Type	2011 Exposure £m	2010 Exposure £m
Mortgage Backed Securities:		
US RMBS	9	530
Non-US RMBS	4,164	5,738
CMBS	4,597	7,503
Collateralised Debt Obligations:		
CLO	1,575	6,283
Other	-	951
Personal Sector:		
Auto Loans	90	874
Credit Cards	-	2,210
Personal Loans	204	266
FFELP Student Loans	4,617	8,728
Other ABS	3,747	5,429
Total	19,003	38,512
Value adjustments taken to reserves [1]	(108)	(492)
Deduction from capital	(150)	(286)
Total Credit Risk Exposure [2] [3]	18,745	37,734

Notes

[1] Value adjustments taken to reserves refer to impairment writedowns, acquisition related fair value adjustments and other fair value adjustments applied against gross positions rated below BB- or that are unrated. The net result is deducted from capital.

[2] Total credit risk exposure is defined as the aggregate of the Group's gross retained or purchased positions, excluding those positions rated below BB- or that are unrated and therefore deducted from capital.

[3] The total credit risk exposure comprises £11,149m (2010: £22,420m) in relation to direct investments in third party asset backed securities and £7,596m (2010: £15,314m) in relation to the underlying asset portfolios of Argento and Grampian.

As at 31 December 2011, securitisation positions relating to the underlying asset portfolios of Argento and Grampian and securitisation and re-securitisation positions relating to the Group's direct investments in third party asset backed securities, risk weighted under the Ratings Based Approach amounted to £19.0bn (2010: £38.5bn), generating a capital requirement of £464m (2010: £503m). An analysis of these positions, by risk weight category, is provided in the table below.

S&P Equivalent Rating and RBA Risk Weight [1]		Securitisation Positions 2011						Re-securitisation Positions 2011				TOTAL 2011		TOTAL 2010 [4]	
		Senior		Non-Senior		Tranches Backed by Non Granular Pools		Senior		Non-Senior					
		Exposure	Cap Req	Exposure	Cap Req	Exposure	Cap Req	Exposure	Cap Req	Exposure	Cap Req	Exposure	Cap Req	Exposure	Cap Req
AAA	(7%, 12%, 20%, 20%, 30%)	5,534	7	442	-	787	12	44	1	-	-	6,807	20	23,032	
AA	(8%, 15%, 25%, 25%, 40%)	2,919	10	314	1	1,536	28	224	3	15	-	5,008	42	7,364	
A+	(10%, 18%, 35%, 35%, 50%)	1,239	8	53	-	488	14	35	1	-	-	1,815	23	1,591	
A	(12%, 20%, 35%, 40%, 65%)	829	6	42	1	369	11	-	-	-	-	1,240	18	1,987	
A-	(20%, 35%, 35%, 60%, 100%)	156	1	-	-	695	21	59	2	-	-	910	24	1,089	
BBB+	(35%, 50%, 50%, 100%, 150%)	798	7	3	-	101	4	29	2	38	2	969	15	561	
BBB	(60%, 75%, 75%, 150%, 225%)	425	20	97	6	276	15	62	5	-	-	860	46	713	
BBB-	(100%, 100%, 100%, 200%, 350%)	165	12	44	4	-	-	17	1	-	-	226	17	534	
BB+	(250%, 250%, 250%, 300%, 500%)	164	32	224	2	-	-	-	-	-	-	388	34	464	
BB	(425%, 425%, 425%, 500%, 650%)	180	65	-	-	73	15	-	-	-	-	253	80	187	
BB-	(650%, 650%, 650%, 750%, 850%)	186	141	2	-	-	-	81	4	-	-	269	145	212	
Below BB- or unrated	Deduction	135	-	123	-		-		-		-	258	-	778	
Total		12,730	309	1,344	14	4,325	120	551	19	53	2	19,003	464	38,512	503
Value adjustments taken to reserves [2]												(108)	-	(492)	-
Deduction from capital												(150)	-	(286)	-
Total Credit Risk Exposure / Cap Req [3]												18,745	464	37,734	503

Notes

[1] The Ratings Based Approach risk weights for each rating are listed in the following order: senior securitisation positions, non-senior securitisation positions, tranches backed by non-granular pools, senior re-securitisation positions and non-senior re-securitisation positions. Positions rated below BB- or that are unrated are deducted from capital, net of value adjustments applied.

[2] Value adjustments taken to reserves refer to impairment writedowns, acquisition related fair value adjustments and other fair value adjustments applied against gross positions rated below BB- or that are unrated. The net result is deducted from capital.

[3] Total credit risk exposure is defined as the aggregate of the Group's gross retained or purchased positions, excluding those positions rated below BB- or that are unrated and therefore deducted from capital. Capital requirements are stated net of value adjustments, where applicable. All retained or purchased positions are held on-balance sheet.

[4] Amendments were made to the application of the Ratings Based Approach at the end of 2011, as a result of the implementation of CRD 3. These amendments include the application of higher risk weights to re-securitisation positions. Prior to this no distinction was made between securitisation and re-securitisation positions under the Ratings Based Approach. As a result the prior year exposure comparatives for 2010 are disclosed in aggregate by rating grade and the resultant capital requirement in total as these are not directly comparable to the current year analysis and results.

Re-securitisation Positions

In relation to the Group's re-securitisation positions arising from sponsoring and investment activities, the underlying securitisation positions relate predominantly to senior positions in CLO transactions (leveraged loans) and junior / mezzanine positions in commercial real estate CDO transactions.

TRADING BOOK SECURITISATIONS

At 31 December 2011 the Group held a small portfolio of non-correlation trading book securitisation positions amounting to £135m with an associated market risk capital requirement of £1.5m.

Trading Book Securitisation Strategy and Roles

The Group's trading book securitisation portfolio consists primarily of investments in third party securitisation positions. No origination activity is conducted through the trading book and no re-securitisation positions were held at year end through the trading book.

The Group holds trading book securitisation positions as part of a threefold strategy:

1. to create a secondary market for the Group's originated securitised bonds;
2. to support third party securitisation activity; and
3. to cover the operating costs of both of the above activities.

Inherent Risks

The key risks attached to the Group's holding of trading book securitisation positions are noted below:

- Price Risk: Systemic and non-systemic risk arising from the fluctuations in securities prices. This includes factors such as interest rates and currency prices.

- Credit Risk: The borrower's inability to meet interest payment obligations on time. Default may occur when maintenance obligations on the underlying collateral are not sufficiently met as detailed in its prospectus. A key indicator of a particular security's default risk is its credit rating. Different tranches within the Group's asset backed securities portfolio are rated differently, with senior classes of most issues receiving the highest rating, and subordinated classes receiving correspondingly lower credit ratings.

- Event Risk: The majority of asset backed securities are subject to some degree of early amortisation or pre-payment risk. The risk stems from specific early amortisation events or payout events that cause the security to be paid off prematurely.

- Interest Rate Fluctuations: The prices of ABS move in response to changes in interest rates. Furthermore, interest rate changes may affect the prepayment rates on underlying loans that back some types of asset backed securities, which can affect yields.

- Moral Hazard: Investors usually rely on the deal manager to price the securitisations' underlying assets. If the manager earns fees based on performance; there may be a temptation to mark up the prices of the portfolio assets. Conflicts of interest can also arise with senior note holders when the manager has a claim on the deal's excess spread.

- Servicer Risk: The transfer or collection of payments may be delayed or reduced if the servicer becomes insolvent. This risk is mitigated by having a backup servicer involved in the transaction.

As the Group's trading book securitisation portfolio is relatively small and highly liquid, with positions held for the short-term, liquidity risk is considered to be of minimal concern.

Monitoring Changes in Credit and Market Risk

The Group's policy is to invest in highly rated securitised bonds, typically carrying ratings of AA or better. Risk management of the Asset Backed Security Trading Book is shared between Credit Risk and Market Risk teams. Under Credit Risk, monitoring positions are subject to notional limits and also maximum holding periods; notional limits are by credit rating and there are also asset class restrictions. Market Risk monitors foreign exchange, interest rate and credit spread risk daily through the VaR model.

In the event of a breach of the maximum holding period the Group will conduct a review of the underlying assets relating to the positions held to assess their creditworthiness and a strict process put in place for managing or reducing the exposure.

Hedging and Unfunded Credit Protection

The policy for hedging exposures within the trading book is governed by the VaR Framework. This establishes trading book risk limits, as well as a requirement to hedge against foreign exchange risk and interest rate risk. All hedges are made with parties internal to the Group.

The Group does not currently make use of any forms of unfunded credit protection in conjunction with its holding of trading book securitisation positions.

Risk Weight Approach and ECAIs Used

The market risk capital requirement associated with the Group's holding of trading book securitisation positions represents the specific interest rate risk of securitisation positions held in the trading book and is determined in accordance with the transitional requirements under BIPRU 7.2.48A, being the higher of the capital charges applied to the net long positions or to the net short positions.

Position Risk Adjustments ('PRAs') under the 'IRB Approach' are applied to the relevant positions in order to determine the specific interest rate risk capital charge. ECAI ratings are used to assign positions to the relevant credit quality step under the Specific Risk PRA – IRB Approach scale. Ratings are based upon the assessments of a least two major ECAIs (e.g. Standard & Poor's, Moody's or Fitch Ratings).

Accounting Policies

The Group recognises its trading book securitisation positions at fair value through profit or loss. The positions are treated as sales (market making) with gains or losses recognised on a daily basis as the price of the underlying bonds change.

Valuations are determined by reference to an independent, third party consensus pricing service.

At year end there were no assets awaiting securitisation in the Group's trading book.

All trading book securitisation positions are on balance sheet.

Summary of Activity

The Group's portfolio of trading book securitisation positions is relatively small and therefore not significant in the context of the overall trading book. The portfolio is likely to remain of a similar size going forward.

Exposures Securitised by the Group

The Group does not securitise any of its own exposures via the trading book.

Analysis of Trading Book Securitisation Positions

The following table analyses the Group's exposure to retained or purchased non-correlation trading book securitisation positions and associated capital requirement by rating grade.

S&P Equivalent Rating and Specific Risk PRA (IRB) [1]		Non-Correlation Trading Book Securitisation Positions 2011 [4]							
		Senior		Non-Senior		Tranches Backed by Non-Granular Pools		TOTAL	
		Exposure £m[2]	Cap Req £m[3]	Exposure £m[2]	Cap Req £m[3]	Exposure £m[2]	Cap Req £m[3]	Exposure £m[2]	Cap Req £m[3]
AAA	(0.56%, 0.96%, 1.60%)	75.5	0.4	0.9	-	-	-	76.4	0.4
AA	(0.64%, 1.20%, 2.00%)	41.1	0.2	0.5	-	-	-	41.6	0.2
A+	(0.80%, 1.44%, 2.80%)	-	-	-	-	-	-	-	-
A	(0.96%, 1.60%, 2.80%)	-	-	2.3	0.1	-	-	2.3	0.1
A-	(1.60%, 2.80%, 2.80%)	0.9	-	3.6	0.1	-	-	4.5	0.1
BBB+	(2.80%, 4.00%, 4.00%)	-	-	-	-	-	-	-	-
BBB	(4.80%, 6.00%, 6.00%)	2.0	0.1	5.1	0.3	-	-	7.1	0.4
BBB-	(8.00%, 8.00%, 8.00%)	2.7	0.2	-	-	-	-	2.7	0.2
BB+	(20.00%, 20.00%, 20.00%)	-	-	0.6	0.1	-	-	0.6	0.1
Total		**122.2**	**0.9**	**13.0**	**0.6**	**-**	**-**	**135.2**	**1.5**

Notes

[1] The specific risk PRAs (IRB Approach) for each rating are listed in the following order: senior positions, non-senior positions and tranches backed by non-granular pools.

[2] The exposure amount is determined by the market value of the individual net positions.

[3] The capital requirement represents the specific interest rate risk of securitisation positions held in the trading book and is determined in accordance with the transitional requirement under BIPRU 7.2.48A, being the higher of the capital charges applied to net long positions or to net short positions.

[4] No prior year comparatives have been provided as the requirement to disclose trading book securitisation positions and the rules surrounding the calculation of the associated capital requirements were not introduced until the implementation of CRD 3 on 31 December 2011.

The following tables analyses the Group's exposure to retained or purchased non-correlation trading book securitisation positions and associated capital requirement by underlying exposure type.

Exposure Type	2011 Exposure £m	2011 Capital Requirement £m
RMBS	90.4	0.5
CMBS	8.6	0.2
Credit Cards	19.4	0.1
Loans to Corporates	4.7	0.3
Trade Receivables	6.0	0.3
Other	6.1	0.1
Total	**135.2**	**1.5**

CREDIT RISK MITIGATION

The Group uses a range of approaches to mitigate credit risk.

INTERNAL CONTROL

Credit principles and policy: Risk Division sets out the credit principles and policy according to which credit risk is managed. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Policies, where appropriate, include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. These policies and procedures define chosen target market and risk acceptance criteria. These have been and will continue to be fine-tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions.

The Group uses a variety of lending criteria within Retail when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using information held by credit reference agencies ('CRA'). The Group also assesses the affordability of the borrowings to the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

The Group's lending practices within Retail have changed since 2009 in several ways: the Group has lowered its maximum loan-to value thresholds, which have been reduced across all mortgage product types; the Group has withdrawn from 'specialist' secured lending since early 2009 (self-certificated and sub-prime lending) and increased credit scorecard cut-offs for both secured and unsecured lending; the Group has tightened its assessments and the maximum limit for affordability of borrowings for both secured and unsecured lending. In addition, the number of properties permitted in buy-to-let portfolios has been reduced.

For UK mortgages, the Group's policy is to reject all standard applications with a loan-to-value ('LTV') greater than 90 per cent. For mainstream mortgages the group has maximum % LTV limits which depend upon the loan size. These limits are currently:

Loan size		
From	**To**	**Maximum LTV**
£1	£750,000	90% LTV
£750,001	£1,000,000	85% LTV
£1,000,001	£2,000,000	80% LTV
£2,000,001	£5,000,000	70% LTV

For mainstream mortgages greater than £5,000,000 the maximum LTV is 50%. Buy-to-let mortgages are limited to a maximum of £1,000,000 and 75% LTV. All mortgage applications above £500,000 are subject to manual underwriting.

The Group's approach to underwriting applications for unsecured products in Retail takes into account the total unsecured debt held by a customer and their affordability. The Group rejects any application for an unsecured product where a customer is registered as bankrupt or insolvent, or has a County Court Judgment registered at a CRA used by the Group. In addition, for credit cards the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA; or revolving debt-to-income ratio greater than 75 per cent; or total unsecured debt-to-income ratio greater than 100 per cent. For unsecured personal loan applications, we reject any applicant with total unsecured debt greater than £50,000 registered at the CRA. Rules around refinancing of debt have also been made more stringent since 2009 as a result of the application of rules relating to the total unsecured debt held by a customer and the Group's approach in assessing affordability. This has resulted in fewer customers being eligible to refinance unsecured debt.

Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). The Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. The most material changes are approved in accordance with the governance framework set by the Model Governance Committee.

Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting is generally the same as that for assets intended to be held over the period to maturity.

Controls over rating systems: The Group has established an independent team in the Risk Division that sets common minimum standards, designed to ensure risk models and associated rating systems are developed consistently, and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating systems are developed and owned by the Risk Division. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions in their respective division.

Cross-border and cross-currency exposures: The Board sets country risk appetite. Within these, country limits are authorised by the country limits panel, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support the approved business and strategic plans of the Group.

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at divisional and business unit level and by rating model and portfolio, for example, within a specific industry sector.

Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

Credit risk assurance and review: Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Group Credit Risk Assurance, a Group level function comprising experienced credit professionals, is also in place. In conjunction with Risk senior management, this team carries out independent risk based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group's wholesale businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of group Group Credit Risk Assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

The determination of cash flows for cases in the Business Support Units (BSU) is undertaken by a specialist risk team who gather a range of information from various sources including the customer, professional advisers and the Group's own credit teams to fully understand and appraise the customer's business and circumstances. A more detailed assessment is undertaken to assist in reducing risk exposure and highlighting potential strategic options. This often involves the Group, in addition to using its own internal experts, engaging professional advisers to perform Independent Business Reviews (IBRs) and, where relevant, independently value collateral held. In more complex cases, such as those involving work-out strategies, the review may also involve:

- critically assessing the customer's ability to successfully manage the business effectively in a distressed situation where turnaround is required;
- analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;
- performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;
- financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides, and;
- determining the most appropriate corporate and capital structure suitable for the work-out strategy concerned.

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU.

COLLATERAL

The principal collateral types for loans and advances are:

- mortgages over residential and commercial real estate;
- charges over business assets such as premises, inventory and accounts receivables;
- charges over financial instruments such as debt securities and equities; and
- guarantees received from third parties.

The Group maintains guidelines on the acceptability of specific classes of collateral.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

It is the Group’s policy that collateral should always be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. For residential mortgages, the Group adjusts open market property values to take account of the costs of realisation and any discount associated with the realisation of the collateral. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are identified for the relevant individual loans and advances.

The Group considers risk concentrations by collateral providers and collateral type, as appropriate, with a view to ensuring that any potential undue concentrations of risk are identified and suitably managed by changes to strategy, policy and / or business plans.

Only certain types of collateral are deemed eligible for regulatory capital purposes. Eligible financial collateral includes cash on deposit within the bank, gold, rated debt securities (subject to certain restrictions), equities or convertible bonds included in a main index and units in certain collective investment undertakings or mutual funds. Other eligible collateral includes forms of real estate collateral, short term financial receivables and other physical collateral, provided the criteria for recognition are met.

MASTER NETTING AGREEMENTS

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), the Group enters into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group’s overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since it is affected by each transaction subject to the agreement.

GUARANTEES

A guarantee is a contract whereby a third party guarantor promises to recompense the lender in the event of failure by a customer to meet their obligations. Regulatory capital relief is only taken through the use of PD substitution for guarantees provided by appropriate central governments, central banks or institutions. Where regulatory capital relief is sought to reflect the risk mitigating effect of a guarantee, there are minimum operational and legal requirements which are required to be met. On the basis that these are met, alternative forms of protection, for example indemnities, may be classified as a guarantee for regulatory capital purposes.

EXPORT CREDIT AGENCIES

These agencies are defined as state or government sponsored, owned or controlled organisations or multi-lateral agencies that promote a country’s exports of goods and services by enabling the exporter or the importer to obtain financing on terms that would not be otherwise available commercially. Such agencies can provide risk mitigation in the form of a guarantee (typically up to 85% - 95% of a contract value) providing cover and guarantee of payment in relation to commercial and political risk, thereby enabling lenders to support customers by offering financing on terms and for periods which might otherwise not be available in certain jurisdictions.

CREDIT DERIVATIVES

Credit derivatives are a method of transferring credit risk from one counterparty (the protection buyer) to another (the protection seller). In return for a risk premium, the protection seller agrees to make a payment (or series of payments) to the protection buyer in the event of the occurrence of a stipulated event. Further details are included within the Counterparty Credit Risk section of the document. Capital relief under regulatory requirements is restricted to the following types of credit derivative: Credit Default Swaps; Total Return Swaps; and Credit Linked Notes (to the extent of their cash funding).

In respect of a Credit Default Swap, various credit events (including non-payment, restructuring, moratorium, bankruptcy) affecting the obligor, can trigger settlement. Settlement usually takes place by the protection buyer delivering a credit obligation of the obligor (e.g. a bond or loan) to the protection seller, in return for a cash payment at par.

Under a Total Return Swap, the protection buyer will pass on to the seller all payments it receives in return for an interest related payment (market rate and spread), plus any decrease in the market value of the credit obligation. Where net payments received from the swap are recorded as net income but any offsetting deterioration in the value of the asset that is protected is not recorded (either through reductions in fair value or by an addition to reserves), the credit protection must not be recognised as eligible.

Under a Credit Linked Note, the protection buyer will issue a bond or note which is linked to a credit obligation of the obligor. The bond or note is purchased by the protection seller (at par) and it will receive a coupon on the bond or note (market rate and spread). If a credit event occurs, the bond or note is redeemed by the protection buyer at an agreed price which is less than the issue price. If no credit event occurs, the bond or note will be redeemed at par by the protection buyer.

OTHER CREDIT RISK TRANSFERS

The Group also undertakes asset sales and securitisations as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

EXPOSURES COVERED BY ELIGIBLE COLLATERAL, GUARANTEES AND CREDIT DERIVATIVES

Where a credit risk exposure subject to the IRB Approach is covered by a form of credit risk mitigation this can result in an adjustment to the PD, LGD or EAD values used in the calculation of the risk weighted asset amount. Under the Foundation IRB Approach the recognition of eligible financial collateral and other eligible collateral will typically result in an adjustment to the regulatory LGD values used. The use of eligible financial collateral may alternatively result in an adjustment to EAD values. The application of guarantees and credit derivatives under the IRB Approach is reflected through an adjustment to either the PD or LGD values.

Where a credit risk exposure subject to the Standardised Approach is covered by a form of eligible financial collateral the EAD value is adjusted. Where guarantees or credit derivatives apply, the risk weight applied to the portion of the exposure covered by the protection provider is based on the risk weight attached to the provider. The covered portion is determined after the application of 'haircuts' applied to the protection provided. The risk weight applied to the uncovered portion of the exposure is unaffected.

The criteria for recognising eligible collateral, guarantees and credit derivatives, the treatments that apply and the extent to which adjustments are made are set out under the relevant BIPRU provisions governing the application of credit risk mitigation under the IRB Approach (BIPRU Chapter 4.10) and the Standardised Approach (BIPRU Chapter 5).

The use of credit derivatives and collateral in respect of securitisation positions and counterparty credit risk exposures respectively are discussed further within the Securitisations and Counterparty Credit Risk sections of the document.

The following table provides an analysis of credit risk exposures covered by eligible financial collateral, other eligible collateral, guarantees or credit derivatives. The analysis excludes exposures covered by forms of credit risk mitigation that are not taken into consideration in the calculation of credit risk capital requirements.

	2011 Exposures Covered by Eligible Financial Collateral £m	2011 Exposures Covered by Other Eligible Collateral £m	2011 Exposures Covered by Guarantees £m	2011 Exposures Covered by Credit Derivatives £m	2011 TOTAL £m
Exposures subject to the IRB Approach					
Foundation IRB Approach					
Corporate - Main	5,002	9,043	113	221	14,379
Corporate - SME	94	7,625	2	-	7,721
Corporate - Specialised lending	85	203	-	-	288
Central governments and central banks	-	-	515	-	515
Institutions	1,063	-	750	-	1,813
Retail IRB Approach					
Retail - Residential mortgages	-	-	-	-	-
Retail - Qualifying revolving retail exposures	-	-	-	-	-
Retail - Other retail	-	-	-	-	-
Retail - SME	-	-	-	-	-
Other IRB Approach					
Corporate - Specialised lending	839	-	-	-	839
Total - IRB Approach	7,083	16,871	1,380	221	25,555
Exposures subject to the Standardised Approach					
Central governments and central banks	-	-	-	-	-
Regional governments or local authorities	-	-	-	-	-
Administrative bodies and non-commercial undertakings	-	-	-	-	-
Multilateral development banks	-	-	-	-	-
Institutions	-	-	-	-	-
Corporates	1,342	-	50	109	1,501
Retail	60	-	-	-	60
Secured on real estate property	-	-	481	-	481
Past due items	67	-	1	-	68
Short term claims on institutions or corporates	-	-	-	-	-
Collective investment undertakings	-	-	-	-	-
Total - Standardised Approach	1,469	-	532	109	2,110
TOTAL	8,552	16,871	1,912	330	27,665

The impact of the above eligible financial collateral, guarantees and credit derivatives on credit risk exposures subject to the Standardised Approach is disclosed on pages 68 to 73.

Further details on collateral held as security for financial assets, collateral pledged as security and collateral repossessed can be found in the Notes to the Consolidated Financial Statements, 2011 Lloyds Banking Group plc Annual Report and Accounts, pages 329 to 331.

	2011 Exposures Covered by Eligible Financial Collateral £m	2011 Exposures Covered by Other Eligible Collateral £m	2011 Exposures Covered by Guarantees £m	2011 Exposures Covered by Credit Derivatives £m	2011 TOTAL £m
Exposures subject to the IRB Approach					
Foundation IRB Approach					
Corporate - Main	5,183	8,968	116	663	14,930
Corporate - SME	133	8,172	12	-	8,317
Corporate - Specialised lending	65	-	1	-	66
Central governments and central banks	-	-	495	-	495
Institutions	1,196	-	873	41	2,110
Retail IRB Approach					
Retail - Residential mortgages	-	-	-	-	-
Retail - Qualifying revolving retail exposures	-	-	-	-	-
Retail - Other retail	-	-	-	-	-
Retail - SME	-	-	-	-	-
Other IRB Approach					
Corporate - Specialised lending	245	-	-	-	245
Total - IRB Approach	6,822	17,140	1,497	704	26,163
Exposures subject to the Standardised Approach					
Central governments and central banks	-	-	-	-	-
Regional governments or local authorities	-	-	-	-	-
Administrative bodies and non-commercial undertakings	-	-	-	-	-
Multilateral development banks	-	-	-	-	-
Institutions	1	-	-	-	1
Corporates	1,853	-	191	112	2,156
Retail	174	-	-	-	174
Secured on real estate property	46	-	505	-	551
Past due items	1	-	2	-	3
Short term claims on institutions or corporates	-	-	-	-	-
Collective investment undertakings	-	-	-	-	-
Total - Standardised Approach	2,075	-	698	112	2,885
TOTAL	8,897	17,140	2,195	816	29,048

Notes

[1] Restated to exclude amounts relating to securities financing transactions.

COUNTERPARTY CREDIT RISK

Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. Such transactions relate to contracts for financial instruments and may include derivative contracts and repo contracts.

INTERNAL CAPITAL AND CREDIT LIMITS

The maximum credit risk appetite for counterparties is determined through a combination of credit quality (expressed as an internal credit rating) and size (measured by its capital and reserves). In general, activity of the Group is conducted with counterparties that have internal credit ratings equivalent to investment grade as measured by external credit rating agencies.

Internal credit ratings are mapped to statistically derived PDs, which when combined with LGDs and EADs determine EL. To calculate EAD, values for derivative products are determined by using the mark-to-market methodology for regulatory purposes and internally developed models for limit management.

Additionally a number of product specific and counterparty specific policies also serve to determine risk management and credit limit setting. Once commercial approval has been obtained for a counterparty, credit limits are established through the Group’s credit approval framework on the basis of the projected maximum potential future exposure of anticipated derivative transaction volumes, based on 95th percentile assumptions.

Credit limits are set by product and reflect documentation held for netting or collateral management purposes. Outstanding exposures are calculated on a mark-to-market plus potential future exposure basis, based upon the transaction characteristics and documentation.

SECURING COLLATERAL AND ESTABLISHING CREDIT RESERVES

Use is made of collateral and risk mitigation techniques to reduce credit risks in various portfolios. These include the use of collateral (principally cash, government securities and guarantees), break clauses and netting. In addition, a gross notional control for repo and stock borrowing exists. Policy is set governing types of acceptable collateral and haircuts, in line with industry norms.

Collateral arrangements are governed by standard agreements (such as Global Master Repurchase Agreements and Credit Support Annexes to ISDA Master Agreements). It is Group policy that an appropriate master agreement is put in place for all clients prior to trading, any exceptions being subject to specific approval from a senior credit risk officer. This policy also defines minimum acceptable requirements for the negotiation of ISDA and CSA documentation.

To recognise the effects of credit risk mitigation, any agreements must be valid, enforceable, unconditional and irrevocable. In addition, collateral must be transferred to the bank through the passing of title and should be netable on a portfolio basis. Once these conditions are met, the effect of collateral received is reflected in reductions to all applicable credit exposures and in capital adequacy calculations.

Collateral received is reviewed daily to ensure quality is maintained and concentrations are avoided as necessary.

CORRELATION RISK

Credit policies are formed to avoid correlation or wrong way risk. Under the repo policies, the issuer of the collateral and the counterparty should be neither the same nor connected. The same rule applies for derivatives under collateral policies. The credit departments have the necessary discretion to extend this rule to other cases where there is significant correlation.

COLLATERAL REQUIREMENTS IN THE EVENT OF A DOWNGRADE IN CREDIT RATING

Downgrades of the Group’s long term debt rating could lead to additional collateral posting and cash outflow. A hypothetical simultaneous two notch downgrade of the Group’s long-term debt rating from all major rating agencies, after initial actions within management’s control, could result in an outflow of £11 billion of cash, £4 billion of collateral posting related to customer financial contracts and £24 billion of collateral posting associated with secured funding. These effects do not take into account additional management and restructuring actions that the Group has identified that could materially reduce the amount of required collateral postings under derivative contracts related to its own secured funding programmes.

The downgrades that the Group experienced in the fourth quarter of 2011, did not significantly change its borrowing costs, reduce its issuance capacity or require significant collateral posting. The Group notes the February 2012 announcements from Moody’s placing the ratings of 114 European financial institutions, including Lloyds Banking Group, on review for downgrade. Even in the case of a simultaneous two notch downgrade from all rating agencies, the Group would remain investment grade.

DERIVATIVE VALUATION ADJUSTMENTS

Details on the application of derivative valuation adjustments, including Credit and Debit Valuation Adjustments (CVA and DVA), by the Group are provided on pages 318 to 319 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY MEASUREMENT APPROACH

The credit risk exposure value in respect of counterparty credit risk as at 31 December 2011 was £23.5bn (2010: £20.6bn). An analysis by measurement approach is presented in the table below.

	2011 Credit Risk Exposure £m	2010 Credit Risk Exposure £m
CCR Standardised Approach	-	-
CCR Mark to Market Method	23,467	20,550
CCR Internal Model Method	-	-
Total	23,467	20,550

Key Movements

- The increase in counterparty credit risk exposures over the year is a result of increased exposure to institutional and corporate counterparties as highlighted in the analysis by exposure class below.

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY EXPOSURE CLASS

An analysis of counterparty credit risk exposures as at 31 December 2011, by exposure class, is presented in the table below.

	2011 Credit Risk Exposure £m	2010 Credit Risk Exposure £m
Foundation IRB Approach		
Central governments and central banks	247	142
Institutions	9,270	7,317
Corporates	5,963	4,577
Other IRB Approach		
Securitisation positions	159	-
Standardised Approach		
Central governments and central banks	1,240	2,216
Institutions	190	206
Corporates	6,398	6,092
Total	23,467	20,550

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY CONTRACT TYPE

An analysis of counterparty credit risk exposures as at 31 December 2011, by contract type, is presented in the table below.

	2011 Credit Risk Exposure £m	2010 Credit Risk Exposure £m
Interest rate contracts	16,330	14,377
Foreign exchange contracts	2,369	1,638
Equity contracts	361	284
Credit derivatives	200	404
Commodity contracts	40	21
Repo contracts	4,095	3,826
Other	72	-
Total	23,467	20,550

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY RISK WEIGHT APPROACH

An analysis of counterparty credit risk exposures and RWAs as at 31 December 2011, by risk weight approach, is presented in the table below.

	2011 Credit Risk Exposure £m	2011 Risk Weighted Assets £m	2010 Credit Risk Exposure £m	2010 Risk Weighted Assets £m
Standardised Approach	7,828	6,474	8,514	6,358
Foundation and Other IRB Approaches	15,639	6,170	12,036	5,207
Total	23,467	12,644	20,550	11,565

COUNTERPARTY CREDIT RISK EXPOSURES: FURTHER ANALYSIS OF FOUNDATION IRB APPROACH EXPOSURES

Further analysis, by PD Grade, of counterparty credit risk exposures subject to the Foundation IRB Approach is provided in the tables below.

CCR - Central Governments and Central Banks

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	140	0.01%	2.86%	54	0.01%	4.08%
2	38	0.02%	1.62%	10	0.02%	3.13%
3	68	0.07%	8.39%	74	0.05%	8.80%
4	-	-	-	2	0.27%	38.56%
5	-	-	-	2	0.68%	64.89%
6	1	13.10%	207.24%	-	-	-
7	-	-	-	-	-	-
Default	-	-	-	-	-	-
Total	247	0.06%	4.68%	142	0.05%	7.90%

CCR - Institutions

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	8,728	0.04%	14.83%	5,591	0.04%	16.13%
4	498	0.34%	57.08%	1,683	0.25%	41.44%
5	40	0.86%	86.08%	27	0.89%	86.72%
6	2	4.68%	139.33%	1	5.89%	146.59%
7	2	48.02%	230.51%	1	56.90%	220.20%
Default	-	-	-	14	100.00%	-
Total	9,270	0.07%	17.46%	7,317	0.29%	22.24%

CCR - Corporates

PD Grade	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %	2010 Credit Risk Exposure £m	2010 Exposure Weighted Average PD %	2010 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	1,351	0.04%	27.14%	880	0.04%	27.59%
4	2,555	0.69%	67.34%	2,034	0.29%	64.13%
5	1,543	1.40%	113.90%	1,179	1.34%	115.20%
6	212	7.14%	187.29%	300	5.42%	171.49%
7	131	56.90%	217.48%	67	56.90%	217.98%
Default	171	100.00%	-	117	100.00%	-
Total	5,963	5.03%	75.90%	4,577	4.23%	77.94%

NET DERIVATIVES CREDIT EXPOSURE

The gross positive fair value of contracts, netting benefits, netted current credit exposure, net potential future credit exposure ('PFE'), collateral held and resultant 'net derivatives credit exposure', as at 31 December 2011, are presented separately in the table below.

	2011 £m	2010 £m
Gross positive fair value of contracts	63,720	45,323
Netting benefits	(47,505)	(31,676)
Netted current credit exposure	16,215	13,647
Net potential future credit exposure	8,379	7,294
Collateral held	(5,222)	(2,929)
Total Net Derivatives Credit Exposure	19,372	18,012

Collateral held primarily relates to cash and government securities.

NOTIONAL VALUE OF CREDIT DERIVATIVE TRANSACTIONS

The notional value of credit derivative transactions outstanding at 31 December 2011 was £10.0bn (2010: £7.1bn), an analysis of which is presented in the table below. These transactions relate entirely to credit default swaps.

	2011 Notional Value £m	2010 Notional Value £m
Own credit portfolio – protection bought	5,796	5,274
Own credit portfolio – protection sold	4,184	1,834
Total	9,980	7,108

MARKET RISK

DEFINITION

The risk of reductions in earnings, value, capital and / or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments. It arises in all areas of the Group's activities and is managed by a variety of different techniques.

RISK APPETITE

Market risk appetite is defined with regard to the quantum and composition of market risk that currently exists in the Group and the Group's risk preferences.

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the Board. With the support of the Group Asset and Liability Committee, the Group Chief Executive allocates this risk appetite across the Group. Individual members of the Group Executive Committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

EXPOSURES

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

Most of the Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange and interest rate products. However, some interest rate, exchange rate and credit spread positions are taken using derivatives and other on-balance sheet instruments with the objective of earning a profit from favourable movements in market rates.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets and liabilities. Interest rate risk arises predominantly from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets.

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Foreign currency risk also arises from the Group's investment in its overseas operations.

The Group's insurance activities also expose it to market risk, encompassing interest rate, exchange rate, property, credit spreads and equity risk:

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.

- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets.

- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.

- Surplus assets are held primarily in four portfolios: (a) in the long-term funds of Scottish Widows plc and its subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk.

MEASUREMENT

The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

- Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used

- Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening
- Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting divisional market risk appetite limits and triggers.

Although an important market standard measure of risk, VaR has limitations. These arise from the use of limited historical data, an assumed distribution, defined holding periods, set confidence intervals and frequency of calculation. The exposure level at the confidence interval does not convey any information about potential losses which may arise if this level is exceeded. A 95% confidence interval with a 1 day holding period is equivalent to an expected 1 in 20 day loss. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at Group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1 day 99%) is compared daily against both forecast and actual profit and loss.

The Group's VaR Model permissions allow it to calculate Pillar 1 market risk capital requirements for the trading book. VaR models are also used by the Group for internal risk measurement of the trading book. The LBG Model permission covers general interest rate and foreign exchange risk across both Lloyds TSB and HBOS. The capital charge is based on the 10 day 99% VaR calculated by the models. This now includes a Stressed VaR component which is the measure of VaR using a continuous one year window based on a period of market stress. In addition the model permission covers specific interest rate risk and is complemented by the Incremental Risk Charge ('IRC').

The Group uses an historical simulation methodology to calculate VaR for the trading book. This methodology consists of calculating historical daily price movements for a full range of market risk factors. The historical daily price movements are applied to positions to create a distribution of hypothetical daily profit and loss scenarios. The hypothetical daily changes in portfolio value are ranked, and the 95th and 99th percentile worst losses are identified.

The Group compares a hypothetical daily profit and loss with VaR calculated at a 1 day 99% confidence level on a daily basis. The purpose of this analysis is to provide an indication of how well the VaR model's output, a VaR forecast, has described the corresponding trading outcome. Analysis is performed at the aggregate trading book level, and individual trading desk level. Hypothetical profit or loss is the profit or loss that would have resulted assuming that the portfolio remains unchanged from one day to the next.

The FSA categorises a VaR model as green, amber or red in accordance with the number of exceptions observed over the back-testing period. The Group’s trading books maintained their green model status in 2011.

2011 Backtesting Results [1]	**Zone**	**Number of reported exceptions**
Lloyds TSB	**Green**	**4 or fewer**
HBOS	**Green**	**4 or fewer**
LBG	**Green**	**4 or fewer**

Notes

[1] Each individual entity is required to have sufficient capital to meet their solo capital requirements. Hence VaR model performance monitoring needs to be performed separately across Lloyds TSB and HBOS. The Group manages its market risk on a consolidated basis and this is reflected in a single CRD 3 Market Risk waiver permission. Hence backtesting is also done on a consolidated basis to monitor VaR model performance at a consolidated Group level.

The Group's trading book stress testing programme consists of sensitivity tests, historical scenario tests and hypothetical scenario tests. Sensitivity tests consist of stressing individual market risk factors, such as interest rates and foreign exchange rates, and calculating the resultant loss. Historical scenario tests consist of identifying major stress events that have occurred historically which would not be captured within VaR, and calculating the resultant loss from these scenarios reoccurring. Hypothetical scenario tests consist of forecasting major economic events, predicting the resultant impact on financial markets and calculating the losses that would occur from these moves in financial markets. In general, the Group’s trading book stress tests are applied across all asset classes and all trading book portfolios simultaneously in order that diversification and correlation effects are fully captured.

As noted above the Group now includes an additional Stressed VaR for the VaR based capital and the default risk charge now includes the migration risk of issuers of traded instruments. This follows the implementation of CRD 3 market risk based calculations. Stressed VaR uses historical market data from a continuous one year period of significant financial stress which is relevant to the trading book positions.

The Incremental Risk Charge measures the risks arising from both default and loss inducing migrations. The charge is computed over a one year capital horizon with the 99.9th percentile worst loss taken as the value of the charge. A Monte Carlo approach is used to simulate the P&L changes arising from migration and default for each portfolio position in turn. The P&L changes from each position contribute to the overall loss distribution. The calculation uses a multi-factor Gaussian Copula model. A one year liquidity horizon is applied for all positions within this portfolio.

Validation of the model uses a number of methods including but not limited to stress tests, sensitivity analyses and scenarios analyses. The model is reviewed independently from the development team and model adequacy and conservatism is re-assessed over time should the portfolio change over time.

Valuation Principles

The consolidated financial statements of the Group are prepared in accordance with International Financial Reporting Standards. Trading securities, other financial assets and liabilities at fair value through profit or loss, derivatives and available-for-sale financial assets are stated at fair value. The fair value of these financial instruments is the amount for which an asset could be exchanged or a liability settled between willing parties in arm's length transactions. The fair values of financial instruments are determined by reference to observable market prices where these are available and the market is active. Where market prices are not available or are unreliable because of poor liquidity, fair values are determined using valuation techniques including cash flow models which, to the extent possible, use observable market parameters. The process of calculating the fair value using valuation techniques may necessitate the estimation of certain pricing parameters, assumptions or model characteristics.

The Group maintains systems and controls sufficient to provide reliable valuation estimates, including documented policies, clearly defined roles and responsibilities and departments accountable for verification that are independent of the front office and report ultimately to a main board director. Where models are used, the assumptions, methodologies, mathematics and software implementation are assessed and challenged by suitably qualified parties independent of the development process.

The Group considers the need for reserves including unearned credit spreads, close-out costs, investing and funding costs. Any material adjustments required by GENPRU 1.3 that are not required by International Financial Reporting Standards are reconciled to the financial statements and reported to the FSA in prudential returns.

Trading Assets and Other Treasury Positions

Based on the 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2011 and 2010 based on the Group's global trading positions were as detailed in the table below. One Day 99% VaR charts for 2011 for the Lloyds TSB, HBOS and LBG VaR models can be found on p.107.

Daily VaR Measures	2011 Close £m	2011 Average £m	2011 Maximum £m	2011 Minimum £m	2010 Close £m
Interest rate risk	2.6	3.0	5.9	1.8	3.9
Foreign exchange risk	0.4	0.5	1.6	0.2	0.4
Equity risk	-	-	-	-	-
Credit spread risk	3.1	2.3	4.5	1.0	1.6
Inflation risk	0.2	0.2	0.5	0.1	0.3
Total VaR	**6.3**	**6.0**	**9.7**	**4.1**	**6.2**

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types, which now includes inflation. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity.

Market Risk Capital Requirement

As at 31 December 2011 the capital requirement in respect of market risk in the trading book amounted to £550m (2010: £338m).

Approach / Risk	2011 Capital Requirement £m	2010 Capital Requirement £m
Internal Models Approach		
VaR	156	200
Stressed VaR	205	-
Incremental Risk Charge	47	-
Standardised Approach		
Interest rate position risk requirement	137	133
Foreign currency position risk requirement	3	5
Commodity position risk requirement	-	-
Specific interest rate risk of securitisation positions [1]	2	-
Total	**550**	**338**

Notes: [1] Further details on the calculation of the specific interest rate risk of securitisation positions is provided on p.90.

No market risk positions within the trading book are subject to the All Price Risk Measure.

Non-Trading

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates including the margin between interbank and central bank rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

The following table shows, split by material currency, Lloyds Banking Group sensitivities as at 31 December 2011 to an immediate up and down 25 basis points change to all interest rates.

	2011 Up 25bps £m	**2011 Down 25bps £m**	2010 Up 25bps £m	2010 Down 25bps £m
Sterling	**(53.1)**	**54.7**	(86.9)	88.4
US Dollar	**(0.4)**	**0.3**	11.1	(11.4)
Euro	**(15.7)**	**15.9**	8.9	(9.0)
Australian Dollar	**(1.8)**	**1.8**	(1.2)	1.2
Other	**(1.4)**	**1.3**	(3.0)	3.1
Total	**(72.4)**	**74.0**	(71.1)	72.3

Base case market value is calculated on the basis of the Lloyds Banking Group current balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates – market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Pension Schemes

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Group Asset and Liability Committee and the Group Market Risk Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

The schemes' main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the pension schemes under International Accounting standard (IAS)19 spreads any adverse impacts of these risks over time.

Insurance Portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2011 and 2010. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

	2011 £m	2010 £m
Equity risk (impact of 10% fall pre-tax)	**(339.4)**	(367.4)
Interest rate risk (impact of 25 basis point reduction pre-tax)	**59.2**	82.1
Credit spread risk (impact of 30% widening)	**(237.3)**	(163.0)

MITIGATION

Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Banking – Non-Trading Activities

Interest rate risk 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.

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 within the Trading Risk Appetite and any residual risk is hedged in the market.

Insurance Activities

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

MONITORING

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored by Risk Division and where appropriate, escalation procedures are in place.

Banking Activities

Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed centrally within limits defined in the detailed Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Insurance Activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the Group Market Risk Committee:

- The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.

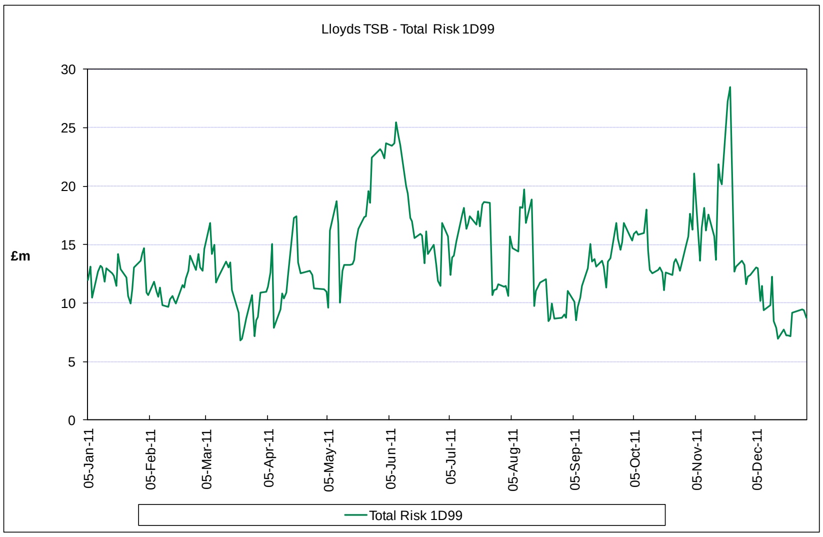
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset / liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.

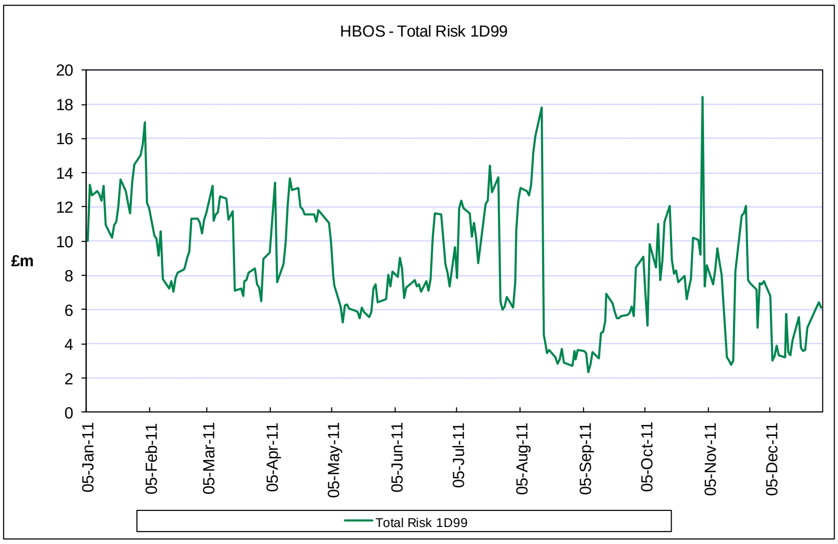
- Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

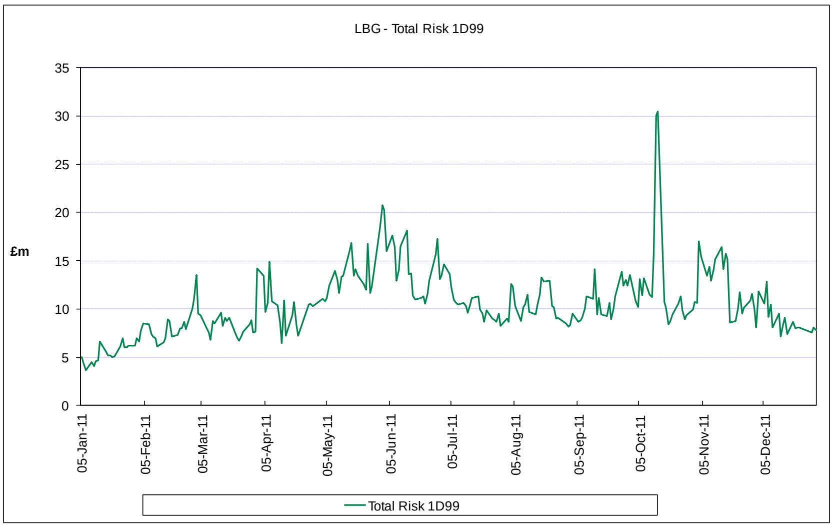
The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

Daily VaR Charts (1 Day 99% VaR)

The charts below show the 1 Day 99% VaR measure for the Lloyds TSB, HBOS and LBG VaR models. The risk of loss measured by the VaR models is the potential loss in earnings for a given confidence level (99%) and time horizon (1 day).







OPERATIONAL RISK

DEFINITION

The risk of reductions in earnings and / or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

There are a number of categories of operational risk:

Regulatory

Regulatory risk is the risk of reductions in earnings and / or value, through financial or reputational loss, from failing to comply with the applicable laws, regulations or codes.

Customer Treatment

The risk of regulatory censure and / or a reduction in earnings / value through financial or reputational loss, from inappropriate or poor customer treatment.

People

The risk of reductions in earnings or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to our people.

Supplier Management

The risk of reductions in earnings and / or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

Customer Processes

The risk of reductions in earnings and / or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and / or system failure.

Financial Crime

The risk of reductions in earnings and / or value, through financial or reputational loss, associated with financial crime and failure to comply with related regulatory obligations, these losses may include censure, fines or the cost of litigation. This includes risks associated with fraud and bribery.

Money Laundering and Sanctions

The risk of reductions in earnings and / or value, through financial or reputational loss, associated with failure to comply with prevailing regulatory obligations on activities related to money laundering, sanctions and counter terrorism, these losses may include censure, fines or the cost of litigation.

Security

The risk of reductions in earnings and / or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

IT Systems

The risk of reductions in earnings and / or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions.

Change

The risk of reductions in earnings and / or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

Organisational Infrastructure

The risk of reductions in earnings and / or value, through financial or reputational loss, resulting from poor internally facing business processes at group, divisional or business unit level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

RISK APPETITE

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation.

The Group has zero risk appetite for regulatory breaches or systemic unfair outcomes for customers. To achieve this, the Group encourages and maintains an appropriately balanced regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

EXPOSURES

By its very nature, operational risks can arise from a wide range of the Group's activities that involve people, processes and systems. The Group's principal operational risks relate to the Group's ability to attract, retain and motivate its people, the rate and scale of change arising from the Group's strategic review programme, the way in which the Group treats its customers and the regulatory environment in which it operates.

The Group continues to face risks relating to its ability to attract, retain, and develop high calibre talent, as a result of challenges arising from ongoing regulatory and public interest in remuneration practices. In addition there is uncertainty from EU state aid requirements and Independent Commission on Banking proposals on banking reform.

The breadth of the strategic review programme is such that all parts of the Group are impacted to a degree. The risks associated with the programme, including implementation and delivery, are the subject of rigorous oversight by business areas and Risk Division, with challenges by Internal Audit, commensurate to the scale of the change.

Customer treatment and how the Group manages its customer relationships affect all aspects of the Group's operations and are closely aligned with achievement of the Group's strategic aim – to be the best bank for customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies.

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

MEASUREMENT

Operational risks are measured against a set of risk appetite metrics, with appropriate limits and triggers, which have been approved by the Board.

MITIGATION

The Group's operational risk management framework consists of the following key components:

- Identification and categorisation of the key operational risks facing a business area, including defining risk appetite.
- Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.
- Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.
- Loss and incident management, capturing actions to manage any losses facing a business area.
- The development of Key Risk Indicators for management reporting, including the monitoring of risk appetite.
- Oversight and assurance of the risk management framework in businesses.
- Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

MONITORING

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. the report is discussed at the monthly Group Operational Risk Committee and Compliance & Conduct Committee. These committees can escalate matters to the Chief Risk Officer, or higher committees, if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

OPERATIONAL RISK CAPITAL REQUIREMENT

As at 31 December 2011, the capital requirement in respect of operational risk amounted to £2,447m (2010: £2,532m), as determined under The Standardised Approach.

APPENDIX 1

LLOYDS TSB BANK GROUP

CAPITAL RESOURCES AND CAPITAL REQUIREMENTS

LLOYDS TSB BANK GROUP CAPITAL RESOURCES

The capital resources of Lloyds TSB Bank Group as at 31 December 2011 are presented in the table below.

	2011		2010	
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		50,599		46,891
Non-controlling interests per balance sheet		674		841
Regulatory adjustments to non-controlling interests		(577)		(524)
Regulatory adjustments:				
Adjustment for own credit		(136)		(8)
Defined benefit pension adjustment		(1,004)		(1,052)
Unrealised reserve on AFS debt securities		(282)		1,405
Unrealised reserve on AFS equity investments		(386)		(462)
Cash flow hedging reserve		(576)		125
Regulatory prudent valuation adjustments		(32)		-
Other items		(4)		(4)
		48,276		47,212
Less: deductions from core tier 1				
Goodwill		(2,016)		(2,016)
Intangible assets		(2,310)		(2,390)
50% excess of expected losses over impairment		(720)		-
50% of securitisation positions		(153)		(214)
Core tier 1 capital		43,077		42,592
Non-controlling preference shares [1]		2,199		1,948
Preferred securities [1]		5,038		4,904
Less: deductions from tier 1				
50% of material holdings		(94)		(69)
Total tier 1 capital		50,220		49,375
Total tier 1 capital (excluding preferred securities)	*45,182*		44,471	
Tier 2				
Undated subordinated debt		2,067		2,136
Dated subordinated debt		22,469		16,290
Unrealised gains on available for sale equity investments		386		462
Eligible provisions		1,259		2,468
Less: deductions from tier 2				
50% excess of expected losses over impairment		(720)		-
50% of securitisation positions		(153)		(214)
50% of material holdings		(94)		(69)
Total tier 2 capital		25,214		21,073
Total tier 2 capital (including preferred securities)	*30,252*		25,977	
Supervisory deductions				
Unconsolidated investments – life		(10,107)		(10,042)
Unconsolidated investments – general insurance and other		(13,052)		(3,070)
Total supervisory deductions		(23,159)		(13,112)
Total Capital Resources		52,275		57,336
Risk Weighted Assets		352,341		406,372
Core tier 1 ratio (%)		12.2%		10.5%
Tier 1 capital ratio (%)		14.3%		12.2%
Total capital ratio (%)		14.8%		14.1%

Notes

[1] Non-controlling preference shares and preferred securities represent the Group's hybrid capital instruments. These are included within tier 1 capital in accordance with grandfathering provisions issued by the FSA (GENPRU TP 8A).

LLOYDS TSB BANK GROUP RISK WEIGHTED ASSETS AND PILLAR 1 CAPITAL REQUIREMENTS

The risk weighted assets and Pillar 1 capital requirements of Lloyds TSB Bank Group as at 31 December 2011 are presented in the table below.

(All figures are in £m)	2011 Risk Weighted Assets	2011 Pillar 1 Capital Requirements	2010 Risk Weighted Assets	2010 Pillar 1 Capital Requirements
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	60,405	4,832	74,720	5,978
Corporate - SME	15,168	1,213	20,285	1,623
Corporate - Specialised lending	6,683	535	7,428	594
Central governments and central banks	1,299	104	1,290	103
Institutions	2,426	194	4,371	350
Retail IRB Approach				
Retail - Residential mortgages	58,926	4,714	60,950	4,876
Retail - Qualifying revolving retail exposures	19,112	1,529	24,765	1,981
Retail - Other retail	18,479	1,478	17,690	1,415
Retail - SME	2,306	184	2,069	166
Other IRB Approaches				
Corporate - Specialised lending	4,469	358	6,397	512
Equities - Exchange traded	-	-	179	14
Equities - Private equity	-	-	3,217	257
Equities - Other	57	5	2,133	171
Securitisation positions	9,376	750	8,954	716
Total - IRB Approach	198,706	15,896	234,448	18,756
Exposures subject to the Standardised Approach				
Central governments and central banks	57	5	60	5
Regional governments or local authorities	8	1	14	1
Administrative bodies and non-commercial undertakings	361	29	294	24
Multilateral development banks	-	-	-	-
Institutions	399	32	292	23
Corporates	33,478	2,678	40,965	3,277
Retail	6,030	482	7,560	604
Secured on real estate property	31,473	2,518	35,582	2,847
Past due items	9,907	792	15,286	1,223
Items belonging to regulatory high risk categories	3,603	288	236	19
Securitisation positions	-	-	28	2
Short term claims on institutions or corporates	451	36	824	66
Collective investment undertakings	24	2	10	1
Other items	17,734	1,419	23,341	1,867
Total - Standardised Approach	103,525	8,282	124,492	9,959
Total Credit Risk	302,231	24,178	358,940	28,715
COUNTERPARTY CREDIT RISK				
IRB Approach	6,170	494	5,207	417
Standardised Approach	6,474	518	6,358	508
Total Counterparty Credit Risk	12,644	1,012	11,565	925
MARKET RISK				
Internal Models Approach	5,096	408	2,494	200
Standardised Approach				
Interest rate position risk requirement	1,717	137	1,657	133
Foreign currency position risk requirement	40	3	61	5
Commodity position risk requirement	6	-	5	-
Specific interest rate risk of securitisation positions	18	2	-	-
Total Market Risk	6,877	550	4,217	338
OPERATIONAL RISK				
Standardised Approach	30,589	2,447	31,650	2,532
Total Operational Risk	30,589	2,447	31,650	2,532
TOTAL	352,341	28,187	406,372	32,510

APPENDIX 2

BOS GROUP

CAPITAL RESOURCES AND CAPITAL REQUIREMENTS

BOS GROUP CAPITAL RESOURCES

The capital resources of BOS Group as at 31 December 2011 are presented in the table below.

		2011		2010
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		18,397		19,842
Non-controlling interests per balance sheet		16		201
Regulatory adjustments to non-controlling interests		12		29
Regulatory adjustments:				
Unrealised reserve on AFS debt securities		859		1,245
Unrealised reserve on AFS equity investments		(342)		(346)
Cash flow hedging reserve		(861)		415
Other items		(16)		-
		18,065		21,386
Less: deductions from core tier 1				
Goodwill		(416)		(401)
Intangible assets		(69)		(58)
50% excess of expected losses over impairment		(684)		-
50% of securitisation positions		(84)		(132)
Core tier 1 capital		16,812		20,795
Preferred securities [1]		700		700
Less: deductions from tier 1				
50% of material holdings		(80)		(25)
Total tier 1 capital		17,432		21,470
Total tier 1 capital (excluding preferred securities)	*16,732*		20,770	
Tier 2				
Undated subordinated debt		4,812		4,819
Dated subordinated debt		7,639		8,244
Unrealised gains on available for sale equity investments		342		346
Eligible provisions		1,203		1,750
Less: deductions from tier 2				
50% excess of expected losses over impairment		(684)		-
50% of securitisation positions		(84)		(132)
50% of material holdings		(80)		(25)
Total tier 2 capital		13,148		15,002
Total tier 2 capital (including preferred securities)	*13,848*		15,702	
Supervisory Deductions				
Unconsolidated investments		(983)		(1,672)
Total supervisory deductions		(983)		(1,672)
Total Capital Resources		29,597		34,800
Risk Weighted Assets		199,249		250,598
Core tier 1 ratio (%)		8.4%		8.3%
Tier 1 capital ratio (%)		8.7%		8.6%
Total capital ratio (%)		14.9%		13.9%

Notes

[1] Preferred securities represent the Group's hybrid capital instruments. These are included within tier 1 capital in accordance with grandfathering provisions issued by the FSA (GENPRU TP 8A).

BOS GROUP RISK WEIGHTED ASSETS AND PILLAR 1 CAPITAL REQUIREMENTS

The risk weighted assets and Pillar 1 capital requirements of BOS Group as at 31 December 2011 are presented in the table below.

(All figures are in £m)	2011 Risk Weighted Assets £m	2011 Pillar 1 Capital Requirements £m	2010 Risk Weighted Assets £m	2010 Pillar 1 Capital Requirements £m
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	17,730	1,418	31,350	2,508
Corporate - SME	6,373	510	10,809	865
Central governments and central banks	12	1	49	4
Institutions	1,059	85	2,711	217
Retail IRB Approach				
Retail - Residential mortgages	43,357	3,468	42,438	3,395
Retail - Qualifying revolving retail exposures	8,846	708	12,993	1,039
Retail - Other retail	4,626	370	5,059	405
Other IRB Approaches				
Corporate - Specialised lending	1,070	86	1,910	153
Equities - Exchange traded	-	-	179	14
Equities - Private equity	-	-	3,217	257
Equities - Other	57	5	2,133	171
Securitisation positions	4,740	379	4,117	329
Total - IRB Approach	87,870	7,030	116,965	9,357
Exposures subject to the Standardised Approach				
Central governments and central banks	-	-	-	-
Regional governments or local authorities	8	1	13	1
Administrative bodies and non-commercial undertakings	360	29	280	23
Institutions	176	14	90	7
Corporates	27,093	2,167	36,043	2,884
Retail	4,392	351	5,792	463
Secured on real estate property	29,255	2,340	33,585	2,687
Past due items	9,655	772	14,975	1,198
Items belonging to regulatory high risk categories	3,331	267	86	7
Securitisation positions	-	-	28	2
Short term claims on institutions or corporates	219	18	805	64
Collective investment undertakings	8	1	-	-
Other items	10,706	856	14,374	1,150
Total - Standardised Approach	85,203	6,816	106,071	8,486
Total Credit Risk	173,073	13,846	223,036	17,843
COUNTERPARTY CREDIT RISK				
IRB Approach	653	52	906	73
Standardised Approach	6,286	503	6,358	508
Total Counterparty Credit Risk	6,939	555	7,264	581
MARKET RISK				
Internal Models Approach	2,652	212	833	66
Standardised Approach				
Interest rate position risk requirement	545	44	1,034	83
Foreign currency position risk requirement	15	1	20	2
Total Market Risk	3,212	257	1,887	151
OPERATIONAL RISK				
Standardised Approach	16,025	1,282	18,411	1,473
Total Operational Risk	16,025	1,282	18,411	1,473
TOTAL	199,249	15,940	250,598	20,048

APPENDIX 3

REMUNERATION DISCLOSURES

REMUNERATION DISCLOSURES

This section discloses the remuneration awards made by the Group to 144 Code Staff (2010: 155) in respect of the 2011 performance year. Additional information summarising the Group's decision-making policies for remuneration are also provided. These disclosures deliver the requirements of the FSA Policy Statement PS10/21 'Implementing CRD3 requirements on the disclosure of remuneration' issued in December 2010.

Code Staff

The following groups of individuals have been identified as meeting the FSA's criteria for Code Staff including those who may have a material impact on the Group's risk profile:

- Senior Management, Executive Board Directors, members of the Group Executive Committee (GEC) and their respective direct reports;
- Non Executive Directors;
- Approved Persons performing Significant Influence Functions; and
- Other highly remunerated individuals whose activities could have an impact on the Group's risk profile.

For performance year 2011 there were 144 Code Staff (2010: 155) identified across the Group.

Aggregate Remuneration Expenditure (Code Staff)

	Dec 2011 Retail £m	Dec 2011 Wholesale £m	Dec 2011 Wealth & International £m	Dec 2011 Insurance £m	Dec 2011 Group Operations £m	Dec 2011 Group Functions £m	Dec 2011 TOTAL £m
Aggregate remuneration expenditure	**9.6**	**16.2**	**13.5**	**4.5**	**7.0**	**30.3**	**81.1**

Risk, HR and Finance functions moved to Group Functions during 2011 to align to the FSA Code.

	Dec 2010 Retail £m	Dec 2010 Wholesale £m	Dec 2010 Wealth & International £m	Dec 2010 Insurance £m	Dec 2010 Group Operations £m	Dec 2010 Group Functions £m	Dec 2010 TOTAL £m
Aggregate remuneration expenditure	12.8	18.4	9.0	6.7	8.2	23.5	78.6

Analysis of Remuneration between Fixed and Variable Amounts

	Dec 2011 Total	Dec 2011 Senior Managers [1]	Dec 2011 Others
Number of Code Staff	**144**	**58**	**86**
	£m	**£m**	**£m**
Fixed:			
Cash based	**40.6**	**25.4**	**15.2**
Total Fixed Pay	**40.6**	**25.4**	**15.2**
Variable:			
Cash	**0.4**	**0.1**	**0.3**
Retained shares [2]	**8.2**	**5.0**	**3.2**
Deferred shares	**19.7**	**12.5**	**7.2**
Total Variable Pay	**28.3**	**17.6**	**10.7**
LTIP [3]	**12.2**	**9.0**	**3.2**

Notes

[1] Senior Managers are defined as Group Executive Committee members and their direct reports. From 2011 this excludes the direct reports of the Group HR Director and the Group Corporate Affairs Director, where they are not also Approved Persons.

[2] Shares subject to retention period.

[3] Notional value.

	Dec 2010 Total	Dec 2010 Senior Managers [1]	Dec 2010 Others
Number of Code Staff	155	51	104
	£m	£m	£m
Fixed:			
Cash based	38.6	20.0	18.6
Total Fixed Pay	38.6	20.0	18.6
Variable:			
Cash	1.2	0.3	0.9
Retained shares [2]	14.2	9.7	4.5
Deferred shares	14.5	13.4	1.1
Total Variable Pay	29.9	23.4	6.5
LTIP [3]	10.1	7.4	2.7

Notes

[1] Senior Managers are defined as Group Executive Committee members and their direct reports.

[2] Shares subject to retention period.

[3] Notional value.

Analysis of Deferred Remuneration

	2011 Code Staff £m
Deferred remuneration at 31 December 2011	
Outstanding, vested	**-**
Outstanding, unvested	**90.1**
Awarded during the financial year	**60.2**
Paid out	**14.1**
Reduced through performance adjustment [1]	**-**

[1] Subsequent to the year end, the Board announced on 20 February 2012 that it will make an adjustment to a proportion of the bonus awards in respect of 2010 for a number of its senior employees, including five Executive Directors. Further details can be found on pages 187 and 196 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

	2010 Code Staff £m
Deferred remuneration at 31 December 2010	
Outstanding, vested	-
Outstanding, unvested	137.1
Awarded during the financial year	51.0
Paid out	6.1
Reduced through performance adjustment	-

Analysis of Sign-On and Severance Payments

	Dec 2011 Code Staff
Severance payments	
Made during the year	**£0.8m**
Number of beneficiaries	**6**
Highest such award to a single person	**£0.5m**

	Dec 2010 Code Staff
Severance payments	
Made during the year	£1.5m
Number of beneficiaries	12
Highest such award to a single person	£0.8m

There were no sign-on awards made to Code Staff during 2011 (2010: nil)

Decision Making Process for Remuneration Policy

There continues to be considerable external focus and scrutiny of executive remuneration with particular focus on the banking sector. The Group has sought views of shareholders and other key stakeholders with regards remuneration policy, whilst ensuring that we continue to motivate, incentivise and retain talent while being mindful of the economic outlook. An essential component of the Group’s approach to remuneration is the governance process that underpins it. This ensures that the policy is robustly applied and risk is managed appropriately.

The overarching purpose of the Remuneration Committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is defined by, supports and is closely aligned to its long-term business strategy, business objectives, risk appetite and values and recognises the interests of relevant stakeholders. The remuneration policy and philosophy covers the whole Group, but the Committee pays particular attention to the top management population, including the highest paid employees in each division, those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group’s risk profile.

The Group has a robust governance framework, with the Remuneration Committee reviewing all compensation decisions for Executive Directors, Senior Managers and Code Staff. This approach to governance is cascaded through the Group with Divisional Remuneration Committees having oversight for all other employees. Control function employees are assessed and their remuneration determined jointly by the relevant business Director and the appropriate Control Function Director. To ensure compliance with the FSA Remuneration Code, the Committee also approves remuneration for Code Staff and that of senior risk and compliance officers.

While there have been no material changes to the overall structure of remuneration, the Group has continued to maintain an open and transparent dialogue with shareholders. This valuable engagement is something the Group will seek to continue into 2012, as the Group recognise the responsibilities to the providers of the equity capital in setting fair and appropriate remuneration policies.

Composition of the Remuneration Committee

The members of the Committee during 2011 were Anthony Watson (chairman); Sir Winfried Bischoff; Sir Julian Horn-Smith; Lord Leitch; David Roberts (also chairman of the Risk Committee) and Tim Ryan.

During 2011, the Committee met 12 times and considered the following principal matters:

- Review of remuneration arrangements for senior executives;
- Determination of the appropriate remuneration packages for a number of senior new hires;
- Determination of bonus pools based on Group performance and adjustment for risk;
- Performance conditions for the Long-Term Incentive Plan;
- Bonus and salary awards for Executive Directors and key senior managers;
- Approval of remuneration and terms of service that fall within the Committee’s terms of reference, including new appointments; and
- Feedback from the Remuneration Committee Chairman on his meetings with the FSA and shareholders.

Role of the Relevant Stakeholders

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, Deloitte LLP advised the Committee. Deloitte has voluntarily signed up to the Remuneration Consultants’ Code of Conduct and are judged by the Committee to be independent.

Eric Daniels (until 28 February 2011), António Horta-Osório (from 1 March 2011), Angie Risley (Group HR Director) and Liz Jackson (HR Director, Reward) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer) and Tim Tookey (Group Finance Director) also attended the Committee to advise as and when necessary on risk and financial matters.

Link Between Pay and Performance

During 2011, a thorough Strategic Review of the business was conducted by the Board, which is now in its implementation phase. Following this review, the Remuneration Committee has worked towards translating the new strategic objectives into meaningful metrics against which to measure performance.

The introduction of a balanced scorecard approach to measure long-term performance from 2012 will enable the Remuneration Committee to assess the performance of the Company and its senior executives in a consistent and performance driven way. The Group’s remuneration policy continues to support the business values and strategy, based on building long-term relationships with customers and employees and managing the financial consequences of business decisions across the entire economic cycle.

The policy is intended to ensure that the remuneration offer is both cost effective and enables us to attract and retain Executive Directors and senior management of the highest calibre, motivating them to perform to the highest standards.

The objective is to align individual reward with the Group's performance, the interests of its shareholders, and a prudent approach to risk management. In this way we balance the requirements of the various stakeholders: customers, shareholders, employees, and regulators. This approach is in line with the Association of British Insurers best practice code on remuneration and the FSA Remuneration Code of Practice, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

Annual and long-term incentives are based on stretching performance objectives and targets in the Group Balanced Scorecard. This Balanced Scorecard is derived from the Medium Term Plan which defines the financial and non-financial targets within the agreed risk appetite over a three year period.

In determining the payout under any component of variable pay, the adopted policy is the use of discretion to assess the extent to which performance has been achieved rather than applying a formulaic approach. The annual bonus for Executive Directors is deferred into shares and released over a period of not less than two years, helping to increase alignment with shareholders. All other Code Staff are subject to deferral at least in line with the FSA Remuneration Code. These deferrals are subject to adjustment through the application of the 'performance adjustment process'.

Design and Structure of Remuneration

Reward is delivered via a combination of fixed (salary) and variable pay (bonus and LTIP). Taking into account the expected value of awards, the performance-related elements of pay make up a considerable proportion of the total remuneration package for Code Staff, whilst maintaining an appropriate balance between the fixed and variable elements.

The approximate make-up of the main components of the package for Executive Directors on an expected value basis is shown below:

Long-term incentive	20%
Short-term incentive	35%
Salary	35%
Pension and benefits	10%

The overall policy objective is met by a focus on the particular aspects detailed below.

Base salary

All Code Staff receive either salaries or fees (Non-Executive Directors). Base salaries are reviewed annually, taking into account individual performance and market information (which is provided by Towers Watson and supplemented with information from Deloitte LLP) and normally adjusted from 1 January of the relevant year. The remuneration committee confirmed during the 2011 review that the FTSE remains the most appropriate comparator group to use to benchmark overall competitiveness of the remuneration package whilst taking particular account of the remuneration practice of direct competitors, namely the major UK banks. Salary as part of the annual review will increase by less than 2.5 per cent, with lower or zero increases at more senior levels.

Annual incentive plan

All Code Staff, excluding Non-Executive Directors, are eligible to be considered for an annual bonus. The annual incentive scheme is designed to reflect specific goals linked to the performance of the business.

Incentive awards are based upon individual contribution and overall corporate results. Incentive opportunity is driven by corporate performance based on profit before tax and economic profit, together with divisional achievement and individual performance. Individual targets relevant to improving overall business performance are contained in a Balanced Scorecard and are grouped under the following headings:

- Financial
- Building the Business
- Customer Service
- Risk
- People Development

These targets apply differently for the Executive Directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to risk management, SME lending, process efficiency, service quality and employee engagement.

The remuneration committee believes that the structure of the incentive – in particular the use of risk-adjusted and non-financial measures – has been highly successful in promoting a long-term focus within the senior management team.

Consistent with the aim of ensuring that short-term financial results are only rewarded if they promote sustainable growth, the 2011 annual incentive is subject to deferral in shares until at least 2014. This deferred amount is subject to performance adjustment if the performance that generated the incentive is found to be unsustainable.

Deferral and vesting

To ensure that the interests of Lloyds Banking Group and its employees are aligned with those of the shareholders, and that the approach to risk management supports the interests of all stakeholders, a proportion of bonus above certain thresholds is deferred into Lloyds Banking Group Shares. The 2011 annual bonus for Executive Directors is deferred in shares until at least March 2014 and is beyond the requirements of the FSA Remuneration Code. For all other Code Staff, bonus is deferred in line with the FSA Code requirements. This deferred amount is subject to adjustment when there is (a) reasonable evidence of employee misbehaviour or mistake, (b) the business unit suffers a material downturn or (c) material failure of risk management.

The committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if they deem this appropriate.

Long-term incentives

The Long Term Incentive Plan remains a core part of the reward strategy. The Group have changed the performance conditions to better ensure alignment with the objectives and timeline of the Strategic Plan as well as to link to retaining key employees and align with other elements of reward.

The Committee believes the LTIP will be more motivational by introducing measures with clear milestones and outcomes that can be communicated regularly, providing a sense of purpose and achievement throughout the life of the plan. The core financial measures remain an important element for top management to ensure alignment with shareholders. Accordingly, it is proposed that Economic Profit and Absolute Total Shareholder Return targets remain in place for Executive Directors, but at a reduced level, with a significant percentage of LTIP based on balanced scorecard measures.

Long-term incentive performance measures

During 2011, the Committee has consulted widely with shareholders on the topic of performance measures and sharing the growth in the Company appropriately between shareholders and management. The Committee believes that the performance measures for the 2012 LTIP award for the Executive Committee should be Economic Profit, Absolute Total Shareholder Return and strategic financial measures. These measures capture risk measurement, profit growth and shareholder experience and align shareholder experience and management reward.

Governance and Risk Management

An essential component of the approach to remuneration is the governance process that underpins it. This ensures that the policy is robustly applied and risk is managed appropriately.

The overarching purpose of the Remuneration Committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is defined by, supports and is closely aligned to its long-term business strategy, business objectives, risk appetite and values and recognises the interests of relevant stakeholders. The Group has a conservative business model characterised by a risk culture founded on prudence and accountability. The remuneration policy and philosophy covers the whole Group, but the Committee pays particular attention to the top management population, including the highest paid employees in each division, those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile.

The Committee's role is to ensure that these colleagues are provided with appropriate incentives and reward to encourage them to enhance the performance of the Group and that they are recognised for their individual contribution to the success of the organisation, whilst ensuring that there is no reward for excessive risk taking. The Committee works closely with the Risk Committee in ensuring the bonus pool is moderated. The two Committees meet every year to determine whether the proposed bonus pool and performance assessments adequately reflected the risk appetite and framework of the Group; whether it took account of current and future risks; and whether any further adjustment is required or merited. The Group and the Remuneration Committee are determined to ensure that the aggregate of the variable remuneration for all colleagues is appropriate and balanced with the interests of shareholders and all other stakeholders.

The Remuneration Committee's terms of reference are available from the Company Secretary and are displayed on the Group's website: www.lloydsbankinggroup.com. These terms were updated in January 2011 to ensure continued compliance with the FSA Code.

Further details on directors' remuneration and other remuneration can be found in the Directors' Remuneration Report and Other Remuneration Disclosures located on pages 187 to 204 of the 2011 Lloyds Banking Group plc Annual Report and Accounts.

APPENDIX 4

GLOSSARY

GLOSSARY

Arrears
A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency. When a customer is in arrears, the entire outstanding balance is said to be delinquent, meaning that delinquent balances are the total outstanding loans on which payments are overdue.

Asset Backed Securities (ABS)
Asset Backed Securities are securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages but could also include leases, credit card receivables, motor vehicles and student loans.

Asset Backed Commercial Paper (ABCP)
See **Commercial Paper**

Basel II
The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.

Basel III
The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in from 1 January 2013 onwards.

Basis point
One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates or yields on securities.

Collateralised Debt Obligations (CDO)
A security issued by a third party which references ABSs or other assets purchased by the issuer. Lloyds Banking Group has invested in instruments issued by other banking groups, including Collateralised Loan Obligations and Commercial Real Estate CDOs.

Collateralised Loan Obligations (CLO)
A security backed by the repayments from a pool of commercial loans. CLOs are usually structured products with different tranches whereby senior classes of holder receive repayment before other tranches are repaid.

Collectively assessed loan impairment provision
A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.

Commercial Mortgage Backed Securities (CMBS)
Commercial Mortgage-Backed Securities are securities that represent interests in a pool of commercial mortgages. Investors in these securities have the right to cash received from mortgage repayments of interest and principal.

Commercial Paper (CP)
Commercial paper is an unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date. Commercial Paper can be issued as an unsecured obligation of the Group or, for example when issued by the Group's conduits, as an asset backed obligation (in such case it is referred to as asset backed commercial paper). Commercial Paper is usually issued for periods from as little as a week up to nine months.

Commercial real estate
Commercial real estate includes office buildings, medical centres, hotels, malls, retail stores, shopping centres, farm land, multifamily housing buildings, warehouses, garages, and industrial properties.

Conduits
A financial vehicle that holds asset backed securities which are financed with short-term deposits (generally commercial paper) that use the asset backed securities as collateral. The conduit will often have a liquidity line provided by a bank that it can draw down on in the event that it is unable to issue funding to the market. The Group sponsors three asset backed conduits Argento, Cancara and Grampian.

Contractual maturities
Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.

Core tier 1 capital
As defined by the FSA mainly comprising shareholders' equity and equity non-controlling interests after deducting goodwill, other intangible assets and other regulatory deductions.

Core tier 1 ratio
Core tier 1 capital as a percentage of risk weighted assets.

Counterparty credit risk
Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. Such transactions relate to contracts for financial instruments and may include derivative contracts and repo contracts.

Credit Conversion Factor (CCF)
Credit conversion factors (CCF) are used in determining the exposure at default (EAD) in relation to a credit risk exposure. The CCF is an estimate of the proportion of undrawn commitments expected to be drawn down at the point of default.

Credit Default Swaps (CDS)
A credit default swap is also referred to as a credit derivative. It is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.

Credit derivatives
A credit derivative is a financial instrument that derives its value from the credit rating of an underlying instrument carrying the credit risk of the issuing entity. The principal type of credit derivatives are credit default swaps, which are used by the Group as part of its trading activity and to manage its own exposure to credit risk.

Credit risk
The risk of reductions in earnings and / or value, through financial loss, as a result of the failure of the party with whom the Group has contracted to meet its obligations (both on and off balance sheet).

Credit risk spread (or credit spread)	The credit spread is the yield spread between securities with the same currency and maturity structure but with different associated credit risks, with the yield spread rising as the credit rating worsens. It is the premium over the benchmark or risk-free rate required by the market to take on a lower credit quality.
Credit Valuation Adjustments (CVA)	These are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty.
Debt restructuring	This is when the terms and provisions of outstanding debt agreements are changed. This is often done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as reducing the debt or interest charged on the loan.
Debt securities	Debt securities are assets held by the Group representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by Central Banks.
Debt securities in issue	These are unsubordinated debt securities issued by the Group. They include commercial paper, certificates of deposit, bonds and medium-term notes.
Embedded equity conversion feature	An embedded equity conversion feature is a derivative contained within the terms and conditions of a debt instrument that enables or requires the instrument to be converted into equity under a particular set of circumstances. The Group's Enhanced Capital Notes (ECNs) contain such a feature whereby these notes convert to ordinary shares in the event that the consolidated core tier 1 ratio of the Group falls below 5 per cent.
Enhanced Capital Notes (ECNs)	The Group's ECNs are subordinated notes issued by the Group that contain an embedded equity conversion feature.
Expected Loss (EL)	Expected loss (EL) represents the anticipated loss, in the event of default, on a credit risk exposure modelled under the internal ratings based approach. EL is determined by multiplying the associated PD%, LGD% and EAD together and assumes a 12 month time horizon.
Exposure at Default (EAD)	Exposure at default (EAD) represents the estimated exposure to a customer in the event of default. In determining EAD amounts, consideration is made of the extent to which undrawn commitments may be drawn down at the point of default (see **Credit Conversion Factors**) and the application of credit risk mitigation (i.e. eligible financial collateral). Analysis of credit risk exposures under Pillar 3 is typically based on EAD amounts, prior to the application of credit risk mitigation.
External Credit Assessment Institutions (ECAI)	External Credit Assessment Institutions (ECAIs) include external credit rating agencies such as Standard & Poor's, Moody's and Fitch.
Fair value adjustment	Fair value adjustments arise on acquisition when assets and liabilities are acquired at fair values that are different from the carrying values in the acquired company. In respect of the Group's acquisition of HBOS the principal adjustments were write-downs in respect of loans and advances to customers and debt issued.
Forbearance	A term generally applied to arrangements provided to support borrowers experiencing temporary financial difficulty. Such arrangements include reduced or nil payments, term extensions, transfers to interest only and the capitalisation of arrears.
Foundation Internal Ratings Based (Foundation IRB) Approach	Application of the Foundation Internal Ratings Based (Foundation IRB) Approach allows internal estimates of PD to be used by the Group in determining credit risk capital requirements for wholesale portfolios. However, LGD and EAD under the Foundation IRB Approach are determined in accordance with standard parameters set by the regulator rather than on the basis of internal estimates. The Foundation IRB Approach cannot be applied to retail portfolios.
Guaranteed mortgages	Mortgages for which there is a guarantor to provide the lender a certain level of financial security in the event of default of the borrower.
Impaired loans	Impaired loans are loans where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than its carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate.
Individually / collectively assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Individually assessed loan impairment provisions	Impairment loss provisions for individually significant impaired loans are assessed on a case-by-case basis, taking into account the financial condition of the counterparty, any guarantor and the realisable value of any collateral held.
Investment Grade	This refers to the highest range of credit ratings, from 'AAA' to 'BBB' as measured by external credit rating agencies.
International Swaps and Derivatives Association (ISDA) master agreement	A standardised contract developed by the ISDA which is used as an umbrella contract for bilateral derivative contracts.
Loan-to-Value Ratio (LTV)	The loan-to-value ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property. A high LTV indicates that there is less value to protect the lender against house price falls or increases in the loan if repayments are not made and interest is added to the outstanding balance of the loan.

Loans past due
Loans are past due when a counterparty has failed to make a payment when contractually due.

Loss Given Default (LGD)
Loss given default (LGD) represents the estimated proportion of an EAD amount that will be lost in the event of default. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.

Market risk
The risk of reductions in earnings, value, capital and / or reserves, through financial or reputational loss, arising from unexpected changes in financial prices, including interest rates, inflation rates, exchange rates, credit spreads and prices for bonds, commodities, equities, property and other instruments.

Mortgage related assets
Assets which are referenced to underlying mortgages.

Operational risk
The risk of reductions in earnings and / or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people-related or external events.

Over-the-Counter (OTC) derivatives
Over the counter derivatives are derivatives for which the terms and conditions can be freely negotiated by the counterparties involved, unlike exchange traded derivatives which have standardised terms.

Private equity investments
Private equity is equity securities in operating companies not quoted on a public exchange. Investment in private equity often involves the investment of capital in private companies or the acquisition of a public company that results in the delisting of public equity. Capital for private equity investment is raised by retail or institutional investors and used to fund investment strategies such as leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital.

Point-in-time (PIT)
Estimates of PD (or other measures) made on a point-in-time (PIT) basis generally cover a short time horizon (usually a 12 month period) and are sensitive to changes in the economic cycle. This differs from a through-the-cycle (TTC) basis which uses long run average economic and risk data to reduce such sensitivity.

Probability of Default (PD)
Probability of default (PD) represents an estimate of the likelihood that a customer will default on their obligation within a 12 month time horizon.

Qualifying Revolving Retail Exposure (QRRE)
Qualifying Revolving Retail Exposures (QRRE) relate to revolving, unsecured retail exposures that, to the extent they are not drawn, are immediately and unconditionally cancellable. Such exposures include credit cards and overdraft facilities.

Re-securitisations
A securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation position.

Renegotiated loans
Loans and advances are generally renegotiated either as part of an ongoing customer relationship or in response to an adverse change in the circumstances of the borrower. In the latter case renegotiation can result in an extension of the due date of payment or repayment plans under which the Group offers a concessionary rate of interest to genuinely distressed borrowers. This will result in the asset continuing to be overdue and will be impaired where the renegotiated payments of interest and principal will not recover the original carrying amount of the asset. In other cases, renegotiation will lead to a new agreement, which is treated as a new loan.

Repurchase agreements or ‘repos’
Short-term funding agreements which allow a borrower to sell a financial asset, such as ABS or Government bonds as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.

Residential Mortgaged Backed Securities (RMBS)
Residential Mortgage Backed Securities are a category of ABS. They are securities that represent interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and / or principal).

Retail Internal Ratings Based (Retail IRB) Approach
The Retail Internal Ratings Based (Retail IRB) Approach allows internal estimates of PD, LGD and EAD to be used in determining credit risk capital requirements for retail portfolios.

Retail loans
Money loaned to individuals rather than institutions. These include both secured and unsecured loans such as mortgages and credit card balances.

Risk weighted assets (RWAs)
A measure of a bank’s assets adjusted for their associated risks. Risk weightings are established in accordance with FSA rules.

Securitisation
Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. Securitisation is the process by which ABS are created. A company sells assets to a special purpose entity which then issues securities backed by the assets. This allows the credit quality of the assets to be separated from the credit rating of the original company and transfers risk to external investors. Assets used in securitisations include mortgages to create mortgage backed securities or residential mortgage-backed securities (RMBS) as well as commercial mortgage backed securities (CMBS). The Group has established several securitisation structures as part of its funding and capital management activities. These generally use mortgages, corporate loans and credit cards as asset pools.

Special Purpose Entities (SPEs)
SPEs are entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses a number of SPEs, including those set-up under securitisation programmes, and as conduits. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group’s results.

Standardised Approach
The Standardised Approach to calculating credit risk capital requirements requires the use of a standard set of risk weights prescribed by the regulator. Use may be made of external credit ratings supplied by ECAIs to assign risk weights to exposures. Standardised approaches, following prescribed methodologies, also exist for calculating market risk and operational risk capital requirements.

Student loan related assets
Assets which are referenced to underlying student loans.

Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.
Synthetic CDO	A security that is similar in structure to a CDO whereby the pool of referenced assets is created synthetically usually by credit default swaps.
The Standardised Approach (TSA)	A standardised measure for calculating operational risk capital requirements based on the three year average of the aggregate risk weighted relevant indicators of the underlying business. The relevant indicators are derived from total income.
Through-the-cycle (TTC)	See **Point-in-time (PIT)**
Tier 1 capital	A measure of a bank's financial strength defined by the FSA. It captures core tier 1 capital plus other tier 1 securities in issue, but is subject to a deduction in respect of material holdings in financial companies.
Tier 1 capital ratio	Tier 1 capital as a percentage of risk weighted assets.
Tier 2 capital	A component of regulatory capital defined by the FSA, mainly comprising qualifying subordinated loan capital, certain non-controlling interests and eligible collective impairment allowances.
Value at Risk (VaR)	Value at Risk is an estimate of the potential loss in earnings which might arise from market movements under normal market conditions, if the current positions were to be held unchanged for one business day, measured to a confidence level of 95 per cent.
Write downs	The depreciation or lowering of the value of an asset in the books to reflect a decline in their value, or expected cash flows.

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