LLOYDS BANKING GROUP

Lloyds Banking Group plc

Pillar 3 Disclosures
31 December 2012

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FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements within the meaning of the safe harbor provisions of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans of Lloyds 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 or may occur in the future.

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

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

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 2012.

The disclosures produced have been prepared in accordance with minimum disclosure requirements established under the Capital Requirements Directive ('CRD'), as modified for both the 'CRD II' and 'CRD III' packages of amendments, and commonly referred to as Basel 2.5.

Directive imposed disclosure requirements are implemented 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 work undertaken by the European Banking Authority ('EBA') and both national and international trade associations in interpreting Pillar 3 disclosure requirements and in establishing best practice guidelines. In addition, during the course of 2012 the Group was actively involved in industry discussions with the FSA in response to the UK Interim Financial Policy Committee's recommendation that UK banks should work with the FSA and the British Bankers' Association ('BBA') to achieve, over time, greater consistency and comparability between their Pillar 3 disclosures. As a result of these discussions a number of initial enhancements were agreed with the FSA and have been implemented for 2012 year end.

In parallel to the discussions on Pillar 3, the FSA also requested that the Group, along with other major UK banks, provide the following via their 2012 year end disclosures:

- A group level reconciliation, on a consistent basis, between accounting capital as published in the financial statements and the estimated 'CRD IV' (Basel III) transitional and fully loaded capital positions. In meeting these capital disclosure requirements, the Group is required to apply the rules set out under European Commission proposals contained within the July 2011 version of the draft 'CRD IV' legislation. Related risk weighted asset disclosures under CRD IV rules are presented on a 'best estimates' basis, taking into account the latest developments surrounding the draft CRD IV text and proposed amendments ahead of finalisation.

- Estimates of the Group's leverage ratio at 31 December 2012 on three different bases:

  - a 'CRD IV transitional' basis;
  - a 'CRD IV fully loaded' basis; and
  - a 'CRD IV fully loaded with ineligible tier 1 instruments grandfathered' basis.

The relevant disclosures can be found on pages 24 to 27, with further detailed analysis of the Group's estimated CRD IV transitional and fully loaded capital positions presented in Appendix 1 of the document.

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') as at 31 December 2012 can be found in Appendix 2 and Appendix 3 of the document.

Remuneration disclosures produced in compliance with CRD III requirements on the disclosure of remuneration can be found in Appendix 4 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 2012 is provided below.

CAPITAL RATIOS

Table 1: **Capital ratios**

	2012 Ratio %	2011 Ratio %
Core tier 1 capital ratio	**12.0%**	10.8%
Tier 1 capital ratio	**13.8%**	12.5%
Total capital ratio	**17.3%**	15.6%

Total capital resources as at 31 December 2012 amounted to £53.6bn (2011: £55.0bn), including tier 1 capital of £42.8bn (2011: £44.0bn). Core tier 1 capital amounted to £37.2bn (2011: £38.0bn).

RISK WEIGHTED ASSETS AND PILLAR 1 CAPITAL REQUIREMENTS

Total risk weighted assets ('RWAs') as at 31 December 2012 amounted to £310.3bn (2011: £352.3bn), generating a Pillar 1 capital requirement of £24.8bn (2011: £28.2bn). A summary breakdown of total RWAs by risk type is provided in the table below.

Table 2: **Summary risk weighted assets and Pillar 1 capital requirements**

Risk Type	2012 Risk Weighted Assets £m	2012 Capital Requirements £m	2011 Risk Weighted Assets £m	2011 Capital Requirements £m
Credit risk (Internal Ratings Based Approach)	**184,453**	**14,756**	198,706	15,896
Credit risk (Standardised Approach)	**73,665**	**5,893**	103,525	8,282
	258,118	**20,649**	302,231	24,178
Counterparty credit risk	**12,848**	**1,028**	12,644	1,012
Market risk	**11,394**	**912**	6,877	550
Operational risk	**27,939**	**2,235**	30,589	2,447
Total Risk Weighted Assets	**310,299**	**24,824**	352,341	28,187

Table 3: **Summary divisional analysis of risk weighted assets**

Division	2012 Risk Weighted Assets £m	2011 Risk Weighted Assets £m
Retail	**95,470**	103,237
Commercial Banking	**165,209**	192,885
Wealth, Asset Finance and International ('WAFI')	**36,167**	43,593
Group Operations and Central Items	**13,453**	12,626
Total Risk Weighted Assets	**310,299**	352,341

Key Movements

- Total risk weighted assets reduced by £42.0bn during the year, reflecting a combination of balance sheet reductions of non-core assets, lower core lending balances and strong management of risk.
- Retail Division RWAs reduced by £7.8bn due largely to lower lending volumes, with customers continuing to reduce their personal indebtedness, and an improved risk profile for retail exposures. Commercial Banking Division RWAs reduced by £27.7bn, primarily reflecting further balance sheet reductions of non-core assets. Wealth, Asset Finance and International Division RWAs reduced by £7.4bn as a result of the run down of non-core asset portfolios and foreign exchange movements.
- Market risk RWAs increased by £4.5bn, primarily reflecting the impact of a temporary capital buffer applied to the Group's internal market risk models. This buffer is expected to be removed once specific market risk infrastructure projects have been completed.
- Operational risk RWAs are determined under the Standardised Approach, a description of which is provided on page 9. The reduction in RWAs of £2.7bn is a result of a reduction in the three year rolling average income used in the calculation.
- During 2012 equity portfolios and investments previously risk weighted under the Standardised Approach were transferred to the Internal Ratings Based ('IRB') Approach. The Group anticipates moving further portfolios currently risk weighted under the Standardised Approach to an IRB Approach methodology during 2013.

CREDIT RISK EXPOSURES

Total credit risk exposures (excluding counterparty credit risk exposures) as at 31 December 2012 amounted to £759.0bn (2011: £807.6bn) on an exposure at default ('EAD') basis, as defined on page 11.

This comprises £575.9bn (76%) of exposures risk weighted under the IRB Approach (2011: £617.6bn, 76%) and £183.1bn (24%) of exposures risk weighted under the Standardised Approach (2011: £190.0bn, 24%). A summary analysis of credit risk exposures is provided in the table below.

Table 4: **Summary credit risk exposures**

Exposure Category	2012 Credit Risk Exposure £m	2012 Risk Weighted Assets £m	2012 Average Risk Weight %
Corporates	127,927	77,728	61%
Central governments and central banks	10,238	1,437	14%
Institutions	5,690	1,447	25%
Retail	409,387	91,445	22%
Equities	2,824	5,709	202%
Securitisation positions	19,847	6,687	34%
Total – IRB Approach	575,913	184,453	32%
Central governments and central banks	93,094	105	0%
Institutions	1,201	566	47%
Corporates	27,290	25,537	94%
Retail	7,479	5,604	75%
Secured by mortgages on residential property	15,891	6,950	44%
Secured by mortgages on commercial real estate	13,821	15,200	110%
Items belonging to regulatory high risk categories	1	1	150%
Other [1]	24,342	19,702	81%
Total – Standardised Approach	183,119	73,665	40%
TOTAL	759,032	258,118	34%

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 by mortgages on residential property	17,490	8,090	46%
Secured by mortgages on commercial real estate	20,547	23,383	114%
Items belonging to regulatory high risk categories	2,433	3,603	148%
Other [1]	33,072	28,485	86%
Total – Standardised Approach	189,998	103,525	54%
TOTAL	807,612	302,231	37%

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.

A detailed analysis of the key movements in exposures and risk weighted assets is provided on pages 35 and 36.

INTRODUCTION AND BACKGROUND

The Capital Requirements Directive (as modified for the CRD II and CRD III packages of amendments) implements the Basel II framework within the European Union ('EU'). Prudential requirements under the Basel II framework are categorised under 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, counterparty credit, market and operational risks. Capital requirements are more commonly expressed as risk weighted assets, being 12.5 times the capital required. A range of approaches, varying in sophistication, are available under the Basel II framework to use in measuring these risks and to determine the minimum level of capital required. A summary of these approaches and their application by the Group is noted below.

Credit Risk and Counterparty Credit Risk

Standardised Approach

Description

- Low risk sensitivity and complexity.
- Relies on the application of a standardised set of risk weightings to credit risk exposures.
- External credit ratings supplied by External Credit Assessment Institutions (‘ECAIs’, for example Standard & Poor's, Moody’s or Fitch) may be used in determining the appropriate risk weight to apply.
- Recognises the application of certain credit risk mitigation techniques.
- No distinction made between expected and unexpected losses.

Group Application

The Group applies the Standardised Approach to those portfolios of the business yet to roll out onto an IRB approach (see below) or that have been permanently exempted from the IRB Approach under the terms of the Group’s IRB Waiver Permission.

Internal Ratings Based (IRB) Approach

Description

- High risk sensitivity and complexity.
- A variety of IRB approaches exist depending on the type of exposure and waiver permission in place.
- There are two main approaches for wholesale exposures – the **Foundation IRB Approach (‘FIRB’)** and the **Advanced IRB Approach (‘AIRB’)**. For retail exposures, a single approach referred to as the **Retail IRB Approach (‘RIRB’)** is available and is equivalent in complexity to the Advanced IRB Approach.
- The FIRB, AIRB and RIRB 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 AIRB and / or RIRB 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 FIRB approach are also required to use credit conversion factors and LGD components within their calculations, but these are set by the regulator.
- The PD, LGD and EAD of a credit risk exposure form the base inputs to the calculation used to derive the RWA in respect of that exposure, from which the credit risk capital requirement is derived (being 8 per cent of the RWA), reflecting the capital required to cover any unexpected loss in relation to the exposure.
- An expected loss ('EL') is derived by multiplying the PD, LGD and EAD risk components together, aligning to long run average PDs and downturn LGDs where available. As such the EL calculated represents an estimate of the monetary amount the business expects to lose from an obligor within a 12 month outcome window, irrespective of current economic conditions. Where expected losses exceed accounting impairment provisions linked to the underlying credit risk exposures the resultant 'excess EL' is deducted from capital resources, split equally between core 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.
- Alternative methodologies exist under the IRB approach for use in risk weighting specific exposure types. These include the **Supervisory Slotting Approach** for corporate specialised lending exposures, the **Simple Risk Weight Method** for equity exposures and the **Ratings Based Approach (‘RBA’)** and **Internal Assessment Approach (‘IAA’)** for securitisation positions.
- Firms must use their IRB model outputs to inform both credit risk management and day to day credit related decision making within the business (the ‘Use Test’). Application of an IRB approach requires FSA approval in the form of a waiver permission.

Group Application

Both the Foundation IRB Approach and the Retail IRB Approach are used within the Group. The Group does not currently have permission to utilise the Advanced IRB Approach for wholesale portfolios. The Group applies the Supervisory Slotting Approach to certain corporate specialised lending exposures and the Simple Risk Weight Method to equity exposures. Securitisation positions are predominantly risk weighted under the Ratings Based Approach, with limited use made of the Internal Assessment Approach.

Counterparty credit risk exposures are first measured under the Mark-to-Market Method, prior to being risk weighted under either the Standardised Approach or relevant IRB approach, as appropriate.

Market Risk

Standardised Approach	**Description** - Low risk sensitivity and complexity. - Requires the calculation of position risk requirements ('PRR') for each type of market risk in the trading book in accordance with standard rules set by the FSA. **Group Application** The Group calculates position risk requirements for trading book positions that are not covered by the scope of the Group's internal VaR models. These include the Group's trading books in Australia, inflation referenced positions, certain FX and credit trading positions and equity positions.
Internal Models Approach	**Description** - High risk sensitivity and complexity. - Involves the use of internal Value at Risk ('VaR') models to measure market risks in the trading book and determine appropriate capital requirements. - FSA approval is required before VaR models can be used for capital calculation purposes. **Group Application** The Group is permitted by the FSA to calculate market risk capital requirements for its trading book positions using its VaR models. The Group applies the Internal Models Approach to the majority of its trading book positions.

Operational Risk

Basic Indicator Approach (BIA)	**Description** - Low risk sensitivity and complexity. - The capital requirement equates to 15 per cent 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. **Group Application** The Group does not apply the Basic Indicator Approach.
Standardised Approach (TSA)	**Description** - Medium risk sensitivity and complexity. - The capital requirement is derived from 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. **Group Application** The Group calculates its operational risk capital requirements under the Standardised Approach. No use is made of the Alternative approach.
Advanced Measurement Approach (AMA)	**Description** - High risk sensitivity and complexity. - The capital requirement is determined 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. **Group Application** The Group does not apply the Advanced Measurement Approach.

Further details on the Group's application of the IRB Approach (credit and counterparty credit risks) and the Internal Models Approach (market risk) are provided on pages 51 to 55 and 101 to 105, respectively.

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 are presented on page 31.

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 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.

FUTURE REGULATORY DEVELOPMENTS

At the end of 2012, the European Commission, European Parliament and European Council were still in the process of negotiating the final elements of the new Capital Requirements Directive and Regulation (‘CRD IV’), designed to implement the Basel III reforms of the Basel Committee on Banking Supervision.

As a result of the ongoing negotiations the implementation of CRD IV has not been finally resolved, though it is currently expected to be implemented in stages starting from 1 January 2014.

Further details on the anticipated impact of CRD IV on the Group’s capital position can be found on pages 24 to 27.

From a Pillar 3 perspective, CRD IV will introduce new disclosure requirements surrounding risk management, corporate governance, capital resources, capital buffers and leverage.

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 and location, verification and risk profile disclosure.

BASIS OF PREPARATION

This document contains the consolidated Pillar 3 disclosures of Lloyds Banking Group plc as at 31 December 2012, 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 2012 Lloyds Banking Group plc Annual Report and Accounts. As such, this document should be read in conjunction with the Annual Report and Accounts and, in particular, whenever the '❖' symbol appears in the document.

It is 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 on pages 13 to 16.

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, undrawn (off balance sheet) commitments and contingent liabilities, post application of credit conversion factors, and other relevant regulatory adjustments. Notable exceptions to this definition include securitisation positions, counterparty credit risk exposures and past due and impaired exposures. A summary, noting the definitions applied, is provided below.

Exposure Type	Definition Applied
Credit risk exposures (excluding securitisation positions)	EAD pre CRM [1]
Counterparty credit risk exposures	EAD post CRM
Securitisation positions	The aggregate of the Group's retained or purchased positions, excluding those positions rated below BB- or that are unrated and therefore deducted from capital.
Past due and impaired exposures	Accounting balance, defined in accordance with International Financial Reporting Standards

Notes

[1] For credit risk exposures risk weighted under the Standardised Approach, the EAD pre CRM value is stated net of individually assessed impairment provisions. Collectively assessed impairment provisions relating to Standardised credit risk exposures form part of tier 2 capital, subject to limits.

Individually and collectively assessed impairment provisions relating to credit risk exposures risk weighted under a relevant IRB Approach methodology are netted against expected losses as described on page 8.

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 do not require to be subjected to an external audit. Instead, the disclosures have been verified and approved through internal governance procedures in line with the Group's Pillar 3 Disclosure Policy, including the review and approval of the disclosures by the Group's Disclosure Committee, Audit Committee and the Board following the receipt of attestations in respect of the both the quantitative and qualitative disclosures from Divisional Finance Directors, Risk Division Officers and other senior executives.

RISK PROFILE DISCLOSURE

In accordance with the requirements of BIPRU Chapter 11 and the Group's Pillar 3 Disclosure Policy, the Group is required to assess whether its external disclosures taken as a whole (including the Group's News Release, Annual Report and Accounts and Pillar 3 Disclosures) comprehensively portray its risk profile.

In this respect, the Group's Annual Report and Accounts provides an in depth analysis of the principal risks and uncertainties and emerging risks to which the Group is exposed, together with further detail on the Group's key risk drivers.

- The relevant analysis is presented in the Risk Management section of the 2012 Lloyds Banking Group plc Annual Report and Accounts:
  - Principal risks and uncertainties, pages 118 to 124;
  - Emerging risks, page 125;
  - Risk drivers, page 131

The Group's Pillar 3 disclosures focus primarily on capital risk and the key risk drivers behind the Group's Pillar 1 capital requirements (i.e. credit, market and operational risks), providing granular information and analysis in addition to that presented within the Annual Report and Accounts.

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 accounting consolidation are also included within the scope of 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 may 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 undertakings are excluded from the calculation of consolidated capital requirements and consolidated capital resources. Investments in insurance undertakings are deducted from capital. The regulatory consolidation group diagram presented on page 14 highlights the key insurance undertakings of the Group that are excluded from the scope of regulatory consolidation.

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 2012 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 on the constraints imposed are provided on page 197 of the Risk Management section of the 2012 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.

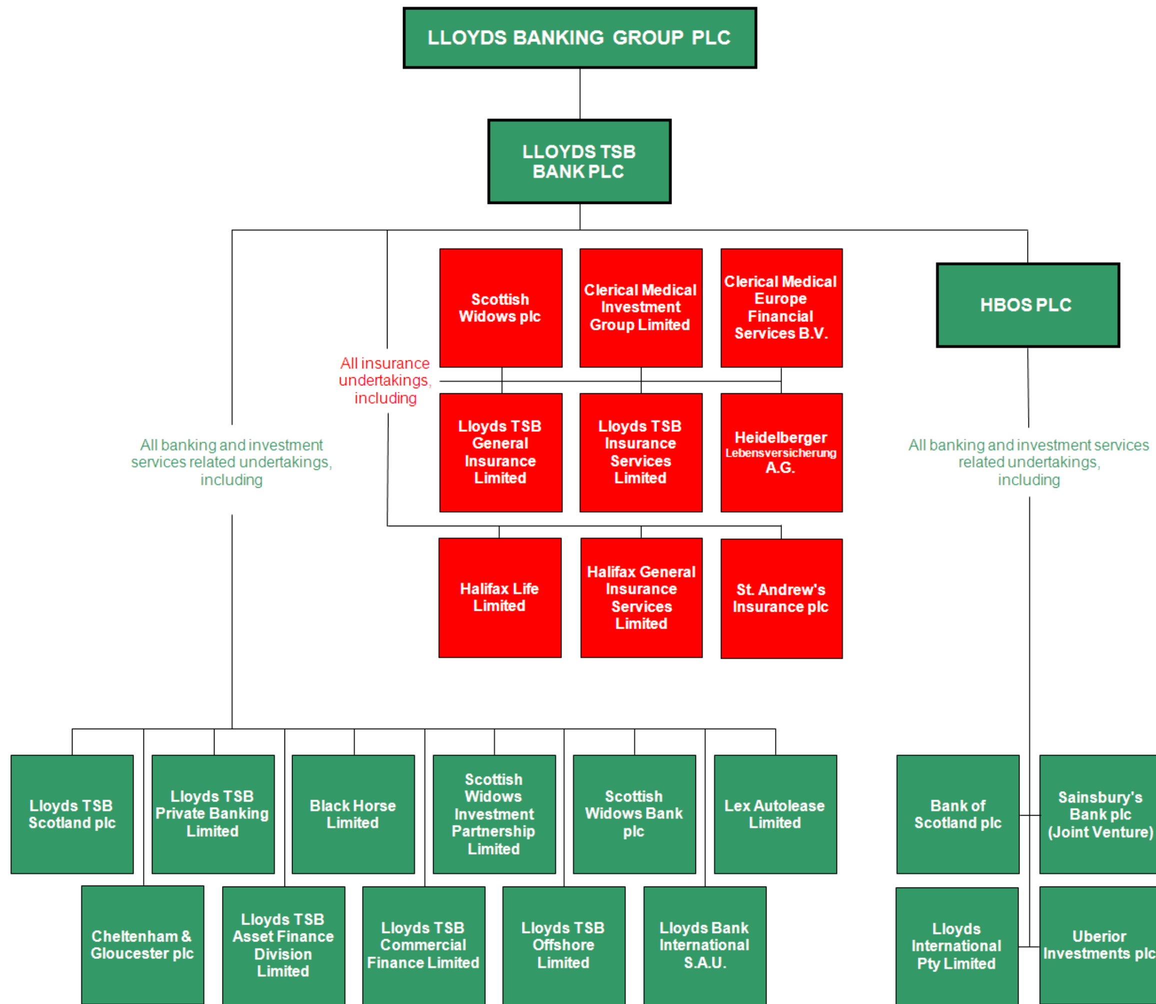
SOLO CONSOLIDATION

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 2012) of the regulatory consolidation group upon which the disclosures presented within this document are based is provided below.



There were no significant changes during 2012 in respect of the Group's banking and investment services related undertakings included within the scope of the regulatory consolidation group, nor were there any significant changes in respect of the Group's insurance undertakings excluded from the scope of the regulatory consolidation group.

CONSOLIDATED BALANCE SHEET UNDER THE REGULATORY SCOPE OF CONSOLIDATION

The following table provides a reconciliation of the Group's consolidated balance sheet on an accounting consolidation basis (as presented on pages 208 to 209 of the 2012 Lloyds Banking Group plc Annual Report and Accounts) to the Group's consolidated balance sheet under the regulatory scope of consolidation.

Table 5: **Consolidated balance sheet (regulatory)**

Balance Sheet Category	Consolidated Balance Sheet (Accounting) £m	Regulatory Reallocations [1] £m	Proportional Consolidation (Joint Ventures / Associates) [2] £m	Deconsolidated Entities (Insurance / Other) [3] £m	Consolidated Balance Sheet (Regulatory) [4] £m
Assets					
Cash and balances at central banks	80,298	-	49	-	80,347
Items in the course of collection from banks	1,256	-	16	-	1,272
Trading and other financial assets at fair value through profit or loss	153,990	(103,130)	202	(40,551)	10,511
Derivative financial instruments	56,550	-	-	(1,210)	55,340
Loans and advances to banks	29,417	445	504	(21,282)	9,084
Loans and advances to customers	517,225	16,669	1,403	(528)	534,769
Debt securities	5,273	(5,273)	-	-	-
Available-for-sale financial assets	31,374	-	-	-	31,374
Investment properties	5,405	-	-	-	5,405
Goodwill	2,016	-	-	-	2,016
Value of in-force business	6,800	-	-	(6,800)	-
Other intangible assets	2,792	-	2	(178)	2,616
Tangible fixed assets	7,342	-	9	(4,775)	2,576
Current tax recoverable	354	-	6	-	360
Deferred tax assets	4,285	-	-	-	4,285
Retirement benefit assets	1,867	-	-	-	1,867
Other assets	18,308	(2,093)	-	(10,272)	5,943
Treasury bills and other eligible bills	-	1,401	237	-	1,638
Equity shares	-	86,990	-	(85,376)	1,614
Investment in group undertakings	-	313	(86)	7,695	7,922
Reverse repurchase agreements and cash collateral on securities borrowed	-	6,206	181	-	6,387
Prepayments and accrued income	-	1,780	11	(553)	1,238
Total Assets	**924,552**	**3,308**	**2,534**	**(163,830)**	**766,564**
Liabilities					
Deposits from banks	38,405	(11,544)	682	(3)	27,540
Customer deposits	426,912	(4,634)	1,621	4,719	428,618
Items in course of transmission to banks	996	-	4	-	1,000
Trading and other financial liabilities at fair value through profit or loss	35,972	(24,553)	-	-	11,419
Derivative financial instruments	48,665	-	3	(928)	47,740
Notes in circulation	1,198	-	-	-	1,198
Debt securities in issue	117,369	(40,673)	-	(3,636)	73,060
Liabilities arising from insurance contracts and participating investment contracts	82,953	-	-	(82,953)	-
Liabilities arising from non-participating investment contracts	54,372	-	-	(54,372)	-
Unallocated surplus within insurance businesses	267	-	-	(267)	-
Other liabilities	33,941	(5,583)	80	(25,816)	2,622
Retirement benefit obligations	300	-	-	-	300
Current and deferred tax liabilities	465	-	7	(475)	(3)
Other provisions	3,961	3,308	47	-	7,316
Subordinated liabilities	34,092	-	55	155	34,302
Covered bonds	-	40,673	-	-	40,673
Liabilities in respect of sale and repurchase agreements and cash collateral received for securities lent	-	40,731	-	-	40,731
Accruals and deferred income	-	5,583	35	(254)	5,364
Total Liabilities	**879,868**	**3,308**	**2,534**	**(163,830)**	**721,880**
Total Equity [5]	**44,684**	**-**	**-**	**-**	**44,684**
Total Equity and Liabilities	**924,552**	**3,308**	**2,534**	**(163,830)**	**766,564**

Notes

[1] Regulatory reallocations are made in accordance with FSA reporting requirements that require certain balances to be re-categorised. In particular, various balances categorised as trading and other financial assets or liabilities at fair value through profit or loss are separated out for regulatory reporting purposes into their underlying asset or liability categories. The net difference arising is due to the reclassification of certain provisions, previously netted against asset balances, to liabilities on the regulatory balance sheet.

[2] In accordance with regulatory consolidation requirements, investments in joint ventures and associates (other than venture capital investments) are proportionally consolidated rather than accounted for under the equity method applied by the Group for statutory accounting purposes. These investments principally relate to Sainsbury's Bank plc, a joint venture banking operation.

[3] As insurance undertakings are excluded from the scope of the Group's regulatory consolidation, assets and liabilities relating to the Group's insurance operations require to be removed from the regulatory balance sheet. Such undertakings are referred to as 'deconsolidated entities' and principally relate to

the insurance operations of Scottish Widows Group (headed by Scottish Widows plc) whose principal activity is the undertaking of ordinary long-term insurance and savings business and associated investment activities. Investments in insurance undertakings are deducted from capital resources, forming part of the supervisory deductions made from total capital.

[4] Regulatory balance sheet assets represent the basis upon which drawn (on-balance sheet) exposures are determined for use in credit risk exposure calculations or the basis upon which capital deductions are determined, depending on the asset category, its regulatory treatment and any regulatory adjustments applied.

[5] A reconciliation of total equity to core tier 1 capital is presented on page 21.

RISK MANAGEMENT

THE GROUP'S APPROACH TO RISK

The Group operates a strong and independent Risk Division with rigorous management controls to keep the Group safe, support sustainable business growth and minimise losses within risk appetite.

The mission of Risk Division is to maintain a robust control framework, identify and escalate emerging risks and support sustainable business growth within risk appetite through good risk reward decisioning.

Risk 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 a prudent approach to managing risk. The Group refreshed its Codes of Business and Personal Responsibility in 2012 reinforcing its approach; colleagues are accountable for the risks they take and the needs of customers are paramount.

The focus remains on building and sustaining long-term relationships with customers whatever the economic climate.

Risk as a Strategic Differentiator

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

The Group believes effective risk management can be a strategic differentiator, in particular:

- **Conservative approach to risk**: The Group has a fully embedded conservative approach to, and prudent appetite for risk with risk culture and appetite driven top down.

- **Strong control framework**: The Group has a strong risk control framework which is the foundation for the delivery of effective risk management. This framework ensures appropriate engagement in developing risk appetite whilst also ensuring business units operate within approved parameters.

- **Effective risk analysis, management and reporting**: Effective risk analysis ensures the identification of opportunities as well as risks and ensures risks are managed appropriately and consistent with strategy. The Group's key risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This ensures the Group fully understands the risk in the business at both an individual risk type and aggregate portfolio level.

- **Business focus and accountability**: Managing risk effectively is a key focus for the Group and is one of the five principal criteria within its Balanced Scorecard on which business areas and individual performance are judged. The Group's approach to risk means that businesses remain accountable for risk but a strong and independent risk function also helps ensure adherence to the Group's risk and control frameworks. The continued investment in risk systems and processes will also help differentiate the Group's risk management approach.

The Group has zero appetite for systemic unfair customer outcomes arising from product design, sales or after-sales processes.

The Group expects its leaders to have the highest integrity and values, thinking and acting for the long-term.

The Group's risk culture is embedded within the Group's risk appetites, policies, procedures, controls and reporting. For example:

- The Group's risk culture is embedded within its approach to conduct risk, and is supported by frameworks to help it deliver the right outcomes for customers, and implemented through policies and standards in key areas such as product governance, responsible lending, claims and complaints handling.

- The Group's risk culture is embedded within its approach to managing credit risk: Board level credit risk appetite is supported by more detailed metrics at Divisional and business level; measurement of credit risk for loans and advances to customers at counterparty level; internal systems of control such as credit policies, assurance and review, controls over rating systems, stress testing and scenario analysis; collateral; master netting agreements and support for customers in difficulty.

Risk Appetite

- The Group defines risk appetite as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate.'

- The Group's strategy operates in tandem with the Group's high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2012 which incorporated recommendations from the non-executive directors and is fully aligned with Group strategy.

- Risk appetite is embedded within policies, authorities and limits across the Group.

- Risk appetite will continue to evolve in tandem with Group strategy.

Governance and Control

- Governance is maintained through delegation of authority from the Board, Board Risk Committee and Audit Committee, down through the management hierarchy supported by a committee-based structure ensuring that the Group's risk appetite, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry good-practice.

- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions.

- 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 where required.

- 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.

- 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.

Risk Decision Making and Reporting

- Taking risks which are well understood, consistent with strategy with appropriate margin is a key driver of shareholder value.

- Risk analysis and reporting supports the identification of opportunities as well as risks.

- An aggregate view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite are reported to and discussed monthly at the Group Risk Committee and Group Asset and Liability Committee with regular reporting to the Board Risk Committee and the Board.

- Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.

- The Chief Risk Officer regularly informs the Board Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Board Risk Committee.

❖ Further details on the Group's risk governance, risk management oversight and risk management framework are presented in the Risk Management section of the 2012 Lloyds Banking Group plc Annual Report and Accounts, pages 126 to 131.

❖ Further details on the Group's risk management processes in relation to the key risk drivers that do not fall under the scope of the Group's Pillar 3 disclosures are presented in the Risk Management section of the 2012 Lloyds Banking Group plc Annual Report and Accounts, as follows:

  - Conduct risk, page 169;
  - People risk, page 176;
  - Liquidity and funding risk, pages 177 to 184;
  - Insurance risk, page 185;
  - Regulatory risk, page 186;
  - Capital risk (life insurance businesses), pages 195 to 200;
  - Financial reporting risk, page 201;
  - Governance risk, page 202.

CAPITAL RESOURCES

CAPITAL RISK

Definition

Capital risk is defined as the risk that the Group has 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, reflecting the Group's strategic plans, regulatory capital constraints and market expectations, and includes a number of minimum capital ratios and target buffers. The Board and the Group Chief Executive, assisted by the Group Asset and Liability Committee, regularly review performance against the 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.

Exposure

A capital exposure arises where the Group has insufficient 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 while optimising value for shareholders.

Measurement

The Group measures the amount of capital it holds using the FSA's definitions. Until the Basel III reforms for an enhanced global capital accord are introduced in the EU through the implementation of the new Capital Requirements Directive and Regulation (CRD IV), the regulatory minimum and buffer amounts of capital continue to be based upon the Basel II framework.

As part of the capital planning process, capital positions are subjected to an extensive stress analysis to determine the adequacy of the Group's capital resources against the minimum requirements including Individual Capital Guidance ('ICG') from the FSA over the forecast period. The outputs from some of these stress analyses are used by the FSA to set a Capital Planning Buffer ('CPB') for the Group. This comprises minimum levels of capital buffers over and above the minimum regulatory requirements for core tier 1 and total capital that should be maintained in non-stressed conditions as mitigation against potential future periods of stress.

The FSA requires ICG and CPB to remain confidential between a bank and the FSA.

Mitigation

The Group has developed procedures to ensure that it complies with current requirements, is positioned to meet anticipated future requirements and that policies and risk appetite are aligned to them.

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, taking account of the potential capital eligibility requirements under CRD IV. 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 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.

Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's budgeting and planning processes.

Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those that could occur under CRD IV and in stressed scenarios, is made to the Senior Asset and Liability Committee (a sub-committee of the Group Asset and Liability Committee), the Group Asset and Liability Committee, the Group Risk Committee and the Board.

The regulatory framework within which the Group operates continues to be enhanced as part of the global banking reforms. The Group monitors these developments very closely, participates actively in the regulatory consultation

processes and analyses the potential financial impacts, ensuring that the Group continues to have a strong loss absorption capacity exceeding regulatory requirements.

Over the course of 2012 some of the key developments were:

- In October, the UK Government published the draft Financial Services (Banking Reform) Bill which will give effect to the recommendations of the Independent Commission on Banking covering banking structural reforms ('ring-fencing' of retail banking activities), bail-in of senior debt and depositor preference. In December, the Parliamentary Commission on Banking Standards published its first report commenting upon the draft Bill.

- In November the Financial Stability Board published an updated list of Global Systemically Important Banks ('G-SIBs') which no longer included the Group. The Group remains, however, a Domestic Systemically Important Bank ('D-SIB') within the UK.

Generally, the reforms are developed and phased in over long periods which allows time for the Group to further strengthen its capital position as necessary through business performance and mitigating actions.

Capital Management in 2012

The Group actively manages its capital position, closely monitoring the changing market and regulatory environments. The Group further strengthened its capital ratios in 2012. This was principally driven by management profit and a reduction in risk-weighted assets, reflecting asset reductions and the substantial decrease in risk, partly offset by statutory items and tax costs. The core business remains strongly capital generative and there is continued progress in simultaneously reducing risk and creating capital through the disposal of non-core assets.

Capital Position at 31 December 2012

The Group's capital position, at 31 December 2012 and applying the existing regulatory framework, is set out in the following section. Additionally, estimated pro forma information about the Group's capital position on a CRD IV basis is set out on pages 24 to 27.

LLOYDS BANKING GROUP CAPITAL RESOURCES

The capital resources of the Group as at 31 December 2012 are presented in the table below.

Table 6: **Capital resources**

	2012		2011	
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		43,999		45,920
Non-controlling interests per balance sheet		685		674
Regulatory adjustments:				
Regulatory adjustments to non-controlling interests		(628)		(577)
Adjustment for own credit		217		(136)
Defined benefit pension adjustment		(1,438)		(1,004)
Unrealised reserve on available-for-sale debt securities		(343)		(940)
Unrealised reserve on available-for-sale equity investments		(56)		(386)
Cash flow hedging reserve		(350)		(325)
Other items		33		(36)
		42,119		43,190
Less: deductions from core tier 1				
Goodwill		(2,016)		(2,016)
Intangible assets		(2,091)		(2,310)
50% excess of expected losses over impairment provisions		(636)		(720)
50% of securitisation positions		(183)		(153)
Core tier 1 capital		37,193		37,991
Non-controlling preference shares [1]		1,568		1,613
Preferred securities [1]		4,039		4,487
Less: deductions from tier 1				
50% of material holdings		(46)		(94)
Total tier 1 capital		42,754		43,997
Total tier 1 capital (excluding preferred securities) [2]	*38,715*		*39,510*	
Tier 2				
Undated subordinated debt		1,828		1,859
Dated subordinated debt		19,886		21,229
Unrealised gains on available-for-sale equity investments		56		386
Eligible provisions		977		1,259
Less: deductions from tier 2				
50% excess of expected losses over impairment provisions		(636)		(720)
50% of securitisation positions		(183)		(153)
50% of material holdings		(46)		(94)
Total tier 2 capital		21,882		23,766
Total tier 2 capital (including preferred securities) [2]	*25,921*		*28,253*	
Supervisory deductions				
Unconsolidated investments – life		(10,104)		(10,107)
Unconsolidated investments – general insurance and other		(929)		(2,660)
Total supervisory deductions		(11,033)		(12,767)
Total Capital Resources		53,603		54,996
Risk Weighted Assets		310,299		352,341
Core tier 1 capital ratio (%)		12.0%		10.8%
Tier 1 capital ratio (%)		13.8%		12.5%
Total capital ratio (%)		17.3%		15.6%

Notes

[1] Non-controlling preference shares and preferred securities represent the Group's hybrid capital securities. 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 2012 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.

MOVEMENTS IN CAPITAL

Core Tier 1 Capital

Core tier 1 capital has reduced by £798m during 2012 primarily due to the attributable loss for the period and the deduction of the increase to the pension scheme asset balances, which have been partially offset by a decrease in the deductions of intangibles, the adjustment for own credit, the excess of expected losses over impairment provisions and share issuance.

The movements in core tier 1, tier 1, tier 2 and total capital in the year are shown below.

Table 7: **Movements in capital**

	Core Tier 1 £m	Tier 1 £m	Tier 2 £m	Total £m
At 1 January 2012	37,991	6,006	23,766	54,996
Loss attributable to ordinary shareholders	(1,427)	-	-	(1,427)
Regulatory post-retirement benefit adjustments	(434)	-	-	(434)
Adjustment for own credit	353	-	-	353
Goodwill and intangible assets deductions	219	-	-	219
Excess of expected losses over impairment allowances	84	-	84	168
Material holdings deduction	-	48	48	96
Eligible provisions	-	-	(282)	(282)
Subordinated debt movements:				
Foreign exchange	-	(194)	(1,186)	(1,380)
New issuances	-	-	128	128
Repurchases, redemptions and other	-	(299)	(316)	(615)
Supervisory deductions from total capital	-	-	-	1,734
Other movements	407	-	(360)	47
At 31 December 2012	**37,193**	**5,561**	**21,882**	**53,603**

Tier 1 Capital

Tier 1 capital has decreased in the period by £445m mainly as a result of a debt exchange undertaken in February 2012 and foreign exchange movements.

Tier 2 Capital

Tier 2 capital has decreased in the period by £1,884m largely arising from a decrease in dated subordinated debt, principally due to amortisation, foreign exchange movements and fair value movements in Enhanced Capital Notes. Unrealised gains on available-for-sale equity investments have also decreased in the year.

Supervisory Deductions

Supervisory deductions principally 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 the Group's general insurance business and the investment in St. James's Place.

At 31 December 2011 deductions for other unconsolidated investments also included private equity investments in non-financial entities. At 31 December 2012, revised regulatory rules have been applied to these investments which are now risk-weighted rather than being deducted from total capital.

CAPITAL SECURITIES

Summary information on the terms and conditions attached to capital securities (subordinated liabilities and share capital) issued by the Group is presented in the Notes to the Consolidated Financial Statements of the Group's Annual Report and Accounts as follows:

- Note 45 (Subordinated liabilities), 2012 Lloyds Banking Group plc Annual Report and Accounts, pages 280 to 284
- Note 46 (Share capital), 2012 Lloyds Banking Group plc Annual Report and Accounts, pages 285 to 286

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.

In accordance with grandfathering provisions established under the CRD II package of amendments, the Group continues to recognise both its preference share capital and preferred securities as forms of hybrid capital securities. These are included within tier 1 capital, subject to the required regulatory adjustments. In accordance with the

requirements of GENPRU Transitional Provision ('TP') 8.5, the 6.90% Perpetual Capital Securities (US$1,000 million) classed as preferred securities for accounting purposes are recognised as perpetual non-cumulative preference shares for regulatory capital purposes.

❖ Further detail on the Group's preference share capital and preferred securities is provided on pages 280 to 281 of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

The implementation of CRD IV is likely to result in further changes to the recognition and treatment of hybrid capital securities and related grandfathering provisions.

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.

❖ Full details on the Group's tier 2 capital securities (undated subordinated liabilities, Enhanced Capital Notes and dated subordinated liabilities) are provided on pages 282 to 284 of the 2012 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.

Table 8: **Subordinated liabilities with an incentive to redeem**

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 (€1,000 million)
• 5.625% Cum. Call. Fixed to Floating Rate Undated Sub. Notes callable 2019 (£500m)	• Subordinated Callable Notes 2017 (US$1,000 million)
• 4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	• Subordinated Callable Floating Rate Instruments 2017 (Aus$400m)
• Floating Rate Undated Subordinated Notes (€500 million)	• 6.75% Sub. Call. Fixed to Floating Rate Instruments 2017 (Aus$200m)
• 5.375% Undated Fixed to Floating Rate Subordinated Notes (US$1,000 million)	• 5.109% Callable Fixed to Floating Rate Notes 2017 (Can$500 million)
• 5.125% Undated Subordinated Fixed to Floating Notes (€750 million)	• 6.305% Sub. Call. Fixed to Floating Rate Notes 2017 (£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 page 282 and page 284 of the 2012 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 detail on the Group's Enhanced Capital Notes is provided on page 283 of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

The following table compares the IFRS accounting value of subordinated liabilities recognised through tier 1 and tier 2 capital to the GENPRU regulatory equivalent.

Table 9: **Value of subordinated liabilities**

Tier / Capital Security	2012 IFRS £m	2012 GENPRU £m	2011 IFRS £m	2011 GENPRU £m
Tier 1 capital				
Non-controlling preference shares	1,599	1,568	1,463	1,613
Preferred securities	4,180	4,039	4,646	4,487
Tier 2 capital				
Undated subordinated debt	1,882	1,828	1,968	1,859
Dated subordinated debt	25,396	19,886	26,015	21,229
Total Subordinated Liabilities [1]	33,057	27,321	34,092	29,188

Notes

[1] Excludes securities issued by Scottish Widows plc and Clerical Medical Finance plc.

PRO FORMA CRD IV CAPITAL AND LEVERAGE RATIO INFORMATION

The following sections provide an analysis of the Group's estimated CRD IV capital position and leverage ratio under both transitional and fully loaded requirements.

A further detailed breakdown and analysis of the Group's estimated CRD IV capital position under transitional and fully loaded requirements, produced in accordance with draft EBA proposals on the disclosure of capital under CRD IV, is provided in Appendix 1.

The estimates provided reflect the Group's current interpretation of the draft rules. The actual impact of CRD IV on capital ratios may be materially different as the requirements and related technical standards have not yet been finalised. The actual impact will also be dependent on required regulatory approvals and the extent to which further management action is taken prior to implementation.

Capital Position on a CRD IV basis

The Group's capital position as at 31 December 2012 calculated on current regulatory rules and also estimated on a pro-forma basis, applying the CRD IV rules and assuming existing FSA waivers still apply, is shown in the table below.

The pro-forma CRD IV capital resources shown reflect estimates of the impact of the rules laid out in the draft of CRD IV published by the European Commission in July 2011 (July 2011 draft) on both a transitional basis as if 2012 had been the first year of transition and on a fully loaded basis (referred to as CRD IV 'end-point definition' in FSA documentation). The transitional position shown is consistent with the FSA's statement 'CRD IV transitional provisions on capital resources' published on 26 October 2012 on the FSA website.

The estimates of pro-forma CRD IV risk-weighted assets shown are also based upon July 2011 draft rules updated to reflect the Group's current view of the most likely application of the final rules.

Table 10: **Capital position on a CRD IV basis**

31 December 2012	Current Rules	Pro-Forma CRD IV Rules	
		Transitional Estimate	Fully Loaded Estimate
	£m	£m	£m
Core / common equity tier 1 (CET1)			
Shareholders' equity per balance sheet	43,999	43,999	43,999
Regulatory adjustments:			
Non-controlling interests	57	57	-
Unrealised reserves on available-for-sale assets	(399)	(399)	-
Other adjustments	(1,538)	(1,675)	(1,675)
	42,119	41,982	42,324
Less: deductions from core / common equity tier 1			
Goodwill and other intangible assets	(4,107)	-	(4,107)
Excess of expected losses over impairment provisions	(636)	-	(1,272)
Securitisation deductions	(183)	(366)	(366)
Significant investments	-	-	(5,066)
Deferred tax assets	-	(511)	(5,655)
Excess AT1 deductions reallocated to CET1	-	(3,720)	-
Core / common equity tier 1 capital	37,193	37,385	25,858
Additional tier 1 (AT1)			
Additional tier 1 instruments	5,607	5,009	-
Less: deductions from tier 1			
Goodwill and other intangible assets	-	(4,107)	-
Excess of expected losses over impairment provisions	-	(636)	-
Significant investments	(46)	(3,986)	-
Reallocated excess AT1 deductions to CET1	-	3,720	-
Total tier 1 capital	42,754	37,385	25,858
Tier 2			
Tier 2 instruments	21,714	20,990	13,571
Unrealised gains on available-for-sale equity investments	56	56	-
Eligible provisions	977	-	-
Less: deductions from tier 2			
Excess of expected losses over impairment provisions	(636)	(636)	-
Securitisation deductions	(183)	-	-
Significant investments	(46)	(3,986)	(2,907)
Subsidiary surplus tier 2	-	-	(371)
Less: deductions from total capital			
Significant investments	(11,033)	-	-
Total Capital Resources	53,603	53,809	36,151
Risk Weighted Assets	310,299	322,468	321,097
Core / common equity tier 1 capital ratio (%)	12.0%	11.6%	8.1%
Tier 1 capital ratio (%)	13.8%	11.6%	8.1%
Total capital ratio (%)	17.3%	16.7%	11.3%

As at 31 December 2012, on a pro-forma CRD IV transitional basis the Group's estimated common equity tier 1 (CET1 – CRD IV equivalent of core tier 1) ratio would have been 11.6 per cent, and on a pro-forma CRD IV fully loaded basis it would have been 8.1 per cent.

The key impacts on capital resources of the transitional rules are that:

- The deductions for goodwill and other intangible assets and excess of expected losses over impairment provisions that are made from core tier 1 under the current rules are made from additional tier 1;
- A part of the deduction that would otherwise be made for significant investments is risk weighted instead. The residual deduction is made 50 per cent from tier 1 and 50 per cent from tier 2 rather than from total capital;
- The deduction made for securitisations is made fully from CET1 rather than 50 per cent from core tier 1 and 50 per cent from tier 2 capital as under the current rules;
- A proportion of the deferred tax asset is deducted from CET1;
- A proportion of the additional tier 1 and tier 2 instruments become ineligible under the grandfathering rules;
- Eligible provisions are nil as collectively assessed impairment provisions for the standardised portfolios can no longer be included under tier 2 capital (instead a corresponding reduction is made to standardised RWAs); and
- The deductions to be made from additional tier 1 exceed the amount of available additional tier 1 capital instruments. The excess is deducted from CET1.

The impact of the fully loaded rules on capital resources is that:

- Non-controlling interests are no longer eligible for inclusion
- The amount of unrealised reserves on available-for-sale assets are included in full rather than being deducted;
- Excess expected losses over impairment provisions and the deduction made for securitisations are deducted fully from CET1 instead of 50 per cent from core tier 1 and 50 per cent from tier 2 under the current rules;
- The amount of significant investments that are not risk weighted is fully deducted following a corresponding deduction approach;
- Deferred tax assets are deducted from CET1;
- Existing additional tier 1 and a proportion of tier 2 instruments become ineligible and are excluded. The Group would expect to accumulate additional tier 1 and tier 2 capital as required through the issuance of subordinated liabilities, taking account of the potential capital eligibility requirements under CRD IV. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time;
- Eligible provisions are nil as collectively assessed impairment provisions for the standardised portfolios can no longer be included under tier 2 capital (instead a corresponding reduction is made to standardised RWAs); and
- Subsidiary surplus within tier 2 relates to the restriction of capital instruments of a subsidiary that can be recognised as capital at the consolidated group level.

The CRD IV impact on risk weighted assets includes estimates for credit valuation adjustment ('CVA') volatility and risk-weighting of the available elements of the deferred tax asset and the investment in the Group's insurance businesses. It is assumed that EU corporates are exempt from the CVA volatility charge and that the national discretion over 180 day definition of default remains for UK retail mortgages.

The Group's capital position may be different should alternative text be agreed. There are potential changes that could result in increases to risk weighted assets including, for example, the application of a 90 day definition of default for retail assets and the EU corporation exemption from CVA not applying. Conversely, if the FSA were to apply the more favourable treatment allowed in relation to insurance holdings (rather than the less favourable treatment that has been assumed will apply), this would increase the estimated fully loaded CET1 ratio by a further 1.0 per cent.

The pro-forma fully loaded CRD IV CET1 ratio of 8.1 per cent comfortably exceeds the 4.5 per cent minimum and the additional 2.5 per cent conservation buffer that are required under the draft rules from 2019. Nevertheless, the Group will continue to monitor closely the emergence of the final rules and their impact upon its ratios. Moreover, through transition to the new rules, the Group is aiming to build the ratio to an amount prudently in excess of 10 per cent by continuing to run down its non-core portfolios and by profit generation.

Leverage Ratio on a CRD IV Basis

The Basel III reforms include the introduction of a capital leverage measure defined as the ratio of tier 1 capital to total exposure. This is intended to reinforce the risk based capital requirements with a simple, non-risk based backstop measure. The Basel Committee have proposed that final adjustments to the definition and calibration of the leverage ratio be carried out in 2017, with a view to migrating to a Pillar 1 treatment in 2018.

In the interim, the FSA has asked the Group to publish the estimated leverage ratio on a fully loaded CRD IV basis, with and without ineligible tier 1 instruments, to indicate the approximate leverage ratio that the Group would have now were the CRD IV rules fully implemented.

The Group's estimates of its leverage ratio as at 31 December 2012 are shown in the table below on three different bases:

- The 'CRD IV Transitional' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV on a transitional basis as if 2012 had been the first year of transition. The tier 1 capital amount corresponds to that shown in the second column of the table on page 25.
- The 'CRD IV fully loaded' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV without applying any transitional provisions and corresponds to the amount shown in the third column in the table on page 25.
- The 'CRD IV fully loaded with ineligible tier 1 instruments grandfathered' basis uses the tier 1 capital calculated by applying the rules laid out in the July 2011 draft publication of CRD IV without transition, with the exception that tier 1 instruments which will be ineligible once the transitional phase has elapsed are counted in full.

Table 11: **Leverage ratio on a CRD IV basis**

31 December 2012	Pro-Forma CRD IV Rules		
	Transitional Estimate	Fully Loaded Estimate	Fully Loaded Estimate (with ineligible tier 1 instruments grandfathered)
	£m	£m	£m
Total tier 1 capital for leverage ratio			
Common equity tier 1	37,385	25,858	25,858
Tier 1 subordinated debt allowable for leverage	5,009	-	5,607
Tier 1 deductions	(5,009)	-	-
	37,385	25,858	31,465
Exposures for leverage ratio			
Total statutory balance sheet assets	924,552	924,552	924,552
Remove accounting value of derivatives and securities financing transactions	(76,731)	(76,731)	(76,731)
Adjustment for insurance assets	(99,464)	(109,786)	(109,786)
Derivatives	20,174	20,174	20,174
Securities financing transactions	7,936	7,936	7,936
Off-balance sheet including unconditionally cancellable	76,899	76,899	76,899
Other regulatory adjustments	(6,781)	(12,619)	(12,619)
Total exposures	846,585	830,425	830,425
Leverage ratio (%)	4.4%	3.1%	3.8%

Derivatives and securities financing transactions have been calculated by applying the accounting measure of exposure (plus, for derivatives, an add-on for potential future exposure) and the regulatory netting rules based on the Basel II framework.

To ensure that the capital and exposure components of the ratio are measured consistently, the assets of the insurance entities included in the accounting consolidation have been excluded from the exposure measure in proportion to the capital that is excluded in tier 1.

The Group's estimated fully loaded leverage ratio (with ineligible tier 1 instruments grandfathered) is 3.8 per cent and the Group's estimated fully loaded leverage ratio, excluding the tier 1 instruments is 3.1 per cent. These would both be in excess of the Basel Committee's minimum ratio of 3 per cent which is proposed should become a Pillar I requirement by 1 January 2018. The Group will continue to monitor closely the leverage ratio against the emerging rules and minimum calibration and will aim to increase the ratio further by continuing to run down its non-core portfolios and by profit generation.

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 2012 are presented in the table below. Notes in relation to the references below can be found on page 29.

Table 12: **Capital requirements**

(All figures are in £m)	2012 Risk Weighted Assets	2012 Pillar 1 Capital Requirements	2011 Risk Weighted Assets	2011 Pillar 1 Capital Requirements
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	54,835	4,387	60,405	4,832
Corporate - SME	12,628	1,010	15,168	1,213
Corporate - Specialised lending	5,368	429	6,683	535
Central governments and central banks	1,437	115	1,299	104
Institutions	1,447	116	2,426	194
Retail IRB Approach				
Retail - Residential mortgages	56,527	4,522	58,926	4,714
Retail - Qualifying revolving retail exposures	17,261	1,381	19,112	1,529
Retail - Other retail	15,206	1,216	18,479	1,478
Retail - SME	2,451	196	2,306	184
Other IRB Approaches [1]				
Corporate - Specialised lending	4,897	392	4,469	358
Equities - Exchange traded	248	20	-	-
Equities - Private equity	4,917	393	-	-
Equities - Other	544	44	57	5
Securitisation positions [2]	6,687	535	9,376	750
Total - IRB Approach	184,453	14,756	198,706	15,896
Exposures subject to the Standardised Approach				
Central governments and central banks	105	9	57	5
Regional governments or local authorities	18	1	8	1
Administrative bodies and non-commercial undertakings	62	5	361	29
Multilateral development banks	-	-	-	-
Institutions	566	45	399	32
Corporates	25,537	2,043	33,478	2,678
Retail	5,604	448	6,030	482
Secured by mortgages on residential property	6,950	556	8,090	647
Secured by mortgages on commercial real estate	15,200	1,216	23,383	1,871
Past due items	6,218	498	9,907	792
Items belonging to regulatory high risk categories	1	-	3,603	288
Short term claims on institutions or corporates	187	15	451	36
Collective investment undertakings	53	4	24	2
Other items [3]	13,164	1,053	17,734	1,419
Total - Standardised Approach	73,665	5,893	103,525	8,282
Total Credit Risk	258,118	20,649	302,231	24,178
COUNTERPARTY CREDIT RISK				
IRB Approach	6,162	493	6,170	494
Standardised Approach	6,686	535	6,474	518
Total Counterparty Credit Risk	12,848	1,028	12,644	1,012
MARKET RISK				
Internal Models Approach	9,316	746	5,096	408
Standardised Approach				
Interest rate position risk requirement	1,719	138	1,717	137
Foreign currency position risk requirement	291	23	40	3
Equity position risk requirement	41	3	-	-
Commodity position risk requirement	5	-	6	-
Specific interest rate risk of securitisation positions	22	2	18	2
Total Market Risk	11,394	912	6,877	550
OPERATIONAL RISK				
Standardised Approach	27,939	2,235	30,589	2,447
Total Operational Risk	27,939	2,235	30,589	2,447
TOTAL	310,299	24,824	352,341	28,187

DIVISIONAL RISK WEIGHTED ASSETS

The risk weighted assets of the Divisions as at 31 December 2012 are presented in the table below.

Table 13: **Divisional risk weighted assets**

(All figures are in £m)	2012 Retail	2012 Commercial Banking	2012 WAFI	2012 Group Ops & Central Items	2012 TOTAL
CREDIT RISK					
Exposures subject to the IRB Approach					
Foundation IRB Approach					
Corporate - Main	-	53,388	1,447	-	54,835
Corporate - SME	-	12,628	-	-	12,628
Corporate - Specialised lending	-	5,368	-	-	5,368
Central governments and central banks	-	192	-	1,245	1,437
Institutions	-	1,438	8	1	1,447
Retail IRB Approach					
Retail - Residential mortgages	45,695	2,629	8,197	6	56,527
Retail - Qualifying revolving retail exposures	17,261	-	-	-	17,261
Retail - Other retail	13,067	-	2,139	-	15,206
Retail - SME	-	2,451	-	-	2,451
Other IRB Approaches [1]					
Corporate - Specialised lending	-	4,897	-	-	4,897
Equities - Exchange traded	-	248	-	-	248
Equities - Private equity	-	4,917	-	-	4,917
Equities - Other	-	238	100	206	544
Securitisation positions [2]	-	6,680	-	7	6,687
Total - IRB Approach	76,023	95,074	11,891	1,465	184,453
Exposures subject to the Standardised Approach					
Central governments and central banks	-	-	105	-	105
Regional governments or local authorities	-	1	17	-	18
Administrative bodies and non-commercial undertakings	-	55	7	-	62
Multilateral development banks	-	-	-	-	-
Institutions	65	174	207	120	566
Corporates	12	18,281	5,318	1,926	25,537
Retail	1,152	1,098	3,354	-	5,604
Secured by mortgages on residential property	1,905	-	5,045	-	6,950
Secured by mortgages on commercial real estate	-	13,938	1,262	-	15,200
Past due items	828	2,035	3,355	-	6,218
Items belonging to regulatory high risk categories	-	1	-	-	1
Short term claims on institutions or corporates	-	187	-	-	187
Collective investment undertakings	38	-	15	-	53
Other items [3]	684	985	1,600	9,895	13,164
Total - Standardised Approach	4,684	36,755	20,285	11,941	73,665
Total Credit Risk	80,707	131,829	32,176	13,406	258,118
COUNTERPARTY CREDIT RISK					
IRB Approach	-	6,115	-	47	6,162
Standardised Approach	-	6,686	-	-	6,686
Total Counterparty Credit Risk	-	12,801	-	47	12,848
MARKET RISK					
Internal Models Approach	-	9,316	-	-	9,316
Standardised Approach					
Interest rate position risk requirement	-	1,711	8	-	1,719
Foreign currency position risk requirement	-	291	-	-	291
Equity position risk requirement	-	41	-	-	41
Commodity position risk requirement	-	5	-	-	5
Specific interest rate risk of securitisation positions	-	22	-	-	22
Total Market Risk	-	11,386	8	-	11,394
OPERATIONAL RISK					
Standardised Approach	14,763	9,193	3,983	-	27,939
Total Operational Risk	14,763	9,193	3,983	-	27,939
TOTAL	95,470	165,209	36,167	13,453	310,299

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 and the Ratings Based 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)	2011 Retail	2011 Commercial Banking	2011 WAFI	2011 Group Ops & Central Items	2011 TOTAL
CREDIT RISK					
Exposures subject to the IRB Approach					
Foundation IRB Approach					
Corporate - Main	-	58,490	1,824	91	60,405
Corporate - SME	-	15,145	23	-	15,168
Corporate - Specialised lending	-	6,683	-	-	6,683
Central governments and central banks	-	590	-	709	1,299
Institutions	-	2,407	19	-	2,426
Retail IRB Approach					
Retail - Residential mortgages	47,705	2,381	8,825	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	-	4,469	-	-	4,469
Equities - Exchange traded	-	-	-	-	-
Equities - Private equity	-	-	-	-	-
Equities - Other	-	-	-	57	57
Securitisation positions [2]	-	9,376	-	-	9,376
Total - IRB Approach	82,139	101,847	13,848	872	198,706
Exposures subject to the Standardised Approach					
Central governments and central banks	-	-	57	-	57
Regional governments or local authorities	-	-	8	-	8
Administrative bodies and non-commercial undertakings	-	350	11	-	361
Multilateral development banks	-	-	-	-	-
Institutions	84	75	124	116	399
Corporates	34	24,991	6,769	1,684	33,478
Retail	1,147	1,067	3,816	-	6,030
Secured by mortgages on residential property	2,553	-	5,537	-	8,090
Secured by mortgages on commercial real estate	-	20,787	2,596	-	23,383
Past due items	836	4,882	4,189	-	9,907
Items belonging to regulatory high risk categories	-	3,557	46	-	3,603
Short term claims on institutions or corporates	-	451	-	-	451
Collective investment undertakings	8	-	16		24
Other items [3]	981	4,311	2,488	9,954	17,734
Total - Standardised Approach	5,643	60,471	25,657	11,754	103,525
Total Credit Risk	87,782	162,318	39,505	12,626	302,231
COUNTERPARTY CREDIT RISK					
IRB Approach	68	6,102	-	-	6,170
Standardised Approach	-	6,474	-	-	6,474
Total Counterparty Credit Risk	68	12,576	-	-	12,644
MARKET RISK					
Internal Models Approach	-	5,096	-	-	5,096
Standardised Approach					
Interest rate position risk requirement	-	1,717	-	-	1,717
Foreign currency position risk requirement	-	38	2	-	40
Equity position risk requirement	-	-	-	-	-
Commodity position risk requirement	-	6	-	-	6
Specific interest rate risk of securitisation positions	-	18	-	-	18
Total Market Risk	-	6,875	2	-	6,877
OPERATIONAL RISK					
Standardised Approach	15,387	11,116	4,086	-	30,589
Total Operational Risk	15,387	11,116	4,086	-	30,589
TOTAL	103,237	192,885	43,593	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 and the Ratings Based 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 an amount equal to 8 per cent of risk weighted assets and represents the minimum total amount of 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, counterparty credit risk, operational risk and market risk (trading book) by assessments of the material risks not covered or 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. Such correlation can arise from, for example, geographic, sectoral and large exposure concentrations.

- Underestimation Risk – where it is considered that the Pillar 1 capital assessments for credit, market or operational risk underestimate the risk other than, for credit risk, as a result of loan default correlation which is covered by the concentration risk assessment.

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 extensive stress analyses to determine the adequacy of the Group's capital resources against the minimum requirements including ICG in the defined stress scenarios. The FSA uses the output from some of these stress analyses to set a Capital Planning Buffer for the Group defining the minimum 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 Board and submitted to the FSA.

CREDIT RISK

DEFINITION

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on 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, Asset Finance and International Divisions, 'commercial' and 'corporate', 'financial institutions' or 'sovereigns' arising in the Commercial Banking and Wealth, Asset Finance 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 corporate 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.

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;
- aside from the asset(s) being financed 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 through Commercial Banking 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 Group models, is delegated to the Group 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 reporting 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 Group Model Governance Committee.

CREDIT RISK EXPOSURE: ANALYSIS BY EXPOSURE CLASS

As at 31 December 2012 the total credit risk exposures of the Group amounted to £759.0bn (2011: £807.6bn).

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.

Table 14: **Credit risk exposures**

Exposure Class	2012 Credit Risk Exposure £m	2012 Risk Weighted Assets £m	2012 Average Risk Weight %	2012 Average Credit Risk Exposure [4] £m
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	94,908	54,835	58%	97,303
Corporate - SME	19,053	12,628	66%	21,239
Corporate - Specialised lending	7,110	5,368	76%	7,721
Central governments and central banks	10,238	1,437	14%	11,519
Institutions	5,690	1,447	25%	8,348
Retail IRB Approach				
Retail - Residential mortgages	355,966	56,527	16%	357,875
Retail - Qualifying revolving retail exposures	36,305	17,261	48%	37,383
Retail - Other retail	14,306	15,206	106%	15,434
Retail - SME	2,810	2,451	87%	2,805
Other IRB Approaches [1]				
Corporate - Specialised lending	6,856	4,897	71%	6,541
Equities - Exchange traded	86	248	290%	75
Equities - Private equity	2,591	4,917	190%	2,515
Equities - Other	147	544	370%	227
Securitisation positions [2]	19,847	6,687	34%	23,760
Total - IRB Approach	575,913	184,453	32%	592,745
Exposures subject to the Standardised Approach				
Central governments and central banks	93,094	105	0%	94,131
Regional governments or local authorities	42	18	43%	43
Administrative bodies and non-commercial undertakings	76	62	82%	290
Multilateral development banks	83	-	-	83
Institutions	1,201	566	47%	1,172
Corporates	27,290	25,537	94%	31,364
Retail	7,479	5,604	75%	7,719
Secured by mortgages on residential property	15,891	6,950	44%	16,661
Secured by mortgages on commercial real estate	13,821	15,200	110%	17,598
Past due items	5,506	6,218	113%	6,967
Items belonging to regulatory high risk categories	1	1	150%	505
Short term claims on institutions or corporates	179	187	105%	247
Collective investment undertakings	261	53	20%	237
Other items [3]	18,195	13,164	72%	20,287
Total - Standardised Approach	183,119	73,665	40%	197,304
TOTAL	759,032	258,118	34%	790,049

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 and the Ratings Based 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 exposures reduced by £10.9bn during the year, primarily driven by non-core asset reduction. Core lending reduced as demand for new corporate lending and refinancing of existing facilities was more than offset by the level of maturities, reflecting a continued trend of subdued corporate lending demand and client deleveraging as credit facilities matured and were not renewed by clients. Risk weighted assets reduced by £9.4bn primarily reflecting repayments, the impact of subdued corporate lending and non-core asset disposals. The average risk weight for corporate main exposures and corporate specialised lending exposures reduced from 60% to 58% and from 83% to 76% respectively, reflecting both risk profile changes and a reduction in non-core assets that typically carried a higher risk weighting.

- Foundation IRB institution exposures reduced by £6.2bn during the year following the active reduction of the non-core financial institutions covered bonds portfolio (through disposals and bond maturities) and further reductions in exposures to financial institutions domiciled in peripheral Eurozone countries.

- The average risk weight for Foundation IRB central government and central bank exposures increased from 7% to 14% as a result of the application of revised PDs and the holding of US Treasury Bills with longer term maturities.

Notes in relation to the references below can be found on page 35.

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 by mortgages on residential property	17,490	8,090	46%	16,700
Secured by mortgages on commercial real estate	20,547	23,383	114%	24,029
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

Key Movements – cont.

- Corporate specialised lending exposures subject to the IRB Supervisory Slotting Approach ('Other IRB Approaches') increased by £0.9bn as a result of the roll-out of shipping and property development portfolios on to the slotting approach during the year. The average risk weight reduced marginally from 75% to 71% as a result of a higher proportion of exposures being categorised as Strong, Good or Satisfactory in comparison to the prior year.

- Retail IRB exposures reduced by £9.6bn during the year following reduced customer demand for new credit, existing customers continuing to reduce their personal indebtedness, non-core lending run-off and maintaining a sustainable approach to risk. The reduction in lending to customers was in part due to the repayment of unsecured debt. The overall reduction in Retail IRB risk weighted assets of £7.4bn was a result of lower lending balances, effective portfolio management and prior de-risking of the balance sheet. The average risk weight for other retail exposures reduced from 111% to 106% as a result of an improved risk mix within the portfolio.

- Equity exposures previously subject to the Standardised Approach ('Items belonging to regulatory high risk categories') were transitioned to the IRB Simple Risk Weight Method ('Other IRB Approaches') during the year following FSA approval.

- Securitisations positions reduced by £11.2bn during the year as a result of major ABS disposal programmes, the closure of both the Argento and Grampian conduit programmes, sell downs and the non-replenishment of holdings after amortisations or maturities. The increase in average risk weight from 30% to 34% primarily reflects the downgrade of positions held in non-core portfolios.

- The significant increase in Standardised Approach central government and central bank exposures of £20.7bn reflects a combination of increased deposits with the Bank of England and Dutch Central Bank and further investment in UK Government securities, primarily for regulatory liquidity purposes.

- Standardised Approach exposures in the form of corporates, retail, secured by mortgages on residential property / commercial real estate and past due items reduced by £19.6bn during the year, mainly reflecting non-core asset disposals and balance sheet de-risking through Commercial Banking Division and Wealth, Asset Finance and International Division.

CREDIT RISK EXPOSURE: ANALYSIS BY DIVISION

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

Table 15: **Divisional credit risk exposures**

Division	Risk Weight Approach	2012 Credit Risk Exposure £m	2011 Credit Risk Exposure £m
Retail	IRB	387,154	397,083
	Standardised	10,069	11,016
Commercial Banking	IRB	169,393	198,407
	Standardised	109,605	106,385
WAFI	IRB	11,932	14,159
	Standardised	31,799	35,133
Group Ops & Central Items	IRB	7,434	7,965
	Standardised	31,646	37,464
Total		759,032	807,612

CREDIT RISK EXPOSURE: ANALYSIS BY INDUSTRY

Credit risk exposures as at 31 December 2012, analysed by major industrial sector, are provided in the table below.

Table 16: **Credit risk exposures analysed by major industrial sector**

(All figures are in £m)	2012 Agriculture, Forestry and Fishing	2012 Energy and Water Supply	2012 Manufacturing	2012 Construction	2012 Transport, Distribution and Hotels	2012 Postal and Comms	2012 Property Companies	2012 Financial, Business and Other Services	2012 Personal: Mortgages	2012 Personal: Other	2012 Lease Financing	2012 Hire Purchase	2012 TOTAL
Exposures subject to the IRB Approach													
Foundation IRB Approach													
Corporate - Main	300	2,413	11,941	4,451	12,387	2,752	16,152	40,118	-	9	3,180	1,205	94,908
Corporate - SME	753	30	1,428	627	2,572	325	7,469	5,373	-	17	71	388	19,053
Corporate - Specialised lending	8	-	-	64	48	-	6,350	640	-	-	-	-	7,110
Central governments and central banks	-	-	-	-	-	-	-	10,238	-	-	-	-	10,238
Institutions	-	45	-	-	-	-	-	5,317	-	-	328	-	5,690
Retail IRB Approach													
Retail - Residential mortgages	1,327	4	323	378	1,688	30	4,108	1,686	346,420	2	-	-	355,966
Retail - Qualifying revolving retail exposures	-	-	-	-	-	-	-	-	-	36,305	-	-	36,305
Retail - Other retail	-	-	-	-	-	-	-	-	-	11,211	-	3,095	14,306
Retail - SME	227	2	248	412	757	22	326	811	-	5	-	-	2,810
Other IRB Approaches													
Corporate - Specialised lending	-	951	27	325	2,099	8	637	1,988	-	-	821	-	6,856
Equities - Exchange traded	-	-	-	-	-	-	13	73	-	-	-	-	86
Equities - Private equity	-	-	-	-	29	-	561	2,001	-	-	-	-	2,591
Equities - Other	-	-	-	-	-	-	7	140	-	-	-	-	147
Securitisation positions	172	-	70	52	552	12	287	18,702	-	-	-	-	19,847
Total – IRB Approach	2,787	3,445	14,037	6,309	20,132	3,149	35,910	87,087	346,420	47,549	4,400	4,688	575,913
Exposures subject to the Standardised Approach													
Central governments and central banks	-	-	-	-	-	-	-	93,068	-	-	26	-	93,094
Regional governments or local authorities	-	-	-	-	-	-	-	12	-	-	30	-	42
Administrative bodies and non-commercial undertakings	-	2	-	-	-	-	-	57	-	-	17	-	76
Multilateral development banks	-	-	-	-	-	-	-	83	-	-	-	-	83
Institutions	-	-	-	-	-	-	-	1,201	-	-	-	-	1,201
Corporates	1,953	1,350	1,146	690	3,594	1,143	3,008	10,072	15	1,494	2,730	95	27,290
Retail	1,462	14	60	101	44	72	18	496	24	4,464	315	409	7,479
Secured by mortgages on residential property	1	-	3	3	8	1	68	12	15,795	-	-	-	15,891
Secured by mortgages on commercial real estate	2	-	13	107	320	9	11,799	1,522	-	45	4	-	13,821
Past due items	22	19	102	118	871	415	2,149	450	1,157	197	-	6	5,506
Items belonging to regulatory high risk categories	-	-	-	-	-	-	-	1	-	-	-	-	1
Short term claims on institutions or corporates	7	-	14	-	6	2	-	149	-	1	-	-	179
Collective investment undertakings	-	-	-	-	-	-	-	261	-	-	-	-	261
Total – Standardised Approach	3,447	1,385	1,338	1,019	4,843	1,642	17,042	107,384	16,991	6,201	3,122	510	164,924
Total	6,234	4,830	15,375	7,328	24,975	4,791	52,952	194,471	363,411	53,750	7,522	5,198	740,837
Other items													18,195
Total Credit Risk Exposure													759,032

(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 by mortgages on residential property	1	-	16	5	4	-	88	16	17,360	-	-	-	17,490
Secured by mortgages on commercial real estate	2	-	18	172	522	23	17,936	1,818	-	56	-	-	20,547
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
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

CREDIT RISK EXPOSURE: ANALYSIS BY GEOGRAPHY

Credit risk exposures as at 31 December 2012, analysed by geographical region, based on the country of residence of the customer, are provided in the table below.

Table 17: **Credit risk exposures analysed by geographical region**

(All figures are in £m)	2012 United Kingdom	2012 Rest of Europe	2012 United States of America	2012 Asia-Pacific	2012 Other	2012 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	68,746	12,202	10,797	915	2,248	94,908
Corporate - SME	18,827	88	54	33	51	19,053
Corporate - Specialised lending	5,585	1,076	88	5	356	7,110
Central governments and central banks	-	287	9,727	6	218	10,238
Institutions	1,664	2,939	536	339	212	5,690
Retail IRB Approach						
Retail - Residential mortgages	350,368	5,598	-	-	-	355,966
Retail - Qualifying revolving retail exposures	36,305	-	-	-	-	36,305
Retail - Other retail	14,236	70	-	-	-	14,306
Retail - SME	2,810	-	-	-	-	2,810
Other IRB Approaches						
Corporate - Specialised lending	3,369	1,571	947	90	879	6,856
Equities - Exchange traded	86	-	-	-	-	86
Equities - Private equity	2,349	148	75	-	19	2,591
Equities - Other	78	15	-	54	-	147
Securitisation positions [1]	16,319	2,453	973	-	102	19,847
Total – IRB Approach	520,742	26,447	23,197	1,442	4,085	575,913
Exposures subject to the Standardised Approach						
Central governments and central banks	56,115	36,830	-	44	105	93,094
Regional governments or local authorities	12	-	-	30	-	42
Administrative bodies and non-commercial undertakings	56	-	-	17	3	76
Multilateral development banks	-	83	-	-	-	83
Institutions	867	114	56	29	135	1,201
Corporates	15,078	5,783	1,014	4,185	1,230	27,290
Retail	4,176	216	8	3,031	48	7,479
Secured by mortgages on residential property	5,425	8,736	306	1,237	187	15,891
Secured by mortgages on commercial real estate	10,251	3,253	44	14	259	13,821
Past due items	1,738	3,221	104	370	73	5,506
Items belonging to regulatory high risk categories	1	-	-	-	-	1
Short term claims on institutions or corporates	142	26	9	-	2	179
Collective investment undertakings	261	-	-	-	-	261
Total – Standardised Approach	94,122	58,262	1,541	8,957	2,042	164,924
Total	614,864	84,709	24,738	10,399	6,127	740,837
Other items						18,195
Total Credit Risk Exposure						759,032

[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)	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 by mortgages on residential property	5,537	10,511	164	1,278	-	17,490
Secured by mortgages on commercial real estate	14,694	4,165	209	519	960	20,547
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
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

[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 2012, analysed by residual contractual maturity, are provided in the table below.

Table 18: **Credit risk exposures analysed by residual contractual maturity**

(All figures are in £m)	2012 On demand	2012 Repayable in 3 months or less	2012 Repayable between 3 months and 1 year	2012 Repayable between 1 and 5 years	2012 Repayable over 5 years or undated	2012 TOTAL
Exposures subject to the IRB Approach						
Foundation IRB Approach						
Corporate - Main	6,395	5,476	12,768	52,682	17,587	94,908
Corporate - SME	1,666	1,138	2,277	7,765	6,207	19,053
Corporate - Specialised lending	152	987	1,027	4,402	542	7,110
Central governments and central banks	-	2,218	59	1,921	6,040	10,238
Institutions	207	893	1,027	2,697	866	5,690
Retail IRB Approach						
Retail - Residential mortgages	2,620	884	6,362	20,169	325,931	355,966
Retail - Qualifying revolving retail exposures	36,305	-	-	-	-	36,305
Retail - Other retail	203	412	1,380	9,737	2,574	14,306
Retail - SME	1,833	9	31	313	624	2,810
Other IRB Approaches						
Corporate - Specialised lending	114	219	429	2,602	3,492	6,856
Equities - Exchange traded	-	-	-	62	24	86
Equities - Private equity	1	-	-	2,029	561	2,591
Equities - Other	-	-	-	69	78	147
Securitisation positions	67	3,616	4,848	2,805	8,511	19,847
Total – IRB Approach	49,563	15,852	30,208	107,253	373,037	575,913
Exposures subject to the Standardised Approach						
Central governments and central banks	41,714	33,646	604	628	16,502	93,094
Regional governments or local authorities	-	-	1	32	9	42
Administrative bodies and non-commercial undertakings	-	-	1	23	52	76
Multilateral development banks	-	-	-	-	83	83
Institutions	553	353	72	152	71	1,201
Corporates	589	689	4,339	12,911	8,762	27,290
Retail	517	152	295	3,795	2,720	7,479
Secured by mortgages on residential property	231	67	116	700	14,777	15,891
Secured by mortgages on commercial real estate	100	1,010	2,642	7,993	2,076	13,821
Past due items	104	181	480	2,575	2,166	5,506
Items belonging to regulatory high risk categories	-	-	-	-	1	1
Short term claims on institutions or corporates	63	116	-	-	-	179
Collective investment undertakings	261	-	-	-	-	261
Total – Standardised Approach	44,132	36,214	8,550	28,809	47,219	164,924
Total	93,695	52,066	38,758	136,062	420,256	740,837
Other items						18,195
Total Credit Risk Exposure						759,032

(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 by mortgages on residential property	254	67	123	663	16,383	17,490
Secured by mortgages on commercial real estate	184	1,826	3,480	10,746	4,311	20,547
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
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

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

References to the Group's accounting policy in respect of impaired exposures ('financial assets') and impairment provisions raised in respect of loans and receivables are provided below.

- Impairment of financial assets, Note 2 (Accounting policies), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts:
  - (1) Assets accounted for at amortised cost, pages 219 to 221
  - (2) Available-for-sale financial assets, page 221

MANAGING IMPAIRED EXPOSURES AND IMPAIRMENT PROVISIONS

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 Risk Division Impairment Policies, which are reviewed and approved on an annual basis.

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.

Any assessment of impairment must be based on the information and events that have already occurred as at the review 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 are 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 charges and balance sheet provisions.

In addition, comprehensive monthly reporting packs are produced by the Global Business Support Unit, which actively manages distressed commercial 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.

MANAGEMENT OF CUSTOMERS EXPERIENCING FINANCIAL DISTRESS

Information and analysis on the measures adopted by the Group to support retail and commercial customers experiencing financial distress is provided in the following locations:

- Intensive care of customers in difficulty, Risk Management, 2012 Lloyds Banking Group plc Annual Report and Accounts:
  - Retail Customers, pages 135 to 136;
  - Commercial Customers pages 136 to 137
- Treatment of customers experiencing financial stress, Note 55 (Financial risk management), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts:
  - Retail customers, pages 329 to 332;
  - Commercial customers, pages 332 to 333

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 2012, past due but not impaired exposures in respect of loans and advances to customers amounted to £15.3bn (2011: £16.3bn). Impaired exposures in respect of loans and advances to customers amounted to £46.3bn (2011: £60.3bn), of which £3.8bn (2011: £6.5bn) were classified as 'impaired – no provision required' and the remaining £42.5bn (2011: £53.8bn) 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 2012, by major industrial sector, is provided in the table below.

Table 19: **Past due but not impaired and impaired loans and advances analysed by major industrial sector**

	Past due but not impaired		Impaired	
	2012 £m	**2012 As a % of Credit Risk Exposure**	**2012 £m**	**2012 As a % of Credit Risk Exposure**
Agriculture, forestry and fishing	**88**	**1.41%**	**164**	**2.63%**
Energy and water supply	**17**	**0.35%**	**46**	**0.95%**
Manufacturing	**103**	**0.67%**	**616**	**4.01%**
Construction	**96**	**1.31%**	**1,921**	**26.21%**
Transport, distribution and hotels	**384**	**1.54%**	**6,939**	**27.78%**
Postal and communications	**3**	**0.06%**	**91**	**1.90%**
Property companies	**495**	**0.93%**	**17,731**	**33.49%**
Financial, business and other services	**508**	**0.26%**	**7,580**	**3.90%**
Personal: Mortgages	**12,880**	**3.54%**	**8,132**	**2.24%**
Personal: Other	**592**	**1.10%**	**2,731**	**5.08%**
Lease financing	**54**	**0.72%**	**55**	**0.73%**
Hire purchase	**109**	**2.10%**	**287**	**5.52%**
Total	**15,329**	**2.02%**	**46,293**	**6.10%**

	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%

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 2012, by geographical region, based on the country of residence of the customer, is provided in the table below.

Table 20: **Past due but not impaired and impaired loans and advances analysed by geographical region**

	Past due but not impaired		Impaired	
	2012 £m	**2012 As a % of Credit Risk Exposure**	**2012 £m**	**2012 As a % of Credit Risk Exposure**
United Kingdom	**13,880**	**2.26%**	**29,625**	**4.82%**
Rest of Europe	**1,047**	**1.24%**	**14,514**	**17.13%**
United States of America	**2**	**0.01%**	**376**	**1.52%**
Asia-Pacific	**361**	**3.47%**	**648**	**6.23%**
Other	**39**	**0.64%**	**1,130**	**18.44%**
Total	**15,329**	**2.02%**	**46,293**	**6.10%**

	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%

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 2011 to 31 December 2012, in respect of loans and advances to customers is provided below.

Table 21: **Movement in impairment provisions (loans and advances to customers)**

	£m
At 31 December 2011	**18,732**
Exchange and other adjustments	**(379)**
Advances written off	**(8,697)**
Recoveries of advances written off in previous years	**843**
Unwinding of discount	**(374)**
Charge to the income statement	**5,125**
At 31 December 2012 (Lloyds Banking Group plc Annual Report and Accounts 2012, page 254)	**15,250**

	£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 (Lloyds Banking Group plc Annual Report and Accounts 2012, page 254)	18,732

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].

Table 22: **Impairment provisions, net charge and advances written off analysed by major industrial sector**

	2012 Impairment Provisions £m	2012 Net Charge £m	2012 Advances Written Off £m
Agriculture, forestry and fishing	67	54	45
Energy and water supply	191	71	77
Manufacturing	337	236	226
Construction	504	326	654
Transport, distribution and hotels	2,162	649	458
Postal and communications	40	8	7
Property companies	6,664	1,725	3,554
Financial, business and other services	2,764	824	1,071
Personal: Mortgages	1,113	278	133
Personal: Other	1,147	881	2,267
Lease financing	33	26	75
Hire purchase	228	47	130
Total	15,250	5,125	8,697

	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

Notes

[1] Extracted from the 'Summary of Loan Loss Experience' analysis presented on pages 96 to 105 of the 2012 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 geographical region, based on the country of residence of the customer, is provided in the table below.

Table 23: **Impairment provisions, net charge and advances written off analysed by geographical region**

	2012 Impairment Provisions £m	2012 Net Charge £m	2012 Advances Written Off £m
United Kingdom	11,545	3,976	8,038
Rest of Europe	9,227	1,382	2,416
United States of America	137	26	13
Asia-Pacific	477	301	1,494
Other	386	(31)	36
	21,772	5,654	11,997
Fair value and other adjustments [1]	(6,522)	(529)	(3,300)
Total	15,250	5,125	8,697

	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

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 geographical region, 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 page 321 of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

IMPAIRED LOANS AND ADVANCES TO BANKS

As at 31 December 2012, loans and advances to banks amounting to £3m (2011: £111m) were deemed to be impaired. Impairment provisions held in respect of these impaired balances amounted to £3m (2011: £14m). An analysis of the movement in impairment provisions, from 31 December 2011 to 31 December 2012, is provided below.

Table 24: **Movement in impairment provisions (loans and advances to banks)**

	£m
At 31 December 2011	14
Exchange and other adjustments	(1)
Advances written off	(10)
Recoveries of advances written off in previous years	-
Unwinding of discount	-
Charge to the income statement	-
At 31 December 2012	3

(Lloyds Banking Group plc Annual Report and Accounts 2012, page 254)

	£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 2012, page 254)

IMPAIRED DEBT SECURITIES CLASSIFIED AS LOANS AND RECEIVABLES

As at 31 December 2012, impairment provisions held in respect of debt securities classified as loans and receivables amounted to £206m (2011: £276m). An analysis of the movement in impairment provisions, from 31 December 2011 to 31 December 2012, is provided below.

Table 25: **Movement in impairment provisions (debt securities)**

	£m
At 31 December 2011	276
Exchange and other adjustments	(8)
Advances written off	(73)
Recoveries of advances written off in previous years	15
Unwinding of discount	-
Release to the income statement	(4)
At 31 December 2012	206

(Lloyds Banking Group plc Annual Report and Accounts 2012, page 254)

	£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 2012, page 254)

FACTORS IMPACTING LOSS EXPERIENCE

The Group continues to improve asset quality through the ongoing application of the Group's conservative credit risk appetite, strong risk management controls and de-risking of portfolios. This resulted in a reduction in the Group impairment charge of 42 per cent to £5.7bn. The overall performance of the portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although reducing, unemployment.

Core Impairment

The core impairment charge of £1.9bn was 34 per cent lower than the charge in 2011, primarily driven by better performance in Retail, which reduced by 34 per cent to £1.2bn, and Commercial Banking, which reduced by 33 per cent to £0.7bn. The reduction in Retail was mainly driven by a reduction in the unsecured charge driven by the Group's sustainable approach to risk, reduced balances and effective portfolio management, while the secured portfolio also saw a lower charge as a result of a fall in impaired loans. Within Commercial Banking the fall in the core impairment charge was primarily attributable to lower impairments in some core portfolios, including Mid Markets, Corporate and SME. In

Mid Markets and Corporate, there were specific large impairments in these portfolios in 2011, which were not repeated in 2012.

Non-core Impairment

The non-core impairment charge of £3.8bn was 45 per cent lower than the charge in 2011, driven by material reductions of 29 per cent to £2.2bn in the Commercial Banking charge, and of 60 per cent to £1.3bn in the International charge. In Commercial Banking, non-core impairments decreased, particularly in the Australasian and Acquisition Finance portfolios, partly offset by further deterioration in the Shipping portfolio as a result of a weak market. In International, the impairment charge reduction was largely as a result of lower charges in the Irish business.

Non-core loans and advances to customers accounted for 72 per cent of the Group's impaired loans.

EXPOSURES SUBJECT TO THE INTERNAL RATINGS BASED APPROACH

The Group applies a variety of approaches for calculating credit risk capital requirements, a summary of which are provided below.

- Standardised Approach: portfolios whose associated models have yet to roll out (transition to an IRB approach described below), or where no model roll out is planned, are risk weighted under this approach. The latter includes portfolios that are permanently exempt from an IRB approach, Existing permanent exemptions comprise small or 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 together with the IRB roll-out plan is reviewed on a regular basis by the FSA.

- Foundation IRB Approach: use of internal PD models together with regulatory provided credit conversion factors and LGD.

- Retail IRB Approach: use of internal models to calculate PD, LGD and EAD.

- Supervisory Slotting Approach: use of an IRB methodology provided by the regulator for corporate specialised lending portfolios.

- Other regulatory treatments: the Simple Risk Weight Method for equity exposures and alternative treatments for securitisation positions including the Internal Assessment Approach and the Ratings Based Approach, further details on which can be found in the Non-Trading Book Securitisations section of the document.

The Group operates a range of models for calculating credit risk capital requirements under the Foundation IRB and Retail IRB approaches.

Development, implementation and use of Foundation IRB models and Retail IRB models are rigorously controlled through application of a policy framework defining the development, validation and governance approach.

Stringent internal assessment, approval and monitoring, independent of model developers and users are used to ensure IRB models are robust. Appropriate conservatism is applied to ensure capital adequacy. New IRB models and all material model changes are subject to additional scrutiny and approval by the FSA before they are implemented for regulatory capital calculation purposes.

SCOPE OF THE IRB PERMISSION

The Group has regulatory approval to use its internal credit models in the calculation of the majority of its credit risk exposures.

The table on the following page summarises the principal portfolios within the Group that use the Standardised, Supervisory Slotting, Foundation IRB and Retail IRB approaches.

Application of Standardised and IRB Approaches to Group Portfolios

Portfolio	Standardised Approach	IRB Supervisory Slotting Approach	Foundation IRB Approach	Retail IRB Approach
Retail UK	A small number of secured portfolios are permanently exempt, including lifetime mortgages, and other minor mortgage portfolios. The largest of the secured Standardised portfolios is sub prime. This is due to transition to Retail IRB in 2015. Certain minor permanently exempt unsecured portfolios including joint ventures and closed books.	None	None	Most secured portfolios, including the Mainstream, Buy-To-Let, and Self Certified mortgage portfolios. Most unsecured portfolios, including personal current accounts, unsecured loans and credit cards.
International Retail	A number of permanently exempt minor secured and unsecured portfolios. A number of portfolios including the Lloyds International Retail Motor portfolio are on the roll-out plan to move to Retail IRB in 2013.	None	None	Ireland residential mortgage portfolio.
Commercial Banking UK[1]	The smaller part of the Commercial Banking portfolio is rated on the Standardised approach. A minority of this portfolio is permanently exempt. The majority of the Standardised portfolios are moving to the IRB Supervisory Slotting Approach in 2013. These include BOS Property Investment and BOS Project Finance. BOS derivative exposures are on the roll-out plan to move to an IRB approach (depending upon balance sheet treatment) in 2013. The HBOS Retail Commercial portfolio will transition to Retail IRB in 2014. The Special Industry Finance (non Special Purpose Vehicle) portfolio is due to transition to Foundation IRB in 2014. Agriculture is due to transition across both Foundation and Retail IRB approaches in 2015.	Property Development and Marine.	The larger part of UK Commercial Banking. Portfolios include Publicly Quoted, Unquoted, Banks, LTSB Property Investment, LTSB Project Finance and Housing Associations. LTSB Property Investment (including any associated derivative exposures) and LTSB Project Finance will transition to the IRB Slotting Approach in 2013.	A smaller proportion of Commercial Banking exposures meet the retail definition.
International Commercial Banking[1]	Most portfolios are rated on the Standardised Approach, of which a minority are permanently exempt. The latter include Ireland and Dubai Corporate Lending amongst others. The Property portfolios for Ireland, Australia, Europe and North America, together with Australia Project Finance will move to IRB Slotting in 2013.	None	Predominantly LTSB Commercial Banking Europe Corporate. This will move to Standardised in 2013.	None.
Asset Finance	A minority of the Asset Finance portfolio is permanently exempt. These portfolios are closed to new business and in run-off.	None	A lower proportion of the IRB exposures comprising mainly non-Retail Contract Hire and non-Contract Hire motor portfolios.	The majority of Asset Finance relating to Retail motor and Personal Finance secured portfolios.
Commercial Finance	Minor permanently exempt portfolios relating to Germany, France and USA.	None	Most portfolios, including Invoice Discounting, Invoice Factoring, HP and Leasing.	None

[1] UK and International Commercial Banking also include exposures which are rated under the Simple Risk Weight Method.

INTERNAL DEVELOPMENT AND MONITORING OF IRB 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 (those categorised as most material to the Group). 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 the Model Governance Committee ('MGC') situated within the Risk Division. The MGC comprises the Risk Modelling Director, Chief Credit Officer - Retail and Wealth, Risk Director – Commercial Banking and the Market and Liquidity Risk Director or their delegates, together with representatives from Risk Division, Finance and as appropriate, Business MD / CEO (or equivalent) or their delegates.

Group Risk Model Governance Policy sets out the risk model control framework as well as defining minimum technical standards. The Policy prescribes the overarching development, approval and governance framework that applies to IRB and other risk models. It provides principles and baseline guidance for all risk models and all risk model related activity covering; data integrity, development and validation, model review and approval, model implementation and usage of IRB credit models.

An inventory of approved risk models is held centrally and is used to ensure that models are reviewed annually, covering the following aspects; data, design, validation, conservatism, calibration, sensitivity analysis / stress testing, implementation, operational aspects, usage, governance, independence, regulatory compliance and performance monitoring and reporting.

Independent, ongoing assessments of adherence to the risk model Policy is undertaken through a combination of first line technical review fora, the second line assurance teams in the Risk Division and Internal Audit. Model risk is reported monthly to the MGC and the GRC with key risks reported through to the Board Risk Committee. Model performance monitoring is rigorously reviewed through divisional fora, with quarterly reporting to MGC and half yearly to GRC.

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, which in turn is the basis for divisional and business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Divisional and business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. 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 commercial 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 Loss ('LEL') measures, which are aligned with IRB models;
- Approvals provided either via individual delegated sanctioning authorities or by dual sanctioning or by specific Credit Committees;
- Separate authorities for different types of credit risk (sovereign / bank / non bank);
- Authorities based on business need, and on the credit competence of the individuals concerned, rather than position within the Group hierarchy;
- Tight control procedures which must 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 are assessed using the LEL to ensure that pricing is appropriate for the risk involved.

For Commercial Banking Division, a number of pricing models are in place to support the relationship manager in determining price. Rating model outputs are 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

Statistical techniques (predominantly regression) are used to construct capital models, but the actual methodology and approach used to construct individual models depends 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 vary by customer type and lending product, which span the spectrum of:

- Purely data driven models e.g. in retail portfolios where a long time series of rich, abundant and representative data exists.

- Greater reliance on expert judgement and external benchmarking based models e.g. in the more specialised commercial portfolios where data is comparatively sparse.

In all instances suitable levels of conservatism are included within the model build to cover any modelling weaknesses. This ensures that model outputs provide appropriate capital requirements. The level to which any such conservatism is deemed adequate is robustly challenged through the Group’s internal review and approval process and ultimately by the FSA.

Except where agreed with the regulator, the PDs are calibrated to equal the long-run average observed default rate of that grade. 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 of the portfolio, rather than changes in the economy. However, PDs vary in their sensitivity to changes in the economy between the two extremes of Point-in-Time (changes in the economy are fully captured by changes in the PDs) and Through-the-Cycle (PDs are unaffected by changes in the economy) with some representing a hybrid position.

The extent to which PDs are affected by changes in the economy primarily depends upon the data available to the model development and the calibration methodology chosen. For example:

- For many commercial portfolios the PDs are hybrid.

- In Retail Division some secured portfolios adopt a Variable Scalar approved by the FSA to produce TTC PDs. For others the PDs are adjusted quarterly so that they equal the most recent observed default rates with a buffer to ensure conservatism if default rates change between calibrations i.e. they are broadly PiT.

Commercial Banking 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 External Credit Assessment Institutions (‘ECAIs’) and then apply this approach to all counterparties across the given portfolio.

For corporates the Group 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 (retail commercial exposures only). 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.

The bank participates in the annual Hypothetical Portfolio Exercises ('HPEs') undertaken by the FSA and EBA. Outputs from these assist in benchmarking the Group's own models to that of the broader industry. Outcomes from the Group's specialist and publicly quoted portfolio models are consistent with external ratings and in line with industry averages.

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. 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 alongside 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 for fees, expenses, 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 ensure capital sufficiency.

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

Table 26: **Wholesale Master Scale**

PD Grade	Range			External Ratings – Approximate Equivalents		
	Lower	Mid	Upper	S&P	Moody's	Fitch
1	0.000%	0.005%	0.010%	AAA / AA+	Aaa / Aa1	AAA / AA+
2	0.011%	0.018%	0.025%	AA / AA-	Aa2 / Aa3	AA / AA-
3	0.026%	0.063%	0.100%	A+ to A-	A1 to A3	A+ to A-
4	0.101%	0.311%	0.510%	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
5	0.511%	1.751%	3.000%	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
6	3.001%	11.501%	20.000%	B+ to B-	B1 to B3	B+ to B-
7	20.001%	60.000%	99.999%	CCC+ to CC	Caa1 to Ca	CCC+ to C
Default	100.000%	-	-	Default	Default	Default

Retail Master Scale

Table 27: **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%	-	-

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 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 2012, corporate exposures subject to the Foundation IRB Approach totalled £121.1bn (2011: £132.0bn).

Corporate Main

Table 28: **Corporate Main exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	1,534	0.03%	22.50%	2,391	0.03%	10.91%
2	4,025	0.03%	18.61%	3,453	0.03%	16.83%
3	18,456	0.05%	25.78%	19,833	0.05%	25.24%
4	34,522	0.25%	48.98%	32,916	0.24%	48.11%
5	18,963	1.25%	96.85%	19,895	1.36%	99.68%
6	5,770	7.12%	157.66%	8,634	6.66%	159.40%
7	1,872	33.25%	246.20%	2,142	30.66%	239.46%
Default	9,766	100.00%	-	11,532	100.00%	-
Total	94,908	11.73%	57.78%	100,796	13.02%	59.93%

Corporate SME

Table 29: **Corporate SME exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	18	0.03%	24.25%	23	0.03%	20.36%
2	106	0.03%	20.48%	28	0.03%	20.19%
3	1,266	0.05%	23.85%	1,102	0.06%	27.57%
4	2,449	0.47%	36.79%	2,674	0.24%	48.01%
5	6,615	1.31%	82.52%	7,776	1.30%	78.05%
6	4,471	7.43%	118.55%	4,942	6.92%	121.37%
7	349	28.20%	183.46%	788	29.19%	189.43%
Default	3,779	100.00%	-	5,829	100.00%	-
Total	19,053	22.61%	66.28%	23,162	28.11%	65.48%

Corporate Specialised Lending

Table 30: **Corporate specialised lending exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	156	0.06%	16.74%	64	0.06%	27.75%
4	2,492	0.32%	64.45%	2,750	0.30%	61.58%
5	2,777	1.27%	97.07%	3,946	1.31%	102.20%
6	631	6.00%	164.87%	584	4.87%	160.71%
7	-	-	-	-	-	-
Default	1,054	100.00%	-	684	100.00%	-
Total	7,110	15.96%	75.51%	8,028	9.62%	83.24%

Key Movements

- The average risk weights for corporate main and corporate specialised lending exposures reduced from 59.93% to 57.78% and from 83.24% to 75.51% 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 2012, central government and central bank exposures subject to the Foundation IRB Approach totalled £10.2bn (2011: £17.7bn).

Central Governments and Central Banks

Table 31: **Central government and central bank exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	243	0.01%	14.72%	7,544	0.01%	10.54%
2	9,990	0.02%	14.01%	10,154	0.02%	4.92%
3	-	-	-	12	0.07%	19.59%
4	5	0.21%	32.21%	-	-	-
5	-	-	-	3	1.24%	85.00%
6	-	-	-	-	-	-
7	-	-	-	-	-	-
Default	-	-	-	1	100.00%	-
Total	10,238	0.02%	14.04%	17,714	0.02%	7.34%

Key Movements

- At year end the Group's central governments and central banks exposures risk weighted under the Foundation IRB Approach predominantly related to exposures to the US Federal Reserve Bank of New York. The increase in average risk weight from 7.34% to 14.04% resulted from a combination of the application of revised PDs and investment in longer term US Treasury Bills, leading to an increase in the maturity factor applied in the IRB risk weight calculations.

Institution Exposures

As at 31 December 2012, institution exposures subject to the Foundation IRB Approach totalled £5.7bn (2011: £11.9bn).

Institutions

Table 32: **Institution exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	13	0.03%	8.04%	13	0.03%	8.04%
2	12	0.03%	8.59%	137	0.03%	10.66%
3	2,550	0.04%	14.34%	7,607	0.04%	13.34%
4	2,751	0.26%	31.39%	3,631	0.18%	30.48%
5	355	1.11%	57.52%	420	0.85%	65.22%
6	7	8.16%	161.97%	5	6.75%	173.77%
7	-	-	-	3	30.14%	250.37%
Default	2	100.00%	-	76	100.00%	-
Total	5,690	0.27%	25.43%	11,892	0.76%	20.40%

Key Movements

- The significant reduction in PD Grade 3 exposures during the year (£5.1bn) was primarily a result of the active reduction of the non-core financial institutions covered bonds portfolio, through a combination of disposals and bond maturities. The subsequent shift in risk profile resulted in a slight increase in the average risk weight of the overall book from 20.40% to 25.43%.

ANALYSIS OF EXPOSURES SUBJECT TO THE RETAIL IRB APPROACH

This section provides a detailed analysis, by PD Grade, of 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 2012, retail exposures subject to the Retail IRB Approach totalled £409.4bn (2011: £419.0bn).

Residential Mortgages

Table 33: **Residential mortgage exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Exposure Weighted Average LGD [1] %	2012 Average Risk Weight %	2012 Undrawn Commitments (Gross) [2] £m	2012 Undrawn Commitments (Post Credit Conversion Factor) £m
0	126,196	0.11%	8.46%	2.31%	2,964	1,998
1	116,819	0.29%	11.92%	6.95%	1,459	917
2	42,748	0.70%	13.35%	14.02%	646	509
3	20,275	1.29%	14.64%	22.50%	1,027	566
4	15,748	2.33%	15.60%	33.11%	1,753	1,127
5	5,855	4.37%	17.55%	55.12%	77	68
6	4,451	7.83%	18.98%	78.75%	40	38
7	2,988	11.86%	19.60%	95.17%	91	89
8	2,851	14.62%	20.28%	107.02%	24	21
9	2,254	22.51%	16.08%	95.44%	10	9
10	2,309	31.61%	17.16%	104.74%	1	-
11	2,766	43.14%	18.58%	107.06%	9	8
12	2,579	67.83%	20.93%	74.92%	2	1
Default	8,127	100.00%	19.48%	93.90%	14	5
Total	355,966	4.24%	11.85%	15.88%	8,117	5,356

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

Notes

[1] The 10% LGD floor that applies to residential mortgage exposures is applied at sub-portfolio level rather than at account level. The current 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 predominantly relate to pipeline mortgages. The risk rating methodology for pipeline loans was amended in 2012 in order to reflect more accurately the credit risk at loan origination.

Key Movements

- The significant migration of exposures from PD Grade 0 to PD Grade 1 during 2012 predominantly results from the FSA approval, and subsequent implementation, of the redeveloped heritage HBOS mortgage ratings models following integration of model methodologies of the former heritage Lloyds TSB and heritage HBOS portfolios. The migration is therefore a natural consequence of the new aligned models, ongoing model review and reflective of up-to-date and prudent risk categorisation of the exposures. Capital requirements did not materially change during 2012 as a result of the implementation of the redeveloped models as reported risk weighted assets have been adjusted upwards to reflect the new models since 2010 in order to ensure adequacy.

- The average risk weight for residential mortgage exposures risk weighted under the Retail IRB Approach reduced from 16.32% to 15.88% over the course of 2012. The Group continually reviews the capital it holds against these exposures, utilising its deep experience and understanding of the UK housing market and its assessment of future potential losses to assess the appropriateness of the level of capital held. In addition the residential mortgage models are subject to rigorous internal review and external review and approval by the FSA. The Group remains comfortable that the level of capital resources allocated to support its mortgage business remains appropriate for what it considers to be a high quality mortgage portfolio.

Qualifying Revolving Retail Exposures

Table 34: **Qualifying revolving retail exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Exposure Weighted Average LGD %	2012 Average Risk Weight %	2012 Undrawn Commitments (Gross) £m	2012 Undrawn Commitments (Post Credit Conversion Factor) [1] £m
0	7,446	0.05%	74.94%	2.89%	10,166	7,154
1	7,461	0.22%	78.22%	9.68%	8,625	6,968
2	5,397	0.56%	76.20%	20.08%	10,665	4,201
3	2,246	0.98%	76.95%	31.45%	2,539	1,513
4	3,819	1.77%	77.53%	48.84%	3,397	2,096
5	3,054	3.37%	77.84%	77.76%	1,812	1,164
6	2,523	5.92%	77.49%	112.45%	1,092	709
7	1,399	8.39%	77.43%	141.24%	335	372
8	753	11.75%	78.42%	171.40%	139	151
9	528	16.57%	78.66%	203.88%	75	99
10	353	24.19%	78.52%	235.72%	37	58
11	213	35.99%	78.54%	255.02%	19	33
12	210	65.62%	78.66%	190.94%	12	30
Default	903	100.00%	54.67%	148.14%	58	-
Total	36,305	5.20%	76.42%	47.55%	38,971	24,548

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

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 49.49% to 47.55% reflects an improved risk mix within the credit cards and personal current accounts portfolios.

Other Retail

Table 35: **Other retail exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Exposure Weighted Average LGD %	2012 Average Risk Weight %	2012 Undrawn Commitments (Gross) £m	2012 Undrawn Commitments (Post Credit Conversion Factor) £m
0	**2**	**0.09%**	**79.55%**	**19.28%**	**-**	**-**
1	**1,164**	**0.34%**	**52.64%**	**30.75%**	**5**	**1**
2	**980**	**0.63%**	**77.50%**	**66.29%**	**11**	**2**
3	**1,107**	**1.02%**	**85.78%**	**92.79%**	**10**	**2**
4	**4,637**	**1.75%**	**75.02%**	**98.57%**	**20**	**4**
5	**2,494**	**3.33%**	**89.74%**	**134.11%**	**14**	**3**
6	**1,648**	**5.89%**	**78.44%**	**124.78%**	**8**	**2**
7	**389**	**8.53%**	**90.79%**	**154.40%**	**2**	**-**
8	**207**	**11.56%**	**91.05%**	**170.66%**	**1**	**-**
9	**172**	**17.64%**	**90.91%**	**203.22%**	**4**	**1**
10	**158**	**21.82%**	**65.83%**	**161.47%**	**-**	**-**
11	**220**	**39.60%**	**69.89%**	**194.66%**	**4**	**2**
12	**161**	**71.80%**	**82.90%**	**158.08%**	**1**	**-**
Default	**967**	**100.00%**	**59.58%**	**99.03%**	**-**	**-**
Total	**14,306**	**11.01%**	**76.88%**	**106.29%**	**80**	**17**

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

Key Movements

- The reduction in the overall average risk weight from 111.04% to 106.29% reflects an improved risk mix within the portfolio.

Retail SME

Table 36: **Retail SME exposures by PD Grade**

PD Grade	**2012 Credit Risk Exposure £m**	**2012 Exposure Weighted Average PD %**	**2012 Exposure Weighted Average LGD %**	**2012 Average Risk Weight %**	**2012 Undrawn Commitments (Gross) £m**	**2012 Undrawn Commitments (Post Credit Conversion Factor) £m**
0	-	-	-	-	-	-
1	-	-	-	-	-	-
2	**751**	**0.62%**	**53.39%**	**70.92%**	**592**	**559**
3	**415**	**1.14%**	**58.91%**	**85.77%**	**216**	**210**
4	**231**	**1.69%**	**60.96%**	**96.23%**	**96**	**95**
5	**284**	**2.64%**	**63.78%**	**106.66%**	**84**	**83**
6	**187**	**5.73%**	**65.54%**	**118.53%**	**57**	**56**
7	**215**	**8.03%**	**60.32%**	**119.96%**	**103**	**103**
8	**129**	**10.79%**	**72.10%**	**143.74%**	**36**	**35**
9	**68**	**18.49%**	**76.68%**	**183.83%**	**13**	**13**
10	-	-	-	-	-	-
11	**33**	**34.93%**	**78.29%**	**225.78%**	**5**	**4**
12	**17**	**79.59%**	**82.92%**	**155.16%**	**6**	**3**
Default	**480**	**100.00%**	**3.26%**	**30.76%**	**2**	**2**
Total	**2,810**	**20.65%**	**50.53%**	**87.24%**	**1,210**	**1,163**

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

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

Corporate Specialised Lending Exposures Subject to Supervisory Slotting

Corporate specialised lending exposures subject to the IRB Supervisory Slotting Approach 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 that applies 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 2012, corporate specialised lending exposures subject to supervisory slotting amounted to £6.9bn (2011: £6.0bn). Risk weighted assets arising from this amounted to £4.9bn (2011: £4.5bn) as analysed in the table below.

Table 37: **Corporate specialised lending exposures subject to supervisory slotting**

	Remaining Maturity <2.5 years		Remaining Maturity >2.5 years	
Grade	2012 Exposure £m	2012 Risk Weighted Assets £m	2012 Exposure £m	2012 Risk Weighted Assets £m
1) Strong	240	80	1,639	691
2) Good	900	613	2,560	2,215
3) Satisfactory	498	573	528	607
4) Weak	21	51	27	67
5) Default [1]	397	-	46	-
Total	2,056	1,317	4,800	3,580

	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

[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

- Specialised lending exposures subject to the IRB Supervisory Slotting Approach increased by a total of £0.9bn during the year as a result of the roll-out of shipping and property development portfolios on to the slotting approach.

Equity Exposures Subject to the Simple Risk Weight Method

As at 31 December 2012, total credit risk exposures in respect of equities subject to the Simple Risk Weight Method amounted to £2.8bn (2011: £15m). Risk weighted assets arising from this amounted to £5.7bn (2011: £57m).

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

Table 38: **Equity exposures subject to the Simple Risk Weight Method**

	2012 Credit Risk Exposure £m	2012 Risk Weighted Asset £m	2011 Credit Risk Exposure £m	2011 Risk Weighted Asset £m
Privately traded equity exposures – 190% [1]	2,591	4,917	-	-
Publicly traded equity exposures – 290%	86	248	-	-
Other equity exposures – 370%	147	544	15	57
Total	2,824	5,709	15	57

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

Key Movements

- The significant increase in equity exposures subject to the Simple Risk Weight Method is a result of the transitioning of equity exposures previously risk weighted under the Standardised Approach ('Items belonging to regulatory high risk categories') to the IRB Approach (Simple Risk Weight Method) during 2012 following FSA approval.

Further information on non-trading book exposures in equities is provided on page 75.

COMPARISON OF EXPECTED LOSSES TO ACCOUNTING IMPAIRMENT LOSSES AND ALLOWANCES

The table on page 66 provides a comparison of regulatory expected losses to accounting impairment losses (net charge to the income statement) and allowances for impairment losses on loans and receivables (impairment provisions), in respect of credit risk exposures subject to the IRB Approach.

The definition, calculation and treatment of regulatory expected losses are covered on page 8.

In comparing regulatory expected losses to accounting measures of impairment, significant differences in the calculation and scope of each must be taken into account. IRB models are developed to meet precise regulatory requirements and as such the expected losses generated by these models are not directly comparable to impairment losses or allowances derived under IFRS accounting standards. In particular;

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

- Regular detailed analysis of modelled impairment allowance outputs is undertaken to ensure that the models adequately capture all incurred losses. Where this is considered not to be the case, additional accounting impairment allowances are applied to capture the risk.

- Regulatory expected losses generated under the Foundation IRB Approach make use of LGD parameters and credit conversion factors (applied in the calculation of EAD) that are set by the regulator. The assumptions inherent within these regulatory measures may differ significantly to the assumptions applied when estimating future cash flows for use in accounting impairment loss calculations.

- Regulatory expected loss calculations forecast potential losses arising from all accounts including those that currently exhibit no indication of impairment.

- Regulatory expected losses in relation to portfolios that are based on Through-the-Cycle ('TTC') PD estimates utilise historic default experience, whereas accounting impairment losses and allowances are based on the losses that have been incurred at the balance sheet date.

- Regulatory expected loss calculations anticipate additional drawings made by customers who are yet to default (EAD estimate). Accounting impairment losses reflect exposure values and conditions at the balance sheet date.

- In certain cases regulatory expected losses are determined through the application of a fixed percentage applied to the exposure, for example expected losses calculated in respect of corporate specialised lending exposures subject to the Supervisory Slotting Approach.

In addition, regulatory 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. Accounting 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 regulatory expected losses to accounting impairment losses, consideration of the above should be taken into account.

Table 39: **Regulatory expected losses, impairment losses and allowances for impairment losses**

	Regulatory Expected Losses as at 31 December 2012	Allowance for Impairment Losses on Loans and Receivables as at 31 December 2012	Regulatory Expected Losses as at 31 December 2011	Impairment Losses for the year to 31 December 2012	Allowance for Impairment Losses on Loans and Receivables as at 31 December 2011	Regulatory Expected Losses as at 31 December 2010	Impairment Losses for the year to 31 December 2011	Allowance for Impairment Losses on Loans and Receivables as at 31 December 2010
	£m	£m	£m	£m	£m	£m	£m	£m
Foundation IRB Approach								
Corporates	6,910	5,936	9,057	1,746	7,553	9,541	2,386	8,196
Central governments and central banks	1	-	1	-	-	1	-	-
Institutions	5	4	39	(8)	86	69	68	98
Retail IRB Approach								
Retail - Residential mortgages	2,270	2,562	2,275	616	2,507	2,136	799	1,984
Retail - Qualifying revolving retail exposures	1,057	456	1,414	519	682	1,884	806	982
Retail - Other retail	871	530	1,324	299	807	1,881	798	1,267
Retail - SME	85	20	79	21	24	124	71	36
Other IRB Approaches								
Corporate - Specialised lending	335	215	331	11	148	2,931	462	3,606
Equities	24	-	-	(4)	-	35	-	-
Fair value adjustments [1]	(702)	-	(1,408)	-	-	(3,109)	-	-
Total [2]	10,856	9,723	13,112	3,200	11,807	15,493	5,390	16,169
Standardised Approach and other exposures [3]		13,084		2,497	17,181		4,396	15,141
Fair value and other adjustments		(7,348)		(548)	(9,966)		(1,692)	(12,359)
Total per Income Statement / Balance Sheet		15,459		5,149	19,022		8,094	18,951

Notes

[1] The calculation of excess expected loss ('EEL') amounts, where regulatory expected losses are netted against allowances for impairment losses on IRB portfolios, is subject to the application of acquisition related fair value adjustments.

[2] The analysis provided excludes regulatory expected losses arising on counterparty credit risk exposures that amounted to £139m at 31 December 2012 (2011: £135m; 2010: £90m).

[3] Other exposures include debt securities categorised as securitisation positions under the IRB Approach.

❖ Further details on the fair value and other adjustments applied in respect of impairment losses charged to the income statement and allowances for impairment losses on loans and receivables can be found on pages 138 and 321, respectively, of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

Key Movements

- Factors leading to the reduction in impairment losses during 2012 are explained on pages 49 to 50.
- Regulatory expected losses continue to remain significantly in excess of actual loss experience, as is evident when comparing regulatory expected losses at 31 December 2011 and 31 December 2010 to impairment losses incurred during 2012 and 2011. When compared to the overall allowance for impairment losses on IRB portfolios, total regulatory expected losses are prudently in excess, reflecting the impact of model conservatism in the Group's IRB models.
- At 31 December 2012, the overall allowance for impairment losses on IRB portfolios amounted to 90% (2011: 90%; 2010: 104%) of the total regulatory expected loss (net of fair value adjustments).

MODEL PERFORMANCE

This section provides an analysis of the performance of IRB models over 2012.

The Group operates an ongoing programme to regularly refresh models either through recalibration or replacement. During 2012 the process to integrate or align models has continued to make significant progress. In addition a number of other factors also impact on the metrics shown, for example changes in portfolio composition arising from risk appetite realignment, changes in the risk profile of the portfolio, economic factors, movement in individual model parameters and conservatism within the models.

The table below compares the estimated and actual probability of default (PD), 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 the application of regulatory floors. For the purposes of comparison, EAD weighting has been used throughout.

The 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 page 53.

Table 40: **Model performance**

IRB Exposure Class	Probability of Default		Loss Given Default of Defaulted Assets		EAD of Defaulted Assets
	Estimated Dec 11 %	Actual Dec 12 %	Estimated Dec 11 %	Actual Dec 12 %	Ratio of Predicted to Actual %
Wholesale Business					
Central governments and central banks	0.03%	0.00%			
Institutions	0.08%	0.00%			
Corporates	2.05%	2.76%			
Retail Business					
Residential mortgages	2.15%	1.50%	16.08%	8.04%	1.03
Qualifying revolving retail exposures	3.38%	2.77%	78.71%	66.54%	1.10
Other retail	5.98%	5.01%	81.74%	66.36%	1.09
Retail SME	4.51%	3.95%	64.44%	63.17%	1.05

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

The models and rating systems vary between using a Point-in-Time (PiT) and a Through-the-Cycle (TTC) approach with many representing a hybrid position. Within the Group, the PD models used in the regulatory capital calculation seek to be through-the-cycle calibrated or hybrid models where possible, 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.

The default metric shown is EAD-weighted and therefore sensitive to a small number of high-value corporate defaults resulting in the predicted defaulted exposure value being lower than that observed. Regular model performance monitoring takes place on a number-weighted basis and indicates that the PD prediction is in excess of the observed default rate across the corporates exposure class.

The LGD models are downturn calibrated and for those assets where losses are not yet realised the determination of actual LGD also includes the use of the model estimates. The updating of these models can also contribute therefore 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.

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 2012, credit risk exposures risk weighted under the Standardised Approach amounted to £183.1bn (2011: £190.0bn), generating risk weighted assets of £73.7bn (2011: £103.5bn) and a capital requirement of £5.9bn (2011: £8.3bn).

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 page 36.

Central Governments and Central Banks

Table 41: **Standardised central government and central bank exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	92,989	(1)	92,988	-
100%	105	-	105	105
Total	**93,094**	**(1)**	**93,093**	**105**

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
Total	72,442	-	72,442	57

Regional Governments and Local Authorities

Table 42: **Standardised regional government and local authority exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
20%	30	-	30	6
100%	12	-	12	12
Total	**42**	**-**	**42**	**18**

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

Administrative Bodies and Non-Commercial Undertakings

Table 43: **Standardised administrative body and non-commercial undertaking exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
20%	17	-	17	3
100%	59	-	59	59
Total	76	-	76	62

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

Multilateral Development Banks

Table 44: **Standardised multilateral development bank exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	83	-	83	-
Total	83	-	83	-

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	-

Institutions

Table 45: **Standardised institution exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	11	-	11	-
20%	699	-	699	140
50%	130	-	130	65
100%	361	-	361	361
Total	1,201	-	1,201	566

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
Total	1,177	-	1,177	399

Corporates

Table 46: **Standardised corporate exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	42	-	42	-
20%	20	-	20	4
50%	1,438	-	1,438	719
100%	10,489	(289)	10,200	10,200
150%	14	-	14	21
Other [1]	15,287	(1,619)	13,668	14,593
Total	**27,290**	**(1,908)**	**25,382**	**25,537**

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

Notes

[1] This category includes exposures to corporates, primarily held within Commercial Banking Division, where the risk weighted asset amounts have been determined in accordance with Standardised Approach requirements, supplemented by additional conservative estimates.

Exposures to corporates amounting to £nil (2011: £898m) 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 £42m (2011: £48m) 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.

Exposures to corporates amounting to £nil (2011: £2m) are covered by guarantees that allow a reduced risk weight to be applied.

Exposures to corporates amounting to £nil (2011: £109m) are covered by credit derivatives, allowing a risk weight of 20% to be applied.

Retail

Table 47: **Standardised retail exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	54	-	54	-
35%	-	-	-	-
75%	7,095	(55)	7,040	5,279
100%	323	(9)	314	314
150%	7	-	7	11
Total	**7,479**	**(64)**	**7,415**	**5,604**

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	-
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

Secured by Mortgages on Residential Property

Table 48: **Standardised exposures secured by mortgages on residential property by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	443	-	443	-
20%	-	-	-	-
35%	11,089	-	11,089	3,881
50%	726	-	726	363
75%	3,300	-	3,300	2,475
100%	1	-	1	1
Other [1]	332	-	332	230
Total	15,891	-	15,891	6,950

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%	876	-	876	876
Other [1]	351	-	351	213
Total	17,490	-	17,490	8,090

Notes

[1] This category includes lifetime mortgage exposures that are subject to non-standard risk weights.

Exposures secured by mortgages on residential property amounting to £443m (2011: £481m) are covered by a guarantee provided through a Dutch Government scheme. A risk weight of 0% has been applied to these exposures.

Secured by Mortgages on Commercial Real Estate

Table 49: **Standardised exposures secured by mortgages on commercial real estate by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
100%	2,789	(9)	2,780	2,780
Other [1]	11,032	-	11,032	12,420
Total	13,821	(9)	13,812	15,200

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%	4,971	-	4,971	4,971
Other [1]	15,576	-	15,576	18,412
Total	20,547	-	20,547	23,383

Notes

[1] This category includes commercial real estate exposures, primarily held within Commercial Banking Division, where the risk weighted asset amounts have been determined in accordance with Standardised Approach requirements, supplemented by additional conservative estimates.

Past Due Items

Table 50: **Standardised past due items by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	2	-	2	-
20%	-	-	-	-
35%	-	-	-	-
50%	42	-	42	21
100%	3,837	(2)	3,835	3,835
150%	1,625	(50)	1,575	2,362
Total	5,506	(52)	5,454	6,218

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
100%	6,016	(67)	5,949	5,949
150%	2,627	-	2,627	3,941
Total	8,678	(67)	8,611	9,907

Notes

Past due items amounting to £2m (2011: £nil) are covered by government guarantees that allow a risk weight of 0% to be applied.

Past due items amounting to £nil (2011: £1m) are covered by guarantees that allow a reduced risk weight of 20% to be applied.

Items Belonging to Regulatory High Risk Categories

Table 51: **Standardised items belonging to regulatory high risk categories by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
100%	-	-	-	-
150%	1	-	1	1
Total	1	-	1	1

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

Short Term Claims on Institutions or Corporates

Table 52: **Standardised short term claims on institutions and corporates by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
50%	-	-	-	-
100%	164	-	164	164
150%	15	-	15	23
Total	**179**	**-**	**179**	**187**

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
150%	-	-	-	-
Total	456	-	456	451

Collective Investment Undertakings

Table 53: **Standardised collective investment undertaking exposures by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
20%	260	-	260	52
100%	1	-	1	1
Total	**261**	**-**	**261**	**53**

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

Other Items

Table 54: **Standardised other items by risk weight**

Risk Weight	2012 Credit Risk Exposure (Pre CRM) £m	2012 Credit Risk Mitigation £m	2012 Credit Risk Exposure (Post CRM) £m	2012 Risk Weighted Asset £m
0%	3,855	-	3,855	-
20%	1,117	-	1,117	223
50%	-	-	-	-
75%	-	-	-	-
100%	12,406	-	12,406	12,406
Other [1]	817		817	535
Total	**18,195**	**-**	**18,195**	**13,164**

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

Notes

[1] This category includes residual values of operating lease assets that are subject to non-standard risk weights.

NON-TRADING BOOK EXPOSURES IN EQUITIES

Non-trading book exposures in equities held by the Group primarily arise within Commercial Banking 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, references to which are provided below.

- Available-for-sale financial assets, Note 2 (Accounting policies), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts, page 217
- Equity investments (including venture capital), Note 54 (Financial instruments), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts, page 312

A reference to the Group's accounting policies in relation to the recognition of impairment losses on available-for-sale financial assets is provided on page 44.

The balance sheet value of non-trading book exposures in equities, as at 31 December 2012, is presented in the table below. There was no difference between the balance sheet value and the fair value of these exposures.

Table 55: **Analysis of non-trading book exposures in equities**

Equity Grouping	2012 Balance Sheet Value £m	2011 Balance Sheet Value £m
Publicly quoted equities	94	27
Privately held equities	988	1,953
Total	**1,082**	1,980

Realised gains recognised in the year to 31 December 2012 in respect of the sale and liquidation of non-trading book exposures in equities amounted to £387m (2011: £183m).

As at 31 December 2012, net unrealised gains on available-for-sale equity investments amounted to £56m (2011: £386m). 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 81.

As a sponsor the Group manages and supports, through the provision of liquidity facilities, three asset backed commercial paper conduits (Cancara, Argento and Grampian). During the course of 2012 the Group closed both the Argento and Grampian conduit programmes, further details of which are provided on pages 82 and 84.

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 2012, credit risk exposures classed as securitisation positions amounted to £19.8bn (2011: £31.0bn). 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.

Table 56: **Summary of non-trading book securitisation exposures and capital requirements**

Securitisation type and risk weight approach	2012 Credit Risk Exposure [1] £m	2012 Risk Weighted Assets [2] £m	2012 Capital Requirement £m	2012 Deduction from Capital [3] £m
Originated:				
Ratings Based Approach	5,594	2,636	211	150
	5,594	2,636	211	150
Sponsored and Invested:				
Internal Assessment Approach	5,782	625	50	-
Ratings Based Approach	8,471	3,426	274	216
	14,253	4,051	324	216
TOTAL	19,847	6,687	535	366

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
	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

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 2012 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 216 to 218 (Financial Assets and Liabilities) of the 2012 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 307 to 316 (Fair Values of Financial Assets and Liabilities) of the 2012 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.

Table 57: **Securitisation programmes**

Securitisation Programmes [1]	2012 Gross Assets Securitised £m	2011 Gross Assets Securitised £m	Movement £m	2012 Notes in Issue £m	2011 Notes in Issue £m	Movement £m
UK residential mortgages	80,125	129,764	(49,639)	57,285	94,080	(36,795)
US residential mortgage-backed securities	185	398	(213)	221	398	(177)
Commercial loans	15,024	13,313	1,711	14,110	11,342	2,768
Irish residential mortgages	5,189	5,497	(308)	3,509	5,661	(2,152)
Credit card receivables	6,974	6,763	211	3,794	4,810	(1,016)
Dutch residential mortgages	4,547	4,933	(386)	4,682	4,777	(95)
Personal loans	4,412	-	4,412	2,000	-	2,000
PFI / PPP and project finance loans	688	767	(79)	104	110	(6)
Motor vehicle loans	1,039	3,124	(2,085)	1,086	2,871	(1,785)
	118,183	164,559	(46,376)	86,791	124,049	(37,258)
Less notes held by the Group				(58,732)	(86,637)	
Total				28,059	37,412	

Notes

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

Gross assets securitised decreased by £46.4bn (2011: £16.1bn) during the year, primarily as a result of the closure of several UK residential mortgages and motor vehicle loans programmes. The increase in gross assets securitised in relation to commercial loans of £1.7bn and personal loans of £4.4bn reflects the set up of new securitisation programmes during the year.

No securitisation transactions undertaken during the year were recognised as sales (2011: nil).

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 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, may 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 Cancara conduit programme is covered in more detail on page 83.

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 £8.9bn (2011: £11.6bn) 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.

Table 58: **Analysis of gross securitised exposures on a regulatory basis**

	Gross Securitised Exposure				
	2012 Traditional £m	**2012 Synthetic £m**	**2012 Impaired Exposures £m**	**2012 Past Due but not Impaired Exposures £m**	**2012 Value Adjustments [1] £m**
Commercial, PFI / PPP and project finance loans	-	3,125	170	17	24
Re-securitisations	5,772	-	-	-	2,435
Total	**5,772**	**3,125**	**170**	**17**	**2,459**

	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
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

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, £1,934m (2011: £2,176m) of these value adjustments applied against re-securitisation positions rated below BB- or that were unrated.

Key Movements

- Gross securitised exposures reduced by £2.7bn during the year, reflecting both the amortisation of the pools within the programmes and the winding up of a re-securitisation programme, the underlying assets of which were sold to a third party giving rise to a loss on disposal of £15m.

The net charge to the income statement for the year to 31 December 2012 in respect of losses attributed to the gross securitised exposures noted above amounted to £33m (2011: £55m).

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, 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 page 85.

Use of Credit Default Swaps

The Group uses credit default swaps to securitise, in combination with external funding, commercial, 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

During the year the Group established a warehousing facility for a third party client with facility commitments amounting to £200m. As at 31 December 2012 the facility remained undrawn and the Group had no assets awaiting securitisation through warehousing or pipeline activities (2011: nil).

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 2012, securitisation and re-securitisation positions arising from origination activities and risk weighted under the Ratings Based Approach amounted to £7.7bn (2011: £9.9bn), generating a capital requirement of £211m (2011: £227m). An analysis of these positions, by risk weight category, is provided in the table below.

Table 59: **Analysis of originated positions by risk weight category**

S&P Equivalent Rating and RBA Risk Weight [1]		Securitisation Positions 2012						Re-securitisation Positions 2012				TOTAL 2012		TOTAL 2011	
		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%)	343	2	-	-	-	-	638	11	-	-	981	13	2,752	32
AA	(8%, 15%, 25%, 25%, 40%)	2,010	13	90	1	-	-	-	-	844	29	2,944	43	2,735	44
A+	(10%, 18%, 35%, 35%, 50%)	-	-	50	1	-	-	-	-	214	9	264	10	284	11
A	(12%, 20%, 35%, 40%, 65%)	-	-	28	1	-	-	-	-	221	12	249	13	231	13
A-	(20%, 35%, 35%, 60%, 100%)	-	-	-	-	-	-	-	-	184	16	184	16	201	15
BBB+	(35%, 50%, 50%, 100%, 150%)	-	-	-	-	-	-	-	-	90	11	90	11	125	5
BBB	(60%, 75%, 75%, 150%, 225%)	-	-	43	1	-	-	-	-	122	23	165	24	201	15
BBB-	(100%, 100%, 100%, 200%, 350%)	-	-	-	-	-	-	-	-	121	22	121	22	149	15
BB+	(250%, 250%, 250%, 300%, 500%)	-	-	16	2	-	-	-	-	202	57	218	59	352	76
BB	(425%, 425%, 425%, 500%, 650%)	-	-	2	-	-	-	-	-	176	-	178	-	185	1
BB-	(650%, 650%, 650%, 750%, 850%)	-	-	-	-	-	-	-	-	190	-	190	-	212	-
Below BB- or unrated	Deduction	16	-	51	-	-	-	-	-	2,050	-	2,117	-	2,498	-
Total		2,369	15	280	6	-	-	638	11	4,414	179	7,701	211	9,925	227
Value adjustments taken to reserves [2]												(1,957)	-	(2,342)	-
Deduction from capital												(150)	-	(156)	-
Total Credit Risk Exposure / Cap Req [3]												5,594	211	7,427	227

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.

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.

SPONSORED AND INVESTED SECURITISATIONS

The Group sponsors three asset backed commercial paper ('ABCP') conduits (Cancara, Argento and Grampian) that invest in debt securities and client receivables. The conduit structures consist of a series of bankruptcy remote SPEs that purchase receivables or asset backed securities and are funded either by the issue of asset backed commercial paper or through the provision of liquidity and repo facilities. The structures generate fee income and net interest income for the Group.

During the course of 2012 the Group closed both the Argento and Grampian conduit programmes. As at 31 December 2012 no commercial paper remained in issuance in connection to either conduit and the remaining assets in the respective purchasing vehicles were entirely funded by 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 provided funding for third party originated asset backed securities as well as Lloyds Banking Group originated assets. Following the closure of the programme during 2012, no commercial paper remains in issuance. The remaining assets are entirely funded by the Group.	Grampian was established in 2002 by HBOS. It funded a diverse portfolio of asset backed securities through the issuance of asset backed commercial paper and represented an incremental funding source for the Group. Following the closure of the programme during 2012, no commercial paper remains in issuance. The remaining assets are entirely funded by the Group.
Programme limit / CP outstanding as at 31 December 2012	$20.0bn / $7.5bn (£12.4bn / £4.7bn)	Not applicable	Not applicable
Conduit structure	Fully supported multi-seller	Hybrid, fully supported multi-seller	Securities arbitrage, fully supported
Credit enhancement	Programme wide letter of credit and full support liquidity	Fully supported	Programme wide letter of credit
Liquidity provider	Lloyds Banking Group	Lloyds Banking Group	Lloyds Banking Group

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.

Table 60: **Conduit assets**

	2012 Cancara £m	2012 Argento £m	2012 Grampian £m	2012 TOTAL £m
Loans and advances	4,342	140	58	4,540
Debt securities classified as loans and receivables:				
Asset backed securities	367	603	358	1,328
Debt securities classified as available-for-sale financial assets:				
Asset backed securities	-	396	143	539
Corporate and other debt securities	-	-	-	-
Total assets	4,709	1,139	559	6,407

	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
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

Total consolidated assets decreased by £2.4bn during the year, primarily as a result of the closure of the Argento and Grampian conduit programmes.

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.

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. In March 2012 the conduit was converted from partial support to full support liquidity, covering repayment of issued ABCP in full.

At 31 December 2012, liquidity facilities provided by the Group to Cancara amounted to £5.8bn (2011: £4.9bn), none of which had been drawn down (2011: nil).

Capital assessment

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

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.

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 relevant 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 relating to 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 2012, the total credit risk exposure of the Group in respect of the liquidity facilities provided to Cancara amounted to £5.8bn (2011: £4.9bn). An analysis of this exposure, by underlying exposure type, is provided in the table below.

Table 61: **Analysis of Cancara positions by exposure type**

Exposure Type	2012 Exposure £m	2011 Exposure £m
Mortgage Backed Securities:		
US RMBS	59	-
CMBS	28	-
Personal Sector:		
Auto loans	2,053	1,405
Credit cards	272	480
Trade receivables	1,245	1,045
Insurance premium funding loans	1,089	825
Capital calls	526	685
Other receivables [1]	510	415
Total Credit Risk Exposure	5,782	4,855

Notes

[1] Other receivables relate predominantly to dealer floorplan receivables.

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.

Table 62: **Analysis of Cancara positions by risk weight category**

S&P Equivalent Rating and IAA Risk Weight	2012 Exposure £m	2012 Capital Req £m	2011 Exposure £m	2011 Capital Req £m
AAA: 7%	2,875	17	2,482	15
AA: 8%	1,108	8	714	5
A+: 10%	824	7	633	5
A: 12%	788	8	-	-
A-: 20%	63	1	718	12
BBB+: 35%	-	-	66	2
BBB: 60%	29	1	15	1
BBB-: 100%	95	8	227	19
Total Credit Risk Exposure / Capital Requirement	5,782	50	4,855	59

Argento and Grampian

Liquidity and repo facilities

Following the closure of both the Argento and Grampian conduit programmes, the remaining assets in the conduit purchasing companies are being funded by the Group.

At 31 December 2012, liquidity facilities provided by the Group to Argento amounted to £1.7bn (2011: £4.5bn), of which £0.8bn (2011: nil) had been drawn down.

At 31 December 2012, liquidity facilities provided by the Group to Grampian amounted to £0.5bn (2011: £6.7bn), of which £0.1bn (2011: nil) had been drawn down.

In addition, both Argento and Grampian have repurchase facilities with the Group. At 31 December 2012, £0.6bn (2011: nil) of repo funding was drawn by Argento and £0.6bn (2011: £0.7bn) drawn by Grampian, in relation to the remaining assets from the conduits.

Capital assessment

For both Argento and Grampian, capital requirements are assessed by looking through to the underlying asset portfolios held. As a result the liquidity and repo 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 and Liquidity Facilities

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 direct 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 £5.6bn (2011: £10.7bn), further details on which are presented on page 334 of the 2012 Lloyds Banking Group plc Annual Report and Accounts. The reduction during the year of £5.1bn reflects a combination of disposals and the 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 portfolios is undertaken by the Structured Credit Investment ('SCI') 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, Direct Investment and Liquidity Facility Credit Risk Exposures

As at 31 December 2012, the total credit risk exposure arising in respect of the risk positions attached to the underlying asset portfolios of Argento and Grampian amounted to £2.0bn (2011: £7.6bn).

The total credit risk exposure relating to direct investments in third party asset backed securities and the provision of liquidity facilities to third party securitisations amounted to £6.5bn (2011: £11.1bn).

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

Table 63: **Analysis of Argento, Grampian and other positions by exposure type**

Exposure Type	2012 Exposure £m	2011 Exposure £m
Mortgage Backed Securities:		
US RMBS	215	9
Non-US RMBS	2,997	4,164
CMBS	2,677	4,597
Collateralised Debt Obligations:		
CLO	2,040	1,575
Other	134	-
Personal Sector:		
Auto loans	301	90
Credit cards	188	-
Personal loans	56	204
FFELP Student Loans	151	4,617
Other ABS	-	3,747
Total	8,759	19,003
Value adjustments taken to reserves [1]	(72)	(108)
Deduction from capital	(216)	(150)
Total Credit Risk Exposure [2] [3]	8,471	18,745

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 £6,512m (2011: £11,149m) in relation to direct investments in third party asset backed securities and the provision of liquidity facilities to third party securitisations and £1,959m (2011: £7,596m) in relation to the underlying asset portfolios of Argento and Grampian.

Key Movements

- Credit risk exposures reduced by £10.3bn during the year, primarily reflecting disposals, a reduction in liquidity facilities provided to third parties and the non-replenishment of holdings after amortisations and maturities. Other ABS reduced down during the year for similar reasons, with remaining ABS positions (mainly in relation to Argento and Grampian) reallocated to the main categories analysed, on the basis of the underlying assets.

As at 31 December 2012, 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 and the provision of liquidity facilities to third party securitisations, risk weighted under the Ratings Based Approach, amounted to £8.8bn (2011: £19.0bn), generating a capital requirement of £274m (2011: £464m). An analysis of these positions, by risk weight category, is provided in the table below.

Table 64: **Analysis of Argento, Grampian and other positions by risk weight category**

S&P Equivalent Rating and RBA Risk Weight [1]		Securitisation Positions 2012						Re-securitisation Positions 2012				TOTAL 2012		TOTAL 2011	
		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%)	1,764	10	91	1	711	11	-	-	-	-	2,566	22	6,807	20
AA	(8%, 15%, 25%, 25%, 40%)	437	2	347	5	1,703	24	-	-	-	-	2,487	31	5,008	42
A+	(10%, 18%, 35%, 35%, 50%)	237	-	129	2	246	5	-	-	-	-	612	7	1,815	23
A	(12%, 20%, 35%, 40%, 65%)	260	1	22	-	551	14	-	-	-	-	833	15	1,240	18
A-	(20%, 35%, 35%, 60%, 100%)	34	-	20	1	372	11	-	-	-	-	426	12	910	24
BBB+	(35%, 50%, 50%, 100%, 150%)	194	1	38	2	37	1	-	-	-	-	269	4	969	15
BBB	(60%, 75%, 75%, 150%, 225%)	112	4	120	8	285	18	-	-	-	-	517	30	860	46
BBB-	(100%, 100%, 100%, 200%, 350%)	159	10	40	1	55	5	-	-	-	-	254	16	226	17
BB+	(250%, 250%, 250%, 300%, 500%)	220	41	91	18	-	-	-	-	-	-	311	59	388	34
BB	(425%, 425%, 425%, 500%, 650%)	23	8	49	17	46	16	-	-	-	-	118	41	253	80
BB-	(650%, 650%, 650%, 750%, 850%)	78	37	-	-	-	-	-	-	-	-	78	37	269	145
Below BB- or unrated	Deduction	45	-	195	-	13	-	-	-	35	-	288	-	258	-
Total		3,563	114	1,142	55	4,019	105	-	-	35	-	8,759	274	19,003	464
Value adjustments taken to reserves [2]												(72)	-	(108)	-
Deduction from capital												(216)	-	(150)	-
Total Credit Risk Exposure / Cap Req [3]												8,471	274	18,745	464

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.

Re-securitisation Positions

During 2012 the Group disposed of almost all of its remaining re-securitisation positions arising from investment activities leaving several small re-securitisation positions that are deducted from capital. The underlying securitisation positions in connection to these re-securitisation positions relate to junior and mezzanine positions in commercial real estate CDO transactions.

Provision of Liquidity Facilities to Third Parties

Of the gross exposure amount of £8,759m noted above, exposures amounting to £2,656m (2011: £3,199m) relate to the Group's provision of liquidity facilities to third party securitisations.

TRADING BOOK SECURITISATIONS

At 31 December 2012 the Group held a small portfolio of non-correlation trading book securitisation positions amounting to £155m (2011: £135m) with an associated market risk capital requirement of £1.7m (2011: £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 (2011: nil).

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 models.

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 (2011: nil).

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.

Table 65: **Analysis of trading book securitisation positions by risk weight category**

S&P Equivalent Rating and Specific Risk PRA (IRB) [1]		Non-Correlation Trading Book Securitisation Positions							
		Senior 2012		Non-Senior 2012		TOTAL 2012		TOTAL 2011	
		Exp £m[2]	Cap Req £m[3]	Exp £m[2]	Cap Req £m[3]	Exp £m[2]	Cap Req £m[3]	Exp £m[2]	Cap Req £m[3]
AAA	(0.56%, 0.96%)	124.7	0.7	-	-	124.7	0.7	76.4	0.4
AA	(0.64%, 1.20%)	13.3	0.1	0.3	-	13.6	0.1	41.6	0.2
A+	(0.80%, 1.44%)	0.2	-	-	-	0.2	-	-	-
A	(0.96%, 1.60%)	0.9	-	-	-	0.9	-	2.3	0.1
A-	(1.60%, 2.80%)	0.5	-	-	-	0.5	-	4.5	0.1
BBB+	(2.80%, 4.00%)	1.5	-	-	-	1.5	-	-	-
BBB	(4.80%, 6.00%)	-	-	5.0	0.3	5.0	0.3	7.1	0.4
BBB-	(8.00%, 8.00%)	8.2	0.6	-	-	8.2	0.6	2.7	0.2
BB+	(20.00%, 20.00%)	-	-	-	-	-	-	0.6	0.1
Total		149.3	1.4	5.3	0.3	154.6	1.7	135.2	1.5

Notes

[1] The specific risk PRAs (IRB Approach) for each rating are listed in the following order: senior positions then non-senior positions.

[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.

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.

Table 66: **Analysis of trading book securitisation positions by exposure type**

Exposure Type	**2012 Exposure £m**	**2012 Capital Requirement £m**	2011 Exposure £m	2011 Capital Requirement £m
RMBS	**134.6**	**0.7**	90.4	0.5
CMBS	**2.8**	**-**	8.6	0.2
Credit cards	**-**	**-**	19.4	0.1
Loans to corporates	**8.2**	**0.7**	4.7	0.3
Trade receivables	**5.7**	**0.3**	6.0	0.3
Other	**3.3**	**-**	6.1	0.1
Total	**154.6**	**1.7**	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 the Group to take early and proactive mitigating actions. 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.

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 an independent specialist group function.

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual limit guidelines. 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 and single name concentrations. In addition correlated concentration risks to sectors and movements in such concentrations are monitored regularly to guide risk appetite and limit setting, identify unwanted concentrations, and provide an early warning indicator for potential excesses. 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.

Cross-border and cross-currency exposures: The Board sets country risk appetite. Within these, country limits are authorised by the country limits committee, 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.

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.

Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis. Events are modelled at a Group wide level, at divisional and business unit level and by rating model and portfolio.

Credit risk assurance and review: Group Credit Risk Assurance, a team within Group Audit 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, and bespoke assignments, including impairment adequacy reviews as required. The work of Group Credit Risk Assurance continues to provide executive and senior management (and Audit Committee) with assurance and guidance on credit quality, effectiveness of credit risk controls and Business Support Unit work out strategies as well as accuracy of impairments.

Retail Assets (lending to individuals in Retail and Wealth, Asset Finance and International divisions)

The Group uses a variety of lending criteria 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 per cent LTV limits which depend upon the loan size. These limits are currently:

Table 67: **Loan to value analysis**

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 per cent. Buy-to-let mortgages are limited to a maximum of £1,000,000 and 75 per cent 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, the Group rejects 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.

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 Group Model Governance Committee.

Commercial Customers

Individual credit assessment and sanction with the exception of smaller SME names: Credit risk in commercial customer 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 and limit guidelines. 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.

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.

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.

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 (as specified through the Group's Foundation IRB waiver permission), provided the criteria for recognition are met.

MASTER NETTING AGREEMENTS

Where it is appropriate and likely to be effective, the Group seeks to enter 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 credit derivative based transactions 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

The Group will always consider credit risk mitigation techniques to mitigate credit risk via a charge over collateral and guarantees, use of netting and set off agreements, or via use of credit derivatives or securitisation.

The Group will take a charge over a physical or financial asset as appropriate in order to provide an alternative source of repayment in order to mitigate risk. There are robust policies and procedures in place to ensure this charge is properly perfected and to also ensure the additional regulatory requirements for recognition are met. 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, eligible non-financial collateral will typically result in an adjustment to the regulatory LGD values used subject to LGD floors of 35 per cent for senior debt and 65 per cent for subordinated debt. LBG uses the Financial Collateral Comprehensive Method and applies the relevant adjustments for volatility and currency mis-match, in addition to maturity mismatches for all collateral types. Guarantees and credit derivatives are reflected through an adjustment to either the PD or LGD values. The use of eligible financial collateral may be used to reduce LGD, or alternatively to adjust EAD values (E*). This may result in an effective LGD (LGD*) of less than the values above.

The regulatory requirements for recognition include a number of considerations including, legal certainty of charge, frequency and independency of revaluation and correlation of the value of the underlying asset to the obligor.

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.

The impact of the eligible financial collateral and guarantees on exposures risk weighted under the Standardised Approach is disclosed on pages 69 to 74.

Table 68: **Eligible collateral, guarantees and credit derivatives**

	2012 Exposures Covered by Eligible Financial Collateral £m	2012 Exposures Covered by Other Eligible Collateral £m	2012 Exposures Covered by Guarantees £m	2012 Exposures Covered by Credit Derivatives £m	2012 TOTAL £m
Exposures subject to the IRB Approach					
Foundation IRB Approach					
Corporate – Main	4,185	9,374	620	91	14,270
Corporate – SME	284	5,131	-	-	5,415
Corporate - Specialised lending	25	122	-	-	147
Central governments and central banks	-	-	255	-	255
Institutions	289	-	326	91	706
Retail IRB Approach					
Retail - Residential mortgages	-	-	-	-	-
Retail - Qualifying revolving retail exposures	-	-	-	-	-
Retail - Other retail	-	-	-	-	-
Retail – SME	-	-	-	-	-
Other IRB Approach					
Corporate - Specialised lending	862	-	-	-	862
Total - IRB Approach	5,645	14,627	1,201	182	21,655
Exposures subject to the Standardised Approach					
Central governments and central banks	1	-	-	-	1
Regional governments or local authorities	-	-	-	-	-
Administrative bodies and non-commercial undertakings	-	-	-	-	-
Multilateral development banks	-	-	-	-	-
Institutions	-	-	-	-	-
Corporates	1,908	-	42	-	1,950
Retail	64	-	-	-	64
Secured by mortgages on residential property	-	-	443	-	443
Secured by mortgages on commercial real estate	9	-	-	-	9
Past due items	52	-	2	-	54
Short term claims on institutions or corporates	-	-	-	-	-
Collective investment undertakings	-	-	-	-	-
Total - Standardised Approach	2,034	-	487	-	2,521
TOTAL	7,679	14,627	1,688	182	24,176

Key Movements

- Exposures covered by eligible forms of collateral reduced by £3.1bn during the year, primarily reflecting balance sheet reductions through the disposal of non-core assets and portfolios.

❖ Further details on collateral held as security for financial assets, collateral pledged as security and collateral repossessed can be found in Note 55 (Financial risk management), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts, pages 326 to 329.

	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 by mortgages on residential property	-	-	481	-	481
Secured by mortgages on commercial real estate	-	-	-	-	-
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

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 obligor ratings equivalent to investment grade as measured by external credit rating agencies.

Internal obligor ratings are mapped to modelled 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, obligor quality limit guidelines 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 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. For certain derivative transactions which meet eligibility for clearing at a Central Counterparty ('CCP'), counterparty credit risk is replaced by an exposure against the CCP.

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 (WRONG WAY) 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

Internal stress testing results at 31 December 2012 show that the Group has liquidity resources representing 128 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intra-day requirements and rating dependent contracts under the Group's most severe liquidity stress scenario (the three month combined (market wide and Group specific) scenario).

The Group's stress testing assumes that further credit rating downgrades may reduce investor appetite for some of the Group's liability classes and therefore funding capacity. In June 2012 the Group experienced a one notch downgrade in its long-term rating from Moody's, following the agency's review of 114 European banks. The impact that the Group experienced following the downgrade was not material and was consistent with the modelled outcomes based on the stress testing framework. A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade, implemented instantaneously by all major rating agencies could result in an

outflow of £11.5bn of cash over a period of up to one year, £3.5bn of collateral posting related to customer financial contracts and £18.0bn of collateral posting associated with secured funding. The Group's internal liquidity risk appetite includes such a stress scenario. The stress scenario modelling demonstrates the Group has available liquidity resources to manage such an event.

DERIVATIVE VALUATION ADJUSTMENTS

Details on the application of derivative valuation adjustments, including Credit and Debit Valuation Adjustments (CVA and DVA), are provided in the Group's Annual Report and Accounts as referenced below.

❖ Derivative valuation adjustments, Note 54 (Financial instruments), Notes to the Consolidated Financial Statements, 2012 Lloyds Banking Group plc Annual Report and Accounts, pages 315 to 316.

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY MEASUREMENT APPROACH

The credit risk exposure value in respect of counterparty credit risk as at 31 December 2012 was £26.3bn (2011: £23.5bn). An analysis by measurement approach is presented in the table below.

Table 69: **CCR: Analysis by measurement approach**

	2012 Credit Risk Exposure [1] £m	2011 Credit Risk Exposure [1] £m
CCR Standardised Approach	**-**	-
CCR Mark to Market Method	**26,339**	23,467
CCR Internal Model Method	**-**	-
	26,339	23,467

Notes

[1] Counterparty credit risk exposures are stated on an EAD post CRM basis throughout this section.

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY EXPOSURE CLASS

An analysis of counterparty credit risk exposures as at 31 December 2012, by exposure class, is presented in the table below.

Table 70: **CCR: Analysis by exposure class**

	2012 Credit Risk Exposure £m	2011 Credit Risk Exposure £m
Foundation IRB Approach		
Central governments and central banks	**457**	247
Institutions	**7,389**	9,270
Corporates	**6,449**	5,963
Other IRB Approach		
Securitisation positions	**171**	159
Standardised Approach		
Central governments and central banks	**5,513**	1,240
Institutions	**165**	190
Corporates	**6,195**	6,398
Total	**26,339**	23,467

Key Movements

- Counterparty credit risk exposures increased by £2.9bn over the year, primarily as a result of an increase in repos with the Bank of England and Dutch Central Bank, offset by a reduction in exposure to banks and other financial institutions as a result of maturing trades.

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY CONTRACT TYPE

An analysis of counterparty credit risk exposures as at 31 December 2012, by contract type, is presented in the table below.

Table 71: **CCR: Analysis by contract type**

	2012 Credit Risk Exposure £m	2011 Credit Risk Exposure £m
Interest rate contracts	16,582	16,330
Foreign exchange contracts	1,580	2,369
Equity contracts	378	361
Credit derivatives	228	200
Commodity contracts	74	40
Repo contracts	7,497	4,095
Other	-	72
Total	26,339	23,467

COUNTERPARTY CREDIT RISK EXPOSURES: ANALYSIS BY RISK WEIGHT APPROACH

An analysis of counterparty credit risk exposures and RWAs as at 31 December 2012, by risk weight approach, is presented in the table below.

Table 72: **CCR: Analysis by risk weight approach**

	2012 Credit Risk Exposure £m	2012 Risk Weighted Assets £m	2011 Credit Risk Exposure £m	2011 Risk Weighted Assets £m
Standardised Approach	11,873	6,686	7,828	6,474
Foundation and Other IRB Approaches	14,466	6,162	15,639	6,170
Total	26,339	12,848	23,467	12,644

COUNTERPARTY CREDIT RISK EXPOSURES: FURTHER ANALYSIS OF IRB 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

Table 73: **CCR central government and central bank exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	194	0.01%	0.48%	140	0.01%	2.86%
2	18	0.02%	14.26%	38	0.02%	1.62%
3	236	0.05%	6.31%	68	0.07%	8.39%
4	8	0.11%	14.62%	-	-	-
5	1	1.87%	99.16%	-	-	-
6	-	-	-	1	13.10%	207.24%
7	-	-	-	-	-	-
Default	-	-	-	-	-	-
Total	457	0.04%	4.43%	247	0.06%	4.68%

CCR - Institutions

Table 74: **CCR institution exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	6,182	0.04%	15.57%	8,728	0.04%	14.83%
4	860	0.19%	37.31%	498	0.34%	57.08%
5	335	0.82%	88.82%	40	0.86%	86.08%
6	4	3.91%	130.73%	2	4.68%	139.33%
7	8	56.90%	220.39%	2	48.02%	230.51%
Default	-	-	-	-	-	-
Total	7,389	0.15%	21.70%	9,270	0.07%	17.46%

CCR - Corporates

Table 75: **CCR corporate exposures by PD Grade**

PD Grade	2012 Credit Risk Exposure £m	2012 Exposure Weighted Average PD %	2012 Average Risk Weight %	2011 Credit Risk Exposure £m	2011 Exposure Weighted Average PD %	2011 Average Risk Weight %
1	-	-	-	-	-	-
2	-	-	-	-	-	-
3	1,704	0.04%	26.35%	1,351	0.04%	27.14%
4	2,925	0.67%	67.85%	2,555	0.69%	67.34%
5	1,309	1.31%	110.13%	1,543	1.40%	113.90%
6	211	6.63%	181.72%	212	7.14%	187.29%
7	122	56.90%	216.76%	131	56.90%	217.48%
Default	178	100.00%	-	171	100.00%	-
Total	6,449	4.64%	70.13%	5,963	5.03%	75.90%

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 2012, are presented separately in the table below.

Table 76: **Net derivatives credit exposure**

	2012 £m	2011 £m
Gross positive fair value of contracts	70,028	63,720
Netting benefits	(54,010)	(47,505)
Netted current credit exposure	16,018	16,215
Net potential future credit exposure	10,669	8,379
Collateral held [1]	(7,845)	(5,222)
Total Net Derivatives Credit Exposure	18,842	19,372
Repo contracts	7,497	4,095
Total Counterparty Credit Risk Exposure	26,339	23,467

Notes

[1] 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 2012 was £5.7bn (2011: £10.0bn), an analysis of which is presented in the table below. These transactions relate to credit default swaps and total return swaps.

Table 77: **Notional value of credit derivative transactions**

	2012 Notional Value £m	2011 Notional Value £m
Own credit portfolio – protection bought [1]	2,403	5,796
Own credit portfolio – protection sold [2]	3,329	4,184
Total	5,732	9,980

Notes

[1] Own credit portfolio (protection bought) comprises £2,403m (2011: £5,796m) of credit default swaps.

[2] Own credit portfolio (protection sold) comprises £1,944m (2011: £4,184m) of credit default swaps and £1,385m (2011: nil) of total return swaps.

MARKET RISK

DEFINITION

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

RISK APPETITE

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 cascaded to an appropriate level within their areas of responsibility.

EXPOSURES

Trading Portfolios

The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities. The average 95 per cent 1-day trading Value at Risk (VaR) was £7.0m for the year to 31 December 2012 (2011: £6.0m). 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.

Banking Activities

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.

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. Net investment exposures are disclosed and it is Group policy to hedge non-functional currency exposures.

MEASUREMENT

Market risk is managed within a Board approved framework and risk appetite. A variety of risk measures are used such as:

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

In addition, profit and loss triggers are used in the Trading Books in order to ensure that mitigating action is considered if profit and loss becomes volatile. Both VaR and standard stress measures are 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 per cent confidence interval with a 1-day holding period is equivalent to an expected 1 in 20 day loss.

The Group recognises these limitations and supplements the use of VaR with a variety of other techniques more suited to the nature of the business activity. These 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 the

impact of extreme conditions and to understand more fully the interdependence of different parts of the balance sheet. These measures are reviewed regularly by senior management and to inform effective decision making.

The Group's VaR Model permissions allow it to calculate Pillar 1 market risk capital requirements for the trading book using internal models. 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 heritage portfolios. The capital charge is based on the 10-day 99 per cent VaR calculated by the models. This 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 an Incremental Risk Charge ('IRC') for the trading book.

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'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.

The Group includes an additional Stressed VaR for VaR based capital and a default risk charge that includes the migration risk of issuers of traded instruments. This follows the implementation of CRD III market risk based calculations at the end of 2011.

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 one year dataset can be taken from any period since the beginning of 2007 and therefore potentially include the market movements experienced during the financial crisis. Stressed VaR is calibrated at least quarterly to the period of maximum stress for the current exposures in the Group’s trading books.

The Incremental Risk Charge measures the risks arising from both default and loss inducing rating migrations in the trading book. 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 profit and loss changes arising from migration and default for each portfolio position in turn. The profit and loss 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 models uses a number of methods including but not limited to stress tests, sensitivity analyses and scenarios analyses. The model is reviewed independently of the development team and model adequacy and conservatism is re-assessed over time should the portfolio change over time.

Both the VaR and IRC models are regularly reviewed by an independent validation team. VaR performance, including backtesting analysis, is regularly reviewed by the Model Governance Committee.

Backtesting of VaR Models

The Group compares a hypothetical daily profit and loss with VaR calculated at a 1-day 99 per cent 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 the 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. A backtesting exception is generated when a loss is greater than the 1-day 99 per cent VaR for a given day. The Group’s trading books maintained their green model status in 2012.

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 heritage portfolios. The Group manages its market risk at a consolidated basis and this is reflected in a single CRD III Market Risk waiver permission. Hence backtesting is also done at a consolidated basis to monitor VaR model performance at a consolidated Group level. Below the entity level there is backtesting performed at business area level. The number of exceptions in these portfolios at business area level do not necessarily add up to the number of exceptions in the consolidated portfolio.

Charts comparing VaR to the hypothetical profit and loss on a daily basis, at both entity level and by business area, are provided on pages 107 to 108.

Table 78: **Backtesting results (VaR models)**

2012 Backtesting Results	Zone [1]	Number of reported exceptions
Entity Level		
Lloyds TSB	Green	0
HBOS	Green	2
LBG	Green	0
Business Area		
Rates Trading	Green	1
FX Trading	Green	1
Credit Trading	Green	0
Money Market Trading	Green	1

Note

[1] Green = four exceptions or below; Amber = five to nine exceptions; Red = ten exceptions or more

Analysis

- Statistically the Group would expect to see losses in excess of VaR 1 per cent of the time over a one-year period and the zone categories reflect this expectation. The VaR models have remained well within the green zone at both entity and business area levels. The Group expects exceptions to occur on average 1 per cent of the time and hence has considered that no action is required to rectify or adapt its VaR models.

- The two backtesting exceptions that occurred at HBOS entity level were a result of interest rate movements in GBP. In one case the exception resulted from the Jubilee bank hoilday when GBP markets were closed for two days resulting in a larger movement when GBP markets opened as GBP yields rose significantly to catch up with other markets.

- The Rates Trading and Money Market Trading exceptions were also a result of GBP interest rate movements given that is where most of the Group's Financial Markets activity is focused to support the Group's UK customers. The FX Trading exception occured as a result of the monthly Independent Pricing validation and update of illiquid parameters for the Group's legacy FX Hybrids business.

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.

❖ Full details on the use of valuation models and related adjustments are provided in Note 54 (Financial instruments), Notes to the Consolidated Financial Statements, of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

The main valuation adjustments are summarised below:

- Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking Division.

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

- The Group's derivative trading business applies valuation adjustments against the changing market approach to valuing derivatives that are subject to daily collateral margin, where standard market practice is to pay interest on an Overnight Index Swap basis rather than a Libor rate.

- The carrying amount of issued notes that are designated under the IAS 39 fair value option is adjusted to reflect the effect of changes in own credit spreads.

The 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. The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. Where models are used, the assumptions, methodologies, mathematics and software implementation are assessed and challenged by suitably qualified parties independent of the development process.

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

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 Portfolios

Based on the 1-day 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 2012 and 2011 based on the Group's global trading positions are detailed in the table below.

Table 79: **Trading portfolios: VaR (1-day 95 per cent confidence level)**

VaR Measures	2012 Close £m	2012 Average £m	2012 Maximum £m	2012 Minimum £m
Interest rate risk	2.8	4.2	7.4	1.9
Foreign exchange risk	0.3	0.4	1.0	0.02
Equity risk	-	-	-	-
Credit spread risk	0.8	1.9	3.6	0.7
Inflation risk	0.5	0.5	1.3	0.1
Total VaR	**4.4**	**7.0**	**11.4**	**4.1**

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

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 include 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.

The Group's Stressed VaR (based on a 10-day 99 per cent confidence level) and Incremental Risk Charge measures presented on a similar basis to the VaR measures above are detailed in the table below.

Table 80: **Trading portfolios: Stressed VaR (10-day 99 per cent confidence level) and Incremental Risk Charge**

Stressed VaR / IRC Measures	2012 Close £m	2012 Average £m	2012 Maximum £m	2012 Minimum £m	2011 Close [1] £m
Interest rate risk	45.5	61.6	125.7	24.9	54.4
Foreign exchange risk	17.8	8.7	21.8	0.1	5.8
Credit spread risk	12.2	11.0	27.4	5.4	12.1
Total Stressed VaR	**75.5**	**81.3**	**155.1**	**45.0**	72.3
Incremental Risk Charge	**47.4**	**42.9**	**75.9**	**33.7**	47.2

Notes:

[1] As the Stressed VaR and Incremental Risk Charge measures were formally implemented under CRD III on 31 December 2011, only the close position of each measure has been provided.

Open market risk for the trading operations continues to be low with respect to the size of the Group and similar institutions, reflecting the fact that the Group's trading operations are customer-centric, focusing on hedging and recycling client risks.

Market Risk Capital Requirement

As at 31 December 2012 the capital requirement in respect of market risk in the trading book amounted to £912m (2011: £550m).

Table 81: **Analysis of market risk capital requirement**

Approach / Risk	2012 Capital Requirement £m	2011 Capital Requirement £m
Internal Models Approach		
VaR [1]	119	156
Stressed VaR	280	205
Incremental Risk Charge	47	47
Standardised Approach		
Interest rate position risk requirement	138	137
Foreign currency position risk requirement	23	3
Equity position risk requirement	3	-
Commodity position risk requirement	-	-
Specific interest rate risk of securitisation positions [2]	2	2
	612	550
Temporary capital buffer [3]	300	-
Total	912	550

Notes:

[1] The VaR model capital charge includes £31m (2011: £16m) of additional capital charges calculated in respect of market risk factors captured under the Group's 'Risks not in VaR' framework.

[2] Further details on the calculation of the specific interest rate risk of securitisation positions is provided on page 89 under the Trading Book Securitisations section of the document.

[3] The temporary capital buffer is expected to be removed once specific market risk infrastructure projects have been completed.

The majority of the Group's trading book positions are are assigned a capital requirement under the Internal Models Approach. Where positions in the Group's trading book are not currently included within internal model capital calculations, the market risk capital requirement for these positions is calculated using the FSA standard market risk rules.

No positions within the Group's trading book are subject to the All Price Risk Measure.

Banking Activities

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, the Group's sensitivities at 31 December 2012 to an immediate up and down 25 basis points change to all interest rates.

Table 82: **Banking activities: Market Value sensitivity**

	2012 Up 25bps £m	2012 Down 25bps £m	2011 Up 25bps £m	2011 Down 25bps £m
Sterling	104.9	(108.3)	(53.1)	54.7
US Dollar	14.9	(16.7)	(0.4)	0.3
Euro	14.5	(8.5)	(15.7)	15.9
Australian Dollar	1.0	(1.0)	(1.8)	1.8
Other	(0.1)	0.1	(1.4)	1.3
Total	135.2	(134.4)	(72.4)	74.0

The Group always seeks to maintain minimal interest rate re-pricing mismatch in its banking books. At any point in time, however, some small level of transitory risk will always exist pending, for example, contrary offsetting customer flows and the efficient hedging of the net position with the external market. In addition, during 2012, a number of risks to income

have been managed. These include the potential risk of LIBOR rising relative to the Bank of England Base Rate and the risk to Net Interest Margin of all interest rates remaining lower for longer than is currently implied by current market prices. Such strategic hedges are executed only with the explicit approval of Group Asset and Liability Committee. Overall this hedge portfolio has varied during 2012 as Group Asset and Liability Committee, in response to changing economic conditions, has periodically reviewed and revised its opinion as to which of these various risks is the most likely to crystallise.

Base case market value is calculated on the basis of the Group's 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.

MITIGATION

Various mitigation activities are undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits.

Trading Portfolios and Banking Activities

Management of the balance sheet is centralised and overseen by the Group Asset and Liability Committee. 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.

MONITORING

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure, as part of the wider risk management framework. 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 and triggers are monitored by Risk Division and where appropriate, escalation procedures are in place.

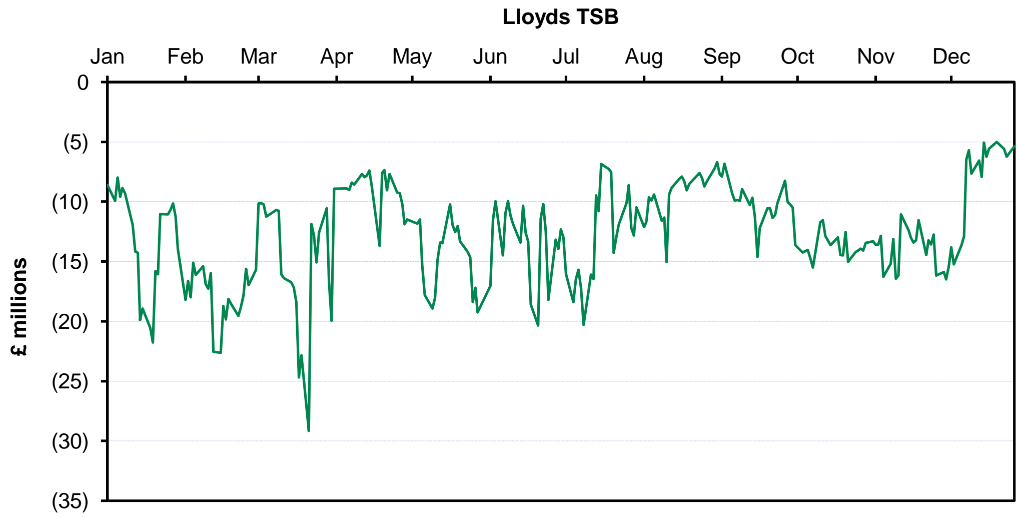
Trading Portfolios and Banking Activities

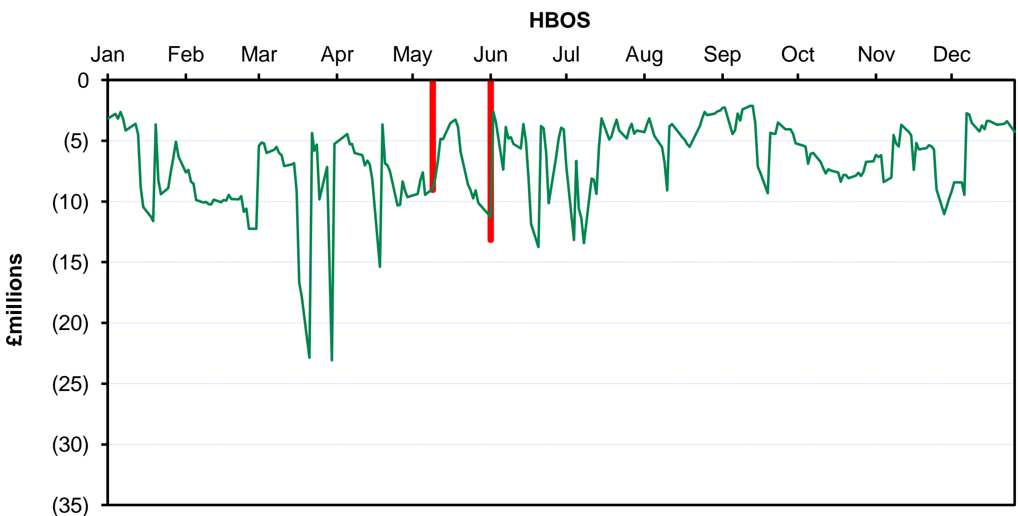
Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

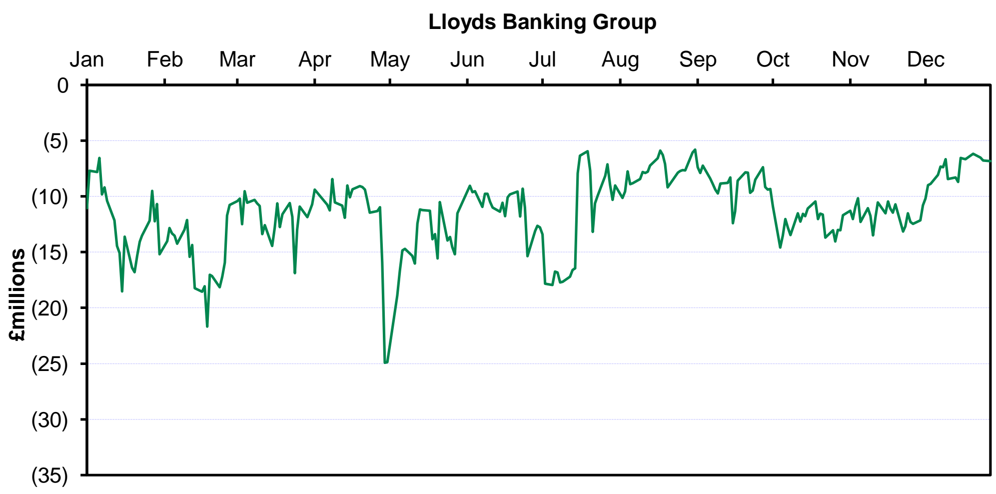
Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed centrally within triggers defined in the Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

Comparison of VaR to Hypothetical Profit and Loss

The following charts provide, by entity, a comparison of VaR (1-day 99 per cent confidence level) to the hypothetical profit and loss on a daily basis over the course of 2012. Backtesting exceptions that arose during period have been identified, with further analysis provided on page 103.

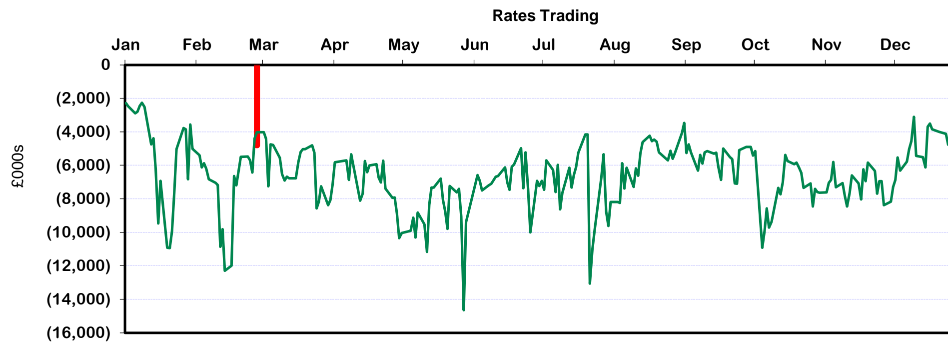


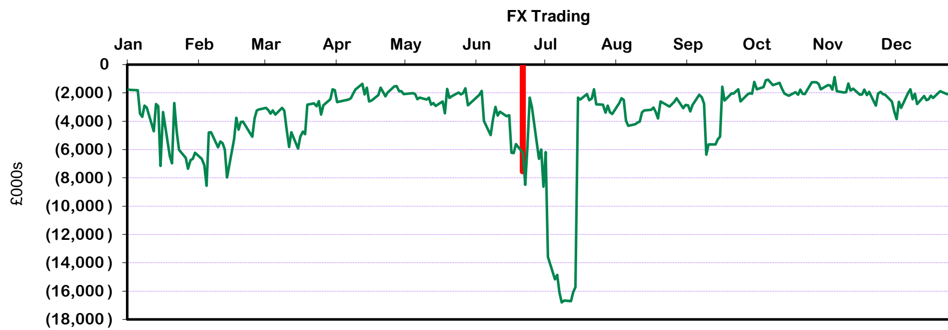


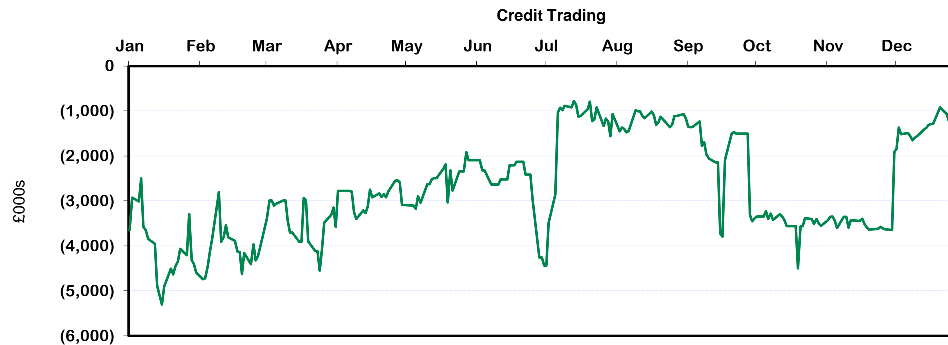


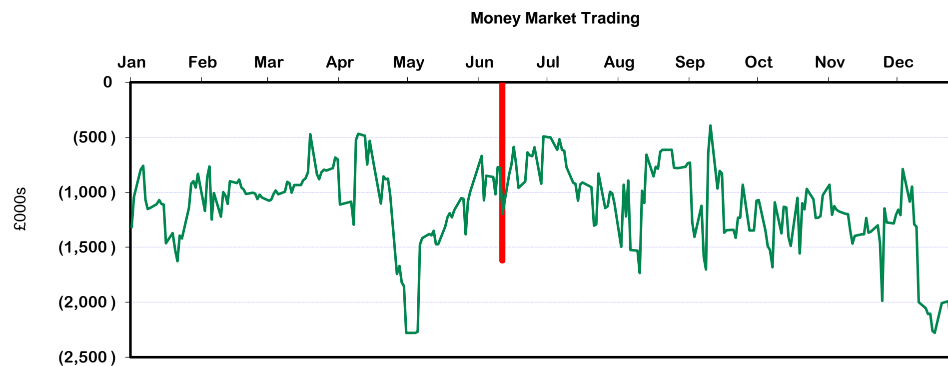
Daily VaR versus hypothetical P&L   Backtesting exception

The following charts provide, by business area, a comparison of VaR (1-day 99 per cent confidence level) to the hypothetical profit and loss on a daily basis over the course of 2012. Backtesting exceptions that arose during period have been identified, with further analysis provided on page 103.









Daily VaR versus hypothetical P&L   Backtesting exception

OPERATIONAL RISK

DEFINITION

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

The Group has implemented an Operational Risk Framework which embraces the risk life-cycle of identification; measurement and assessment; management via appropriate mitigants and controls; and monitoring and reporting. To ensure the rigour of the Operational Risk Framework, the Group defines operational risks in the form of a number of discrete categories, the principal ones being:

- **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.

- **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 and Resilience** – 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. This includes the resilience of the Group's IT infrastructure and systems, rigorous change control processes to minimise the risk of incidents impacting their availability, and formal business continuity and recovery arrangements which are designed and tested to evidence the recoverability of key services within prescribed timescales. Significant business-wide incidents are managed via an incident management process, which is subject to frequent testing.

- **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.

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. Appetite is defined and monitored relative to a number of key indicators, including the size and numbers of material events, and the amounts of operational risk losses that have arisen.

EXPOSURES

The Group's success depends on its ability to attract, retain and develop high calibre talent. Achievement of this aim cannot be guaranteed, particularly in light of ongoing regulatory and public interest in remuneration practices. Macroeconomic conditions and negative media attention on the financial services industry may also adversely impact employee retention, colleague sentiment and engagement.

The continuing structural consolidation and the sale of part of the branch network under Project Verde may result in disruption of senior management's ability to lead and manage the Group effectively. The level and impact of change is managed via robust change management governance and a consolidated Strategic Change Plan. There are separate Governance arrangements in place in Project Verde to oversee the impacts of the divestment on the retained business customers, operations and controls.

The Group's businesses are dependent on processing and reporting accurately and efficiently a high volume of complex transactions across numerous and diverse products and services, in different currencies and subject to a number of different legal and regulatory regimes. The complexity of these operations presents potential risks. In addition, any breach in security of the Group's systems could disrupt its business, result in the disclosure of confidential information and create significant financial and legal exposure.

Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts / events may create economic and political uncertainties, which could have a material adverse effect on UK and international macroeconomic conditions generally, and more specifically on the Group's results of operations, financial condition or prospects in ways that cannot necessarily be predicted.

MEASUREMENT

The Group manages its operational risks via a risk framework which includes definition, monitoring and measurement against appetite targets and thresholds. Appetites are defined with limits and triggers which are approved by the Board and which are regularly reviewed and monitored by the Group Operational Risk Committee. The Group monitors events and losses by size, business unit and internal risk categories. The table below shows high level loss and event trends using Basel II categories.

Table 83: **Operational risk events by risk category**

	% of total volume		% of total value	
	2012	2011	**2012**	2011
Business disruption and system failures	**1.08%**	1.03%	**1.46%**	1.63%
Clients, products and business practices	**15.27%**	18.89%	**58.65%**	54.40%
Damage to physical assets	**0.32%**	0.16%	**0.24%**	0.26%
Employee practices and workplace safety	**0.14%**	0.68%	**0.10%**	0.23%
Execution, delivery and process management	**24.90%**	29.67%	**27.19%**	28.65%
External fraud	**58.02%**	48.89%	**11.99%**	12.98%
Internal fraud	**0.27%**	0.68%	**0.37%**	1.85%
Total	**100.00%**	100.00%	**100.00%**	100.00%

In 2012, the highest frequency of events occurred in external fraud (58.0%) and execution, delivery and process management (24.9%). Clients, products and business practices accounted for 58.7% of losses (54.4% in 2011). The continued high proportion of losses in this category is driven by legacy issues.

The operational risk profile of the Group as a whole and of individual business areas is regularly reviewed within the overarching three lines of defence control framework. Business area reports are reviewed and challenged at Risk Division level, whilst audit and assurance teams ensure that all levels of reporting are subject to rigorous scrutiny.

Operational risk appetites and actual exposures are used by the Group to calculate the appropriate holding of operational risk regulatory capital under the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its operational risk capital requirements using the Standardised Approach (TSA), which the Basel Committee states as being appropriate for an “internationally active” bank.

MITIGATION

Operational risk is relevant to every aspect of the Group’s business and activities. The Group’s operational risk 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

Monitoring and reporting is undertaken at Board, Group committee and business area committee levels, in accordance with delegated limits of authority which are themselves regularly reviewed and refreshed. 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 matters can be escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of systems, monthly reports from business areas, and oversight and challenge from the Risk Division ensures that key risk measures are presented and debated on a monthly basis to an Executive audience.

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 2012, the capital requirement in respect of operational risk amounted to £2,235m (2011: £2,447m), as determined under The Standardised Approach.

APPENDIX 1

CRD IV TRANSITIONAL AND FULLY LOADED CAPITAL POSITIONS

DETAILED ANALYSIS

CRD IV TRANSITIONAL AND FULLY LOADED CAPITAL POSITIONS

A detailed analysis of the Group's estimated CRD IV transitional and fully loaded capital positions, as at 31 December 2012, is provided in the table below. The rules applied are based on the July 2011 version of the draft CRD IV text.

Table 84: **Detailed analysis of CRD IV transitional and fully loaded capital positions**

	CRD IV Transitional Estimate £m	Movement from Transitional to Fully Loaded £m	CRD IV Fully Loaded Estimate £m	Note Reference
Common equity tier 1 (CET1) capital: instruments and reserves				
Capital instruments and related share premium accounts	23,914	-	23,914	
of which: called up share capital	16,872	-	16,872	
of which: share premium	7,042	-	7,042	
Retained earnings	7,183	-	7,183	
Accumulated other comprehensive income and other reserves (including unrealised gains and losses)	12,902	-	12,902	
Minority interests (amount allowed in consolidated CET1)	57	(57)	-	Note 1
Common equity tier 1 (CET1) capital before regulatory adjustments	44,056	(57)	43,999	
Common equity tier 1 (CET1) capital: regulatory adjustments				
Debit valuation adjustments (DVA) and prudent valuation adjustments (PVA)	(376)	-	(376)	
Intangible assets (net of related tax liability)	-	(4,107)	(4,107)	Note 2
Deferred tax assets that rely on future profitability, excluding those arising from temporary differences (net of related tax liability where the conditions in Article 35 (3) of the CRR are met)	(511)	(4,596)	(5,107)	Note 3
Fair value reserves related to gains or losses on cash flow hedges	(350)	-	(350)	
Negative amounts resulting from the calculation of expected loss amounts	-	(1,272)	(1,272)	Note 4
Gains or losses on liabilities valued at fair value resulting from changes in own credit standing	217	-	217	
Defined benefit pension fund assets	(1,438)	-	(1,438)	
Direct, indirect and synthetic holdings by the Group of the CET1 instruments of relevant entities where the Group has a significant investment in those entities (amount above 10% threshold and net of eligible short positions)	-	(5,066)	(5,066)	Note 5
Exposure amount of the following items which qualify for a risk weight of 1,250%, where the Group has opted for the deduction alternative	(366)	-	(366)	
of which: securitisation positions	(366)	-	(366)	Note 6
Amount exceeding the 15% threshold	-	(548)	(548)	
of which: deferred tax assets arising from temporary differences	-	(548)	(548)	Note 7
Regulatory adjustments applied to common equity tier 1 (CET1) in respect of amounts subject to pre-CRR treatment				
Regulatory adjustments relating to unrealised gains and losses pursuant to Articles 449 and 450 of the CRR	(399)	399	-	Note 8
of which: unrealised available-for-sale debt instruments	(343)	343	-	
of which: unrealised available-for-sale equity instruments	(56)	56	-	
Qualifying AT1 deductions that exceed the AT1 capital of the Group	(3,720)	3,720	-	Note 9
Other adjustments	272	-	272	
Total regulatory adjustments applied to common equity tier 1 (CET1)	(6,671)	(11,470)	(18,141)	
COMMON EQUITY TIER 1 (CET1) CAPITAL	37,385	(11,527)	25,858	
Additional tier 1 (AT1) capital: instruments				
Capital instruments and related share premium accounts	5,009	(5,009)	-	
of which: classified as liabilities	5,009	(5,009)	-	
Additional tier 1 (AT1) capital before regulatory adjustments	5,009	(5,009)	-	Note 10
Additional tier 1 (AT1) capital: regulatory adjustments				
Residual amounts deducted from additional tier 1 (AT1) capital with regard to deductions from common equity tier 1 (CET1) capital during the transitional period pursuant to Article 453 of the CRR	(7,276)	7,276	-	Note 11
of which: significant investments	(2,533)	2,533	-	
of which: excess of expected losses over impairment provisions	(636)	636	-	
of which: intangible assets	(4,107)	4,107	-	
Residual amounts deducted from additional tier 1 (AT1) capital with regard to deductions from tier 2 (T2) capital during the transitional period pursuant to Article 455 of the CRR	(1,453)	1,453	-	
of which: significant investments	(1,453)	1,453	-	
Qualifying AT1 deductions that exceed the AT1 capital of the Group	3,720	(3,720)	-	
Total regulatory adjustments applied to additional tier 1 (AT1) capital	(5,009)	5,009	-	
Additional tier 1 (AT1) capital	-	-	-	
TIER 1 CAPITAL	37,385	(11,527)	25,858	
Tier 2 (T2) capital: instruments and provisions				
Capital instruments and related share premium accounts	15,575	(6,728)	8,847	
Qualifying own funds instruments included in consolidated T2 capital (including minority interests and AT1 instruments not included in CET1 or AT1 issued by subsidiaries and held by third parties)	5,415	(1,062)	4,353	
Tier 2 (T2) capital before regulatory adjustments	20,990	(7,790)	13,200	Note 12

Table continued on next page

	CRD IV Transitional Estimate £m	Movement from Transitional to Fully Loaded £m	CRD IV Fully Loaded Estimate £m	Note Reference
Tier (T2) capital: regulatory adjustments				
Residual amounts deducted from tier 2 (T2) capital with regard to deductions from common equity tier 1 (CET1) capital during the transitional period pursuant to Article 453 of the CRR	(3,169)	3,169	-	Note 13
of which: significant investments	(2,533)	2,533	-	
of which: excess of expected losses over impairment provisions	(636)	636	-	
Residual amounts deducted from tier 2 (T2) capital with regard to deductions from additional tier 1 (AT1) capital during the transitional period pursuant to Article 455 of the CRR	(1,453)	1,453	-	
of which: significant investments	(1,453)	1,453	-	
Amount to be deducted from or added to additional tier 2 (AT2) capital with regard to additional filters and deductions required pre CRR	56	(56)	-	
of which: filter for unrealised available-for-sale equity gains	56	(56)	-	
Direct, indirect and synthetic holdings by the Group of the T2 instruments of relevant entities where the Group has a significant investment in those entities (amount above 10% threshold and net of eligible short positions)	-	(2,907)	(2,907)	
Total regulatory adjustments applied to tier 2 (T2) capital	(4,566)	1,659	(2,907)	
TIER 2 (T2) CAPITAL	16,424	(6,131)	10,293	
TOTAL CAPITAL	53,809	(17,658)	36,151	

Notes on Transitional Phasing

[1] Minority interests included in common equity tier 1 capital will be phased out from the second year of transition, at a rate of 20% per annum.

[2] Common equity tier 1 capital regulatory adjustments for intangible assets will be phased in from the second year of transition, at a rate of 20% per annum.

[3] Common equity tier 1 capital regulatory adjustments for deferred tax assets will be phased in, starting at 10% of the balance in the first year of transition, increasing to 20% from the second year of transition and then a further 20% per annum thereafter.

[4] Common equity tier 1 capital regulatory adjustments for negative amounts resulting from the calculation of expected loss amounts will be phased in from the second year of transition, at a rate of 20% per annum.

[5] Common equity tier 1 capital regulatory adjustments for direct, indirect and synthetic holdings by the Group of the CET1 instruments of relevant entities where the Group has a significant investment in those entities will be phased in from the second year of transition, at a rate of 20% per annum.

[6] Securitisation positions will be fully deducted from common equity tier 1 capital in the first year of transition.

[7] Common equity tier 1 capital regulatory adjustments for deferred tax assets arising from temporary differences will be phased in from the second year of transition, at a rate of 20% per annum.

[8] Common equity tier 1 capital regulatory adjustments relating to unrealised gains and losses on available-for-sale debt and equity instruments will be phased out from the second year of transition, at a rate of 20% per annum.

[9] Reallocation to additional tier 1 capital regulatory adjustments (Qualifying AT1 deductions that exceed the AT1 capital of the Group).

[10] Capital instruments recognised as additional tier 1 capital instruments under current rules will continue to be recognised as such under grandfathering provisions that apply during the transitional period. The amounts recognised will be reduced at a rate of 10% per annum from the first year of transition.

[11] Residual amounts deducted from additional tier 1 capital with regard to deductions from common equity tier 1 capital during the transitional period will be phased into common equity tier 1 capital from the second year of transition at a rate of 20% per annum.

[12] Capital instruments recognised as tier 2 capital instruments under current rules will continue to be recognised as such under grandfathering provisions that apply during the transitional period. The amounts recognised will be reduced at a rate of 10% per annum from the first year of transition.

[13] Residual amounts deducted from tier 2 capital with regard to deductions from common equity tier 1 capital during the transitional period will be phased into common equity tier 1 capital from the second year of transition at a rate of 20% per annum.

APPENDIX 2

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 2012 are presented in the table below.

Table 85: **Lloyds TSB Bank Group capital resources**

	2012		2011	
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		48,401		50,599
Non-controlling interests per balance sheet		685		674
Regulatory adjustments:				
Regulatory adjustments to non-controlling interests		(628)		(577)
Adjustment for own credit		217		(136)
Defined benefit pension adjustment		(1,438)		(1,004)
Unrealised reserve on available-for-sale debt securities		315		(282)
Unrealised reserve on available-for-sale equity investments		(56)		(386)
Cash flow hedging reserve		(590)		(576)
Other items		33		(36)
		46,939		48,276
Less: deductions from core tier 1				
Goodwill		(2,016)		(2,016)
Intangible assets		(2,091)		(2,310)
50% excess of expected losses over impairment provisions		(636)		(720)
50% of securitisation positions		(183)		(153)
Core tier 1 capital		42,013		43,077
Non-controlling preference shares [1]		2,343		2,199
Preferred securities [1]		4,766		5,038
Less: deductions from tier 1				
50% of material holdings		(46)		(94)
Total tier 1 capital		49,076		50,220
Total tier 1 capital (excluding preferred securities)	*44,310*		*45,182*	
Tier 2				
Undated subordinated debt		1,996		2,067
Dated subordinated debt		21,082		22,469
Unrealised gains on available-for-sale equity investments		56		386
Eligible provisions		977		1,259
Less: deductions from tier 2				
50% excess of expected losses over impairment provisions		(636)		(720)
50% of securitisation positions		(183)		(153)
50% of material holdings		(46)		(94)
Total tier 2 capital		23,246		25,214
Total tier 2 capital (including preferred securities)	*28,012*		*30,252*	
Supervisory deductions [2]				
Unconsolidated investments – life		(10,104)		(10,107)
Unconsolidated investments – general insurance and other		(929)		(2,660)
Connected lending of a capital nature		(10,159)		(10,392)
Total supervisory deductions		(21,192)		(23,159)
Total Capital Resources		51,130		52,275
Risk Weighted Assets		310,299		352,341
Core tier 1 capital ratio (%)		13.5%		12.2%
Tier 1 capital ratio (%)		15.8%		14.3%
Total capital ratio (%)		16.5%		14.8%

Notes

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

[2] Prior year comparatives on supervisory deductions have been re-presented to reflect the reanalysis of connected lending amounts that were previously incorporated within unconsolidated investments.

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 2012 are presented in the table below.

Table 86: **Lloyds TSB Bank Group capital requirements**

(All figures are in £m)	2012 Risk Weighted Assets	2012 Pillar 1 Capital Requirements	2011 Risk Weighted Assets	2011 Pillar 1 Capital Requirements
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	54,835	4,387	60,405	4,832
Corporate - SME	12,628	1,010	15,168	1,213
Corporate - Specialised lending	5,368	429	6,683	535
Central governments and central banks	1,437	115	1,299	104
Institutions	1,447	116	2,426	194
Retail IRB Approach				
Retail - Residential mortgages	56,527	4,522	58,926	4,714
Retail - Qualifying revolving retail exposures	17,261	1,381	19,112	1,529
Retail - Other retail	15,206	1,216	18,479	1,478
Retail - SME	2,451	196	2,306	184
Other IRB Approaches				
Corporate - Specialised lending	4,897	392	4,469	358
Equities - Exchange traded	248	20	-	-
Equities - Private equity	4,917	393	-	-
Equities - Other	544	44	57	5
Securitisation positions	6,687	535	9,376	750
Total - IRB Approach	184,453	14,756	198,706	15,896
Exposures subject to the Standardised Approach				
Central governments and central banks	105	9	57	5
Regional governments or local authorities	18	1	8	1
Administrative bodies and non-commercial undertakings	62	5	361	29
Multilateral development banks	-	-	-	-
Institutions	566	45	399	32
Corporates	25,537	2,043	33,478	2,678
Retail	5,604	448	6,030	482
Secured by mortgages on residential property	6,950	556	8,090	647
Secured by mortgages on commercial real estate	15,200	1,216	23,383	1,871
Past due items	6,218	498	9,907	792
Items belonging to regulatory high risk categories	1	-	3,603	288
Short term claims on institutions or corporates	187	15	451	36
Collective investment undertakings	53	4	24	2
Other items	13,164	1,053	17,734	1,419
Total - Standardised Approach	73,665	5,893	103,525	8,282
Total Credit Risk	258,118	20,649	302,231	24,178
COUNTERPARTY CREDIT RISK				
IRB Approach	6,162	493	6,170	494
Standardised Approach	6,686	535	6,474	518
Total Counterparty Credit Risk	12,848	1,028	12,644	1,012
MARKET RISK				
Internal Models Approach	9,316	746	5,096	408
Standardised Approach				
Interest rate position risk requirement	1,719	138	1,717	137
Foreign currency position risk requirement	291	23	40	3
Equity position risk requirement	41	3	-	-
Commodity position risk requirement	5	-	6	-
Specific interest rate risk of securitisation positions	22	2	18	2
Total Market Risk	11,394	912	6,877	550
OPERATIONAL RISK				
Standardised Approach	27,939	2,235	30,589	2,447
Total Operational Risk	27,939	2,235	30,589	2,447
TOTAL	310,299	24,824	352,341	28,187

APPENDIX 3

BOS GROUP

CAPITAL RESOURCES AND CAPITAL REQUIREMENTS

BOS GROUP CAPITAL RESOURCES

The capital resources of BOS Group as at 31 December 2012 are presented in the table below.

Table 87: **BOS Group capital resources**

		2012		2011
	£m	£m	£m	£m
Core tier 1				
Shareholders' equity per balance sheet		18,114		18,397
Non-controlling interests per balance sheet		20		16
Regulatory adjustments:				
Regulatory adjustments to non-controlling interests		7		12
Unrealised reserve on available-for-sale debt securities		178		859
Unrealised reserve on available-for-sale equity investments		(33)		(342)
Cash flow hedging reserve		(1,238)		(861)
Other items		-		(16)
		17,048		18,065
Less: deductions from core tier 1				
Goodwill		(374)		(416)
Intangible assets		(92)		(69)
50% excess of expected losses over impairment provisions		(550)		(684)
50% of securitisation positions		(113)		(84)
Core tier 1 capital		15,919		16,812
Preferred securities [1]		700		700
Less: deductions from tier 1				
50% of material holdings		(3)		(80)
Total tier 1 capital		16,616		17,432
Total tier 1 capital (excluding preferred securities)	*15,916*		*16,732*	
Tier 2				
Undated subordinated debt		4,776		4,812
Dated subordinated debt		7,530		7,639
Unrealised gains on available-for-sale equity investments		33		342
Eligible provisions		942		1,203
Less: deductions from tier 2				
50% excess of expected losses over impairment provisions		(550)		(684)
50% of securitisation positions		(113)		(84)
50% of material holdings		(3)		(80)
Total tier 2 capital		12,615		13,148
Total tier 2 capital (including preferred securities)	*13,315*		*13,848*	
Supervisory Deductions				
Unconsolidated investments		(919)		(983)
Total supervisory deductions		(919)		(983)
Total Capital Resources		28,312		29,597
Risk Weighted Assets		162,582		199,249
Core tier 1 capital ratio (%)		9.8%		8.4%
Tier 1 capital ratio (%)		10.2%		8.7%
Total capital ratio (%)		17.4%		14.9%

Notes

[1] Preferred securities represent the Group's hybrid capital securities. 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 2012 are presented in the table below.

Table 88: **BOS Group capital requirements**

(All figures are in £m)	2012 Risk Weighted Assets £m	2012 Pillar 1 Capital Requirements £m	2011 Risk Weighted Assets £m	2011 Pillar 1 Capital Requirements £m
CREDIT RISK				
Exposures subject to the IRB Approach				
Foundation IRB Approach				
Corporate - Main	13,534	1,083	17,730	1,418
Corporate - SME	4,334	347	6,373	510
Central governments and central banks	99	8	12	1
Institutions	568	45	1,059	85
Retail IRB Approach				
Retail - Residential mortgages	41,885	3,351	43,357	3,468
Retail - Qualifying revolving retail exposures	8,307	665	8,846	708
Retail - Other retail	3,946	316	4,626	370
Other IRB Approaches				
Corporate - Specialised lending	1,026	82	1,070	86
Equities - Exchange traded	217	17	-	-
Equities - Private equity	1,187	95	-	-
Equities - Other	544	43	57	5
Securitisation positions	2,652	212	4,740	379
Total - IRB Approach	78,299	6,264	87,870	7,030
Exposures subject to the Standardised Approach				
Central governments and central banks	-	-	-	-
Regional governments or local authorities	18	1	8	1
Administrative bodies and non-commercial undertakings	59	5	360	29
Institutions	158	13	176	14
Corporates	20,356	1,628	27,093	2,167
Retail	4,032	323	4,392	351
Secured by mortgages on residential property	5,210	417	6,207	496
Secured by mortgages on commercial real estate	14,898	1,192	23,048	1,844
Past due items	5,630	450	9,655	772
Items belonging to regulatory high risk categories	1	-	3,331	267
Short term claims on institutions or corporates	187	15	219	18
Collective investment undertakings	38	3	8	1
Other items	6,720	538	10,706	856
Total - Standardised Approach	57,307	4,585	85,203	6,816
Total Credit Risk	135,606	10,849	173,073	13,846
COUNTERPARTY CREDIT RISK				
IRB Approach	592	47	653	52
Standardised Approach	6,532	523	6,286	503
Total Counterparty Credit Risk	7,124	570	6,939	555
MARKET RISK				
Internal Models Approach	4,766	381	2,652	212
Standardised Approach				
Interest rate position risk requirement	454	36	545	44
Foreign currency position risk requirement	47	4	15	1
Equity position risk requirement	41	3	-	-
Total Market Risk	5,308	424	3,212	257
OPERATIONAL RISK				
Standardised Approach	14,544	1,163	16,025	1,282
Total Operational Risk	14,544	1,163	16,025	1,282
TOTAL	162,582	13,006	199,249	15,940

APPENDIX 4

REMUNERATION DISCLOSURES

REMUNERATION DISCLOSURES

This section discloses the remuneration awards made by the Group to 139 Code Staff (2011: 144) in respect of the 2012 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 2012 there were 139 Code Staff (2011: 144) identified across the Group.

Aggregate Remuneration Expenditure (Code Staff)

Table 89: **Analysis of aggregate remuneration expenditure by division**

	Dec 2012 Retail £m	Dec 2012 Commercial Banking £m	Dec 2012 WAFI £m	Dec 2012 Insurance £m	Dec 2012 Group Operations £m	Dec 2012 Group Functions £m	Dec 2012 TOTAL £m
Aggregate remuneration expenditure	7.9	14.8	6.8	0.6	5.6	35.6	71.3

	Dec 2011 Retail £m	Dec 2011 Commercial Banking £m	Dec 2011 WAFI £m	Dec 2011 Insurance £m	Dec 2011 Group Operations £m	Dec 2011 Group Functions £m	Dec 2010 TOTAL £m
Aggregate remuneration expenditure [1]	10.6	16.2	8.8	2.4	5.6	37.5	81.1

Notes

[1] The aggregate remuneration expenditure analysis for 2011 has been restated to provide a clearer year-on-year comparison following the impact of changes in the organisational structure during 2012.

Analysis of Remuneration between Fixed and Variable Amounts

Table 90: **Analysis of remuneration between fixed and variable amounts**

	Dec 2012 Total	Dec 2012 Senior Managers [1]	Dec 2012 Others
Number of Code Staff	139	103	36
	£m	£m	£m
Fixed:			
Cash based	31.7	26.2	5.5
Total Fixed Pay	31.7	26.2	5.5
Variable:			
Cash	0.2	0.2	0.0
Retained shares [2]	12.1	8.5	3.6
Deferred shares	16.7	12.3	4.4
Total Variable Pay	29.0	21.0	8.0
LTIP [3]	10.6	9.3	1.3

Notes

[1] Senior Managers are defined as Group Executive Committee members and their direct reports (excluding the direct reports of the Group HR Director and the Group Corporate Affairs Director, where they are not also Approved Persons). The proportion of individuals disclosed as Senior Managers has

increased on the previous year due to changes in organisational structure which has seen more individuals come within the scope of this category. In addition, a number of individuals identified as registered persons in accordance with FSA guidance also meet the definition of Senior Managers and are therefore reported in this latter category.

[2] Shares subject to retention period.

[3] Notional value.

	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 (excluding 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.

Analysis of Deferred Remuneration

Table 91: **Analysis of deferred remuneration**

	2012 Code Staff £m
Deferred remuneration at 31 December 2012	
Outstanding, vested	**-**
Outstanding, unvested	**106.9**
Awarded during the financial year	**68.6**
Paid out	**13.7**
Reduced through performance adjustment [1]	**0.6**

[1] Excludes the adjusted value of awards which were forfeited by colleagues upon leaving the Group. In addition, the Remuneration Committee has recommended to the Board that it should again exercise its discretion to adjust the value of certain 2010 bonus awards, on a basis equivalent to that applied in the previous year. Any adjustments in this respect will be made in 2013.

	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	-

Analysis of Sign-On and Severance Payments

Table 92: **Analysis of sign-on and severance payments**

	Dec 2012 Code Staff
Severance payments	
Made during the year	**£0.2m**
Number of beneficiaries	**2**
Highest such award to a single person	**£0.1m**

	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

There were no sign-on awards made to Code Staff during 2012 (2011: nil).

Decision Making Process for Remuneration Policy

The ongoing economic challenges currently encountered in the Group's industry and across all aspects of life lead to consistent scrutiny being placed on executive remuneration. The Group has a strong belief in aligning the pay delivered to its executives with the successful performance of the business and, through this, the return of value to the Group's shareholders. The Group has continued to seek the views of shareholders and other key stakeholders with regard to remuneration policy, whilst ensuring that it continues 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 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 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.

Whilst 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 2013, as the Group recognises the responsibilities it has 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 2012 were Anthony Watson (chairman); Sir Winfried Bischoff; Carolyn Fairbairn (from 1 June 2012); Sir Julian Horn-Smith (until 17 May 2012); Lord Leitch (until 29 February 2012); David Roberts (also chairman of the Risk Committee); Tim Ryan and Sara Weller (from 1 February 2012).

During 2012, the Committee met 10 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 have voluntarily signed up to the Remuneration Consultants' Code of Conduct and are judged by the Committee to be independent.

António Horta-Osório, Cathy Turner (as Chief Administrative Officer from 1 June 2012), Angie Risley (Group HR Director until 31 August 2012), Rupert McNeil (Group HR Director from 1 September 2012), Liz Jackson (HR Director, Reward until 31 March 2012) and Paul Hucknall (HR Director, Reward from 1 April 2012) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer), Tim Tookey (Group Finance Director until 24 February 2012) and George Culmer (Group Finance Director from 16 May 2012) also attended the Committee to advise as and when necessary on risk and financial matters.

Link Between Pay and Performance

The Group has a strong belief in aligning the pay delivered to its executives with the successful performance of the business and, through this, the return of value to its shareholders as set out in the Group's 2011 Strategic Review. To this end, the Group has continued to develop its performance management process, with the close participation of the Group's Risk team, to embed meaningful challenging but responsible performance measures across the Group's reward structure which reflects Group and divisional achievement in addition to personal contribution.

The introduction of a balanced scorecard approach to measure long-term performance enables 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 Group's remuneration proposition is both cost effective and enables it 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 the Group balances the requirements of its various stakeholders: its 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:

Component	%
Long-term incentive	**24%**
Short-term incentive	**33%**
Salary	**33%**
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 2012 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 2012 annual incentive is subject to deferral in shares until at least 2015. 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 2012 annual bonus for Executive Directors is deferred in shares until at least March 2015 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 and is an important tool for aligning the Group's reward strategy to the performance of the business. Through the application of carefully considered, stretching target measures, the Group can ensure that awards are forfeited or restricted where performance does not meet the desired level. This directly connects the financial reward for the executive and senior management team with the growth and prosperity of the Company and motivates them to demonstrate appropriate behaviours across all areas of the business.

Executives are also aligned with shareholders through the LTIP, which pays out in shares based on performance against Group financial targets over a three year period. The Committee believes that the performance measures for the 2013 LTIP award for the Executive Committee should incorporate core financial measures alongside strategic non-financial measures to fulfil the Company's operating plan. These measures capture risk management, profit growth and shareholder experience and align shareholder experience and management reward.

Long-term incentive performance measures

During 2012, 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. In addition to the purely financial metrics of Economic Profit and Total Shareholder Return, the performance conditions for the 2013 LTIP will comprise measures linked to the Strategic Review that reflect the wider Group objectives. These measures are SME lending, customer satisfaction, total costs at the end of 2015 and non-core assets (excluding UK Retail) at the end of 2015.

Measure	Basis	Metric	Weighting
Economic Profit	Payout range set relative to 2015 targets	Threshold: £1,254m Maximum: £1,881m	35%
Absolute TSR	Growth in share price including dividends	Threshold: 8% pa Maximum: 16% pa	30%
Customer satisfaction (FSA reportable complaints per 1,000 customers over 3 years)	Payout range set relative to 2015 targets	Threshold: 1.05 Maximum: 0.95	10%
Total costs	Payout range set relative to 2015 targets	Threshold: <= £9,323m Maximum: <= £8,973m	10%
Non-core assets at end of 2015 (excluding UK Retail)	Payout range set relative to 2015 targets	Threshold: < / = £37bn Maximum: < / = £28bn	10%
SME lending	Payout range set relative to performance against market in lending to SMEs over 3 year period to 2015	Threshold: at market Maximum: 4%	5%

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 last updated in April 2012 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 98 to 114 of the 2012 Lloyds Banking Group plc Annual Report and Accounts.

APPENDIX 5

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**

Backtesting
Application of an analytical method where historical data is used to determine how accurately the model has predicted actual results.

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 2.5
The 2009 update to the Basel II framework to strengthen market risk and securitisation capital requirements and to enhance disclosure in these areas. See also **CRD III**.

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. See also **CRD IV**.

Basel III Leverage Ratio
A capital leverage measure, introduced under the Basel III reforms, that is defined as the ratio of tier 1 capital to total exposures, where total exposures equal the sum of all balance sheet assets and off-balance sheet items not deducted in determining tier 1 capital. The leverage ratio is intended to reinforce risk based capital requirements with a simple, non-risk based 'backstop' measure.

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.

Buy-to-let mortgages
Buy-to-let mortgages are those mortgages offered to customers purchasing residential property as a retail investment.

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.

Common equity tier 1 (CET1) capital
The highest quality form of regulatory capital under Basel III that comprises common shares issued and related share premium, retained earnings and other reserves excluding the cash flow hedging reserve, less specified regulatory adjustments.

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 Cancara, Argento 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.

CRD III

Implemented on 31 December 2011 through an EU directive, CRD III strengthened the capital requirements for the trading book, imposed higher capital requirements for re-securitisations, required enhanced public disclosures under Pillar 3 of the capital framework and updated disclosure standards for market risk and securitisations.

CRD IV

In 2011 the European Commission published its proposed legislation for a Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR), which form the CRD IV package. The package implements the Basel III proposals in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. The rules are set to be implemented from 2013 with certain sections set to be phased in.

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 mitigation

A technique used to reduce the credit risk associated with an exposure (which continues to be held) by application of credit risk mitigants such as collateral, guarantees and credit protection.

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, and can be granted on a temporary or permanent basis.

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.

Term	Definition
Hybrid capital securities	Under CRD II, forms of capital securities that are ineligible for inclusion within core tier 1 capital may be included in non-core tier 1 capital if they qualify to be recognised as hybrid capital securities. Such securities must display a greater degree of permanence and loss absorbency than other subordinated liabilities, have flexibility surrounding coupon or dividend payments and include the ability to write down or to convert into ordinary shares upon a trigger event.
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.
Interest rate risk (IRR)	Interest rate risk represents the risk that investment values will change due to a change in the absolute value of interest rates.
Internal Assessment Approach (IAA)	The Internal Assessment Approach is an IRB approach for securitisations whereby a firm applies its internal assessment of the credit quality of the positions in the risk weighted asset calculations. A firm must apply to the FSA for permission to use this approach and must satisfy the FSA of its internal assessment processes. The Internal Assessment Approach may only be applied to exposures arising from asset backed commercial paper programmes.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, based on Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events as they apply on a solo level and on a consolidated level.
Internal Model Method (IMM)	The Internal Model Method is one of three methods available to calculate exposure values for counterparty credit risk. A firm must only apply the IMM if it has counterparty credit risk IMM permission from the FSA.
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.
Mark-to-Market (MTM) Approach	The Mark-to-Market Approach is one of three methods available to calculate exposure values for counterparty credit risk. The method adjusts daily to account for profits and losses in the value of related assets and liabilities.
Market risk	The risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments) lead to reductions in earnings and / or value.
Model validation	The process of assessing and providing evidence that the bank's models perform as planned and adequately reflect the risk profile of the business, and that there are no material misstatements of the capital requirement. See also **Backtesting**.
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.
Pillar 1	The first pillar of the Basel II framework sets out the minimum regulatory capital requirements for credit, operational and market risks.
Pillar 2	The second pillar of the Basel II framework is known as the Supervisory Review Process, and sets out the review process for a banks capital adequacy; the process under which the supervisors evaluate how well financial institutions are assessing their risks and the actions taken as a result of these assessments.

Pillar 3
The third pillar of the Basel II framework aims to encourage market discipline by setting out disclosure requirements for banks on their capital, risk exposures and risk assessment processes. These disclosures are aimed at improving the information made available to the market.

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.

Ratings Based Approach (RBA)
The Ratings Based Approach is an IRB approach for securitisations applied to rated securitisation and re-securitisation positions. The approach applies risk weightings to positions based on a combination of ECAI ratings, the granularity of the underlying pool, the seniority of the position and whether the position is a re-securitisation position.

Regulatory capital
The amount of capital that the Group holds, determined in accordance with rules established by the FSA for the consolidated Group and by local regulators for individual Group companies.

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 appetite
The amount and type of risk that the Group is prepared to seek, accept or tolerate.

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.

Securities financing transactions (SFTs)
Securities financing transactions are repurchase and reverse repurchase agreements, buy / sell backs and securities lending. For the lender (seller) of the securities it is usually a way to raise funds to finance the securities positions. For the borrower (buyer) of the securities it is a way to invest short–term funds or to cover short (bond) positions.

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.

Sovereign exposures
Exposures to central governments and central government departments, central banks and entities owned or guaranteed by the aforementioned.

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.

Stressed VaR (SVaR)
Stressed VaR is a one year forward looking measure of VaR where certain parameters of the portfolio

are calculated under a period of stress.

Stress testing

Stress and scenario testing is the term used to describe techniques where plausible events are considered as vulnerabilities to ascertain how this will impact the capital resources which are required to be held.

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.

Trading book

Positions in financial instruments and commodities held for trading purposes or to hedge other elements of the trading book.

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.

Wrong way risk

The risk that arises from the correlation between a counterparty exposure and the credit quality of the counterparty. It is therefore the risk that the probability of default of the counterparty increases with the exposure.

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