

# Lloyds TSB Bank plc

Report and Accounts

2007

Member of Lloyds TSB Group



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## Directors' report

### Results and dividends

The consolidated income statement on page 10 shows a profit attributable to equity shareholders for the year ended 31 December 2007 of £3,384 million. An interim dividend of £632 million for the year ended 31 December 2007 was paid on 3 October 2007. A second interim dividend of £1,621 million will be paid on 7 May 2008.

### Principal activities

The Bank and its subsidiaries provide a wide range of banking and financial services through branches and offices in the UK and overseas.

### Business review

The Lloyds TSB Bank Group's strategy is to grow the business by building strong customer franchises and, by realising the considerable potential within these franchises, the Group has continued to achieve strong results. During 2007, the Group has continued to extend the reach and depth of its customer relationships, achieving good sales growth, while improving productivity and efficiency. This has resulted in a strong performance against the backdrop of significant turbulence in global financial markets. Profit before tax was £193 million or 5 per cent lower at £4,089 million, compared with £4,282 million in 2006. However, profit attributable to equity shareholders was £3,384 million, an increase of £468 million, or 16 per cent, compared with £2,916 million in 2006, and the post-tax return on equity increased to 26.8 per cent from 25.0 per cent. Like many other financial institutions, the Group has been affected by the recent market dislocation. However the relationship focus of the Group's strategy has limited the impact. In addition the Group has achieved substantial gains, totalling £657 million, on the disposal of non-core businesses.

Along with a number of other UK banks, during the year the Group has received a number of customer claims for the repayment of overdraft fees. On 27 July 2007, several banks, together with the Office of Fair Trading, asked the High Court of England and Wales to clarify the legal position regarding personal current account fees. The 2007 results include a charge of £76 million relating to the settlement of claims during the year, together with related costs.

The Group's income statement includes substantial amounts of income and expenditure attributable to the policyholders of the Group's long-term assurance funds, which are consolidated to meet the requirements of accounting standards. These amounts are volatile and can cause significant variations in net interest income, other income and insurance claims. However they have no overall effect upon profit attributable to equity shareholders. Fluctuations in the value of the Group's investments supporting its insurance liabilities can also result in significant volatility in profit before tax. In order to provide a clearer representation of the underlying performance of the business, the impact of policyholder items has been excluded and an expected return on the Group's investments supporting its insurance liabilities has been included: the difference between this and the actual return is disclosed as insurance volatility. In addition the gain on sale of non-core businesses, the costs of settling overdraft claims and, in 2006, the pension schemes related credit have been excluded.

## Directors' report

A reconciliation of Group and divisional performance, calculated on the basis set out above, to the statutory results is set out below.

### Summarised segmental analysis 2007

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up £m	Group £m
Net interest income	3,783	68	2,518	(704)	5,665	461	6,126
Other income	1,797	1,900	1,773	378	5,848	6,804	12,652
Total income	5,580	1,968	4,291	(326)	11,513	7,265	18,778
Insurance claims	–	(302)	–	–	(302)	(7,220)	(7,522)
Total income, net of insurance claims	5,580	1,666	4,291	(326)	11,211	45	11,256
Operating expenses	(2,548)	(636)	(2,282)	33	(5,433)	(19)	(5,452)
Trading surplus	3,032	1,030	2,009	(293)	5,778	26	5,804
Impairment	(1,224)	–	(572)	–	(1,796)	–	(1,796)
Profit (loss) before tax*	1,808	1,030	1,437	(293)	3,982	26	4,008
Volatility:							
Insurance	–	(267)	–	–	(267)	–	(267)
Policyholder interests	–	–	–	–	–	(233)	(233)
Profit on sale of businesses	–	272	385	–	657	–	657
Settlement of overdraft claims	(76)	–	–	–	(76)	–	(76)
Profit (loss) before tax	1,732	1,035	1,822	(293)	4,296	(207)	4,089

### 2006

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Group excluding insurance gross up £m	Insurance gross up £m	Group £m
Net interest income	3,642	56	2,177	(591)	5,284	78	5,362
Other income	1,621	1,740	2,035	194	5,590	8,306	13,896
Total income	5,263	1,796	4,212	(397)	10,874	8,384	19,258
Insurance claims	–	(200)	–	–	(200)	(8,369)	(8,569)
Total income, net of insurance claims	5,263	1,596	4,212	(397)	10,674	15	10,689
Operating expenses	(2,476)	(646)	(2,264)	(12)	(5,398)	8	(5,390)
Trading surplus	2,787	950	1,948	(409)	5,276	23	5,299
Impairment	(1,238)	–	(308)	(9)	(1,555)	–	(1,555)
Profit (loss) before tax*	1,549	950	1,640	(418)	3,721	23	3,744
Volatility:							
Insurance	–	84	–	–	84	–	84
Policyholder interests	–	–	–	–	–	326	326
Pension schemes related credit	–	–	–	128	128	–	128
Profit (loss) before tax	1,549	1,034	1,640	(290)	3,933	349	4,282

\*Excluding volatility, profit on sale of businesses, the settlement of overdraft claims in 2007 and the pension schemes related credit in 2006.

In 2007, the Group continued to achieve good levels of underlying earnings growth, underpinned by continued momentum in all divisions. On an adjusted basis, profit before tax increased by £261 million, or 7 per cent, to £3,982 million from £3,721 million, notwithstanding the impact of the £280 million market dislocation in Corporate Markets. Revenue growth of 5 per cent exceeded cost growth of 1 per cent, with each division delivering stronger year-on-year revenue growth than cost growth.

## Directors' report

Group net interest income increased by £381 million, or 7 per cent, compared with 2006. Strong levels of customer lending growth in Commercial Banking and Corporate Markets, and good growth in mortgages and retail deposits, more than offset the marketwide impact of lower personal lending balances.

Customer deposits increased by 11 per cent to £157 billion, supported by strong growth in savings balances in the retail bank, where bank savings increased by 15 per cent and wealth management balances grew by 12 per cent. Customer deposits in Wholesale and International Banking increased by 18 per cent.

Other income increased by £258 million, or 5 per cent, to £5,848 million. This reflected higher fees and commissions receivable as a result of strong growth in added value current accounts and higher insurance commissions in the retail bank. In addition, good levels of growth were achieved in non-lending related sales to corporate and commercial banking customers.

The Group continues to make significant investment in improving processing efficiency, resulting in an excellent cost performance. During 2007, operating expenses increased by only 1 per cent to £5,433 million. Over the past 12 months, staff numbers have fallen by 4,552 (7 per cent) to 58,078, largely as a result of greater efficiency in back office processing centres and the disposal of Lloyds TSB Registrars and Dutton-Forshaw. These improvements in operational effectiveness have resulted in a further reduction in the Group cost:income ratio from 50.6 per cent to 48.5 per cent.

Impairment losses increased by 15 per cent to £1,796 million. Our impairment charge on loans and advances expressed as a percentage of average lending was 0.82 per cent, excluding the impact of market dislocation and the 2007 Finance Act, compared with 0.83 per cent in 2006. Impaired lending increased by 8 per cent to £5,311 million, less than the rate of lending growth, and now represents 2.5 per cent of total lending, down from 2.6 per cent at 31 December 2006.

Profit before tax from UK Retail Banking increased by £259 million, or 17 per cent, to £1,808 million, reflecting strong income momentum, up 6 per cent; excellent cost management, with a clear focus on investing to improve processing efficiency and service quality; and a 1 per cent reduction in the impairment charge.

During 2007, UK Retail Banking continued to make substantial progress in each of its key strategic priorities: growing income from its existing customer base; expanding its customer franchise; and improving productivity and efficiency. In each of these areas, a key focus has been on improving sales of recurring income products, such as savings and bancassurance products, which, combined with higher lending related income, has supported the accelerating rate of revenue growth.

The Retail Bank has continued to make excellent progress, with further strong growth in product sales and continued good revenue growth. The Group has continued to increase its market share of new current account customers. It has also performed well in the growing savings and investment market, especially in bank savings, where it has recently benefited from a significantly improved rate of deposit growth.

Overall sales increased by 17 per cent, with improvements over a broad range of products, especially current accounts, bank savings and bancassurance products. Sales volumes were particularly strong in the branch network with an increase of 24 per cent. This continued strong sales growth has benefited from higher levels of new product innovation over the last twelve months with the successful launch of a number of enhanced savings products, an improved range of added value current accounts and the introduction of the innovative Lloyds TSB Duo Airmiles credit card. Customer deposits have increased strongly, by 8 per cent over the past twelve months, with particularly strong progress in growing our bank savings and wealth management deposit balances, with increases of 15 per cent and 12 per cent respectively.

Gross new mortgage lending for the Group totalled £29.4 billion (2006: £27.6 billion). Mortgage balances outstanding increased by 7 per cent to £102.0 billion and net new lending totalled £6.7 billion, resulting in a market share of net new lending of approximately 6.2 per cent.

In addition to the strong growth in product sales from existing customers, the Group has continued to make progress in expanding its customer franchise. Current account recruitment increased by 17 per cent, compared with last year, supported by the range of added value current accounts, in particular the Silver Account focusing on foreign nationals. During 2007, the Group acquired more than 1 million new current account customers.

Impairment losses decreased by £14 million, or 1 per cent, to £1,224 million. During 2007, there has been a reduction in the level of customer insolvencies, improvements in the Group's collections procedures and better than assumed recoveries. The quality of new unsecured lending has continued to be strong and arrears and delinquency trends have improved during the year. In addition, the asset quality of the mortgage portfolio has remained excellent. While the uncertain UK macroeconomic environment and customer insolvency trends remain key factors in the outlook for retail impairment, current lead indicators are good, underwriting and collections procedures continue to improve and the quality of new business remains strong.

Profit before tax from Insurance and Investments increased by 8 per cent to £1,030 million. There was a 7 per cent increase in the present value of new business premiums reflecting, in particular, strong growth in the sales of protection products, corporate pensions and retirement income products.

The value of Scottish Widows' bancassurance new business premiums increased by 20 per cent, building on the success of the simplified product range for distribution through the Lloyds TSB branch network, Commercial Banking and Wealth Management channels. Sales through the Independent Financial Advisors distribution channel increased by 2 per cent, following

## Directors' report

record sales levels in 2006, as Scottish Widows has continued to increase its focus on the more profitable business areas within the IFA market.

Insurance and Investments have made continued improvements in service and operational efficiencies, and the benefits can be seen in a reduction of expenses by 2 per cent compared with prior year, notwithstanding increased sales volumes and the introduction of a number of new products. In addition, customer satisfaction is at its highest ever levels. Scottish Widows has maintained its strong focus on improving capital management. During 2007, Scottish Widows continued to show a more capital efficient product profile and achieve improved internal rates of return. During 2007, £1.9 billion of capital was repatriated to the Group, giving a total capital repatriation of over £3.6 billion since the beginning of 2005.

In General Insurance, profit before tax excluding volatility decreased by £115 million to £128 million, largely as a result of a £113 million increase in weather related claims, primarily reflecting severe flooding in the UK in June and July. Net operating income decreased by £16 million, or 3 per cent, as growth in home and loan protection income was more than offset by lower motor insurance income, increased reinsurance costs and the run-off from the legacy health portfolio. The Group's strong focus on improving operational efficiency and improving the effectiveness of marketing expenditure has resulted in a £3 million, or 2 per cent, reduction in operating costs, while continuing to improve processing efficiency.

Excluding the impact of market dislocation, Wholesale and International Banking pre-tax profits increased by 5 per cent to £1,717 million. Income growth of 6 per cent exceeded cost growth of 1 per cent, leading to a significant reduction in the cost: income ratio to 50.9 per cent. The trading surplus increased by 13 per cent. There was further good progress in expanding our Corporate Markets business, with an 18 per cent increase in Corporate Markets income, supporting a 10 per cent increase in profit before tax, excluding the impact of market dislocation. Cross selling income in Corporate Markets increased by 35 per cent. Continued strong franchise growth in Commercial Banking was supported by 8 per cent growth in income and 13 per cent growth in profit before tax. The Group has retained its leading position as the bank of choice for start-up businesses. Tightened credit criteria in Asset Finance, and a slowdown in demand in the consumer lending portfolio, led to a 47 per cent reduction in profit before tax.

The Wholesale and International Banking charge for impairment losses increased by £264 million to £572 million, including a £92 million charge reflecting the impact of market dislocation and a one-off charge of £28 million relating to the impact of the 2007 Finance Act on the Group's leasing business. The increase in the impairment charge also reflects the recent double-digit growth in Corporate lending and a lower level of releases and recoveries in Corporate Markets and Commercial Banking. Overall, asset quality remains satisfactory.

Shareholders' equity increased by £1,031 million to £13,155 million, largely as a result of retained earnings. Risk-weighted assets increased 10 per cent to £172.0 billion, reflecting strong growth in mortgages and corporate lending. At the end of 2007, the risk asset ratio was 11.9 per cent for total capital.

### Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Bank and its subsidiary undertakings, in relation to the use of financial instruments, is given in note 48 on pages 71 to 90.

### Directors

The names of the directors of the Bank are shown on page 7.

Mr P N Green joined the board on 10 May 2007 and Sir David Manning has been appointed a director from 1 May 2008. Dr DeAnne S Julius and Mr G J N Gemmell left the board on 9 May 2007 and 30 September 2007, respectively.

### Directors' interests

The directors are also directors of Lloyds TSB Group plc and their interests in the share and loan capital of Lloyds TSB Group plc and its subsidiaries are shown in the report and accounts of that company.

### Directors' indemnities

The directors, including two former directors who left during the year, entered into individual contracts of indemnity with Lloyds TSB Group plc which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 1985. These contracts were in force during the whole of the financial year or from the date of appointment in respect of the director who joined the board on 10 May 2007. Since the end of the year, and following the introduction of relevant sections of the Companies Act 2006, revised contracts of indemnity were entered into with the directors which constitute 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' and these remain in force and are available for inspection at the Bank's registered office.

## Directors' report

### Statement of directors' responsibilities

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the consolidated and parent company financial statements in accordance with IFRS as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the parent company and the Group and of the profit or loss of the Group for that period. The directors consider that, in preparing the financial statements on pages 10 to 100, the Bank and the Group have used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and that all accounting standards which they consider applicable have been followed.

The directors have responsibility for ensuring that the Bank and the Group keep proper accounting records which disclose with reasonable accuracy the financial position of the Bank and the Group which enable them to ensure that the financial statements comply with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation. They have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Bank and the Group and to prevent and detect fraud and other irregularities.

A copy of the financial statements is placed on the website of Lloyds TSB Group plc. The directors are responsible for the maintenance and integrity of statutory and audited information in relation to the Bank on that website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

### Employees

The Bank is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief.

In the UK, the Bank belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age and Stonewall. The Bank is also represented on the Board of Race for Opportunity and the Equal Opportunities Commission. Our involvement with these organisations enables us to identify and implement best practice for our staff.

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

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

### Policy and practice on payment of creditors

The Bank follows 'The Better Payment Practice Code' published by the Department for Business, Enterprise and Regulatory Reform (BERR) regarding the making of payments to suppliers. A copy of the code and information about it may be obtained from The BERR Publications Orderline 0845 0150010, quoting ref URN 04/606.

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

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 1985, is 29. This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2007 bears to the aggregate of the amounts invoiced by suppliers during the year.

### Auditors and audit information

Each person who is a director at the date of approval of this report confirms that, so far as the director is aware, there is no relevant audit information of which the Bank's auditors are unaware and each director has taken all steps that he or she ought to have taken as a director to make himself or herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of section 234ZA of the Companies Act 1985.

On behalf of the board  
A J Michie  
Secretary  
21 February 2008



Directors

Sir Victor Blank *Chairman*

J E Daniels *Chief Executive*

M E Fairey *Deputy Chief Executive*  
(retiring on 30 June 2008)

H A Weir CBE *Finance Director*

W C G Berndt

E Brown CBE

T A Dial

J P du Plessis

P N Green

Sir Julian Horn-Smith

A G Kane

Lord Leitch

Sir David Manning  
(from 1 May 2008)

G T Tate

## Independent auditors' report

### **To the members of Lloyds TSB Bank plc**

We have audited the consolidated and parent company financial statements (the 'financial statements') of Lloyds TSB Bank plc for the year ended 31 December 2007 which comprise the consolidated income statement, the consolidated and parent company balance sheets, the consolidated and parent company statements of changes in equity, the consolidated and parent company cash flow statements and the related notes. These financial statements have been prepared under the accounting policies set out therein.

### **Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the statement of directors' responsibilities within the directors' report.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation. We also report to you whether, in our opinion, the information given in the directors' report is consistent with the financial statements.

In addition, we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the annual report and consider whether it is consistent with the audited financial statements. The other information comprises only the directors' report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

## Independent auditors' report

### **Opinion**

In our opinion:

- the consolidated financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2007 and of its profit and cash flows for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2007 and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the consolidated financial statements, Article 4 of the IAS Regulation; and
- the information given in the directors' report is consistent with the financial statements.

PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors

Southampton

21 February 2008

Consolidated income statement  
for the year ended 31 December 2007

	Note	2007 £ million	2006 £ million
Interest and similar income		16,874	14,111
Interest and similar expense		(10,741)	(8,780)
<b>Net interest income</b>	4	<b>6,133</b>	5,331
Fee and commission income		3,227	3,119
Fee and commission expense		(600)	(638)
Net fee and commission income	5	2,627	2,481
Net trading income	6	3,136	6,331
Insurance premium income	7	5,430	4,719
Other operating income	8	952	806
<b>Other income</b>		<b>12,145</b>	14,337
<b>Total income</b>		<b>18,278</b>	19,668
Insurance claims	9	(7,522)	(8,569)
<b>Total income, net of insurance claims</b>		<b>10,756</b>	11,099
Operating expenses	10	(5,528)	(5,262)
<b>Trading surplus</b>		<b>5,228</b>	5,837
Impairment	11	(1,796)	(1,555)
Profit on sale of businesses	12	657	–
<b>Profit before tax</b>		<b>4,089</b>	4,282
Taxation	13	(673)	(1,262)
<b>Profit for the year</b>		<b>3,416</b>	3,020
Profit attributable to minority interests		32	104
Profit attributable to equity shareholders		3,384	2,916
<b>Profit for the year</b>		<b>3,416</b>	3,020

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

Balance sheets  
at 31 December 2007

	Note	The Group		The Bank	
		2007 £ million	2006 £ million	2007 £ million	2006 £ million
<b>Assets</b>					
Cash and balances at central banks		<b>4,330</b>	1,898	<b>4,211</b>	1,678
Items in the course of collection from banks		<b>1,242</b>	1,431	<b>1,196</b>	1,358
Trading and other financial assets at fair value through profit or loss	14	<b>58,096</b>	67,928	<b>9,184</b>	8,819
Derivative financial instruments	15	<b>8,688</b>	5,565	<b>8,624</b>	5,665
Loans and advances to banks	16	<b>34,845</b>	40,638	<b>28,447</b>	86,588
Loans and advances to customers	17	<b>209,814</b>	190,135	<b>212,738</b>	106,576
Available-for-sale financial assets	19	<b>20,196</b>	19,178	<b>4,260</b>	3,972
Investment property	20	<b>3,722</b>	4,739	–	–
Goodwill	21	<b>2,358</b>	2,377	–	8
Value of in-force business	22	<b>2,218</b>	2,723	–	–
Other intangible assets	23	<b>149</b>	138	<b>53</b>	37
Tax recoverable		–	–	<b>93</b>	2
Deferred tax asset	37	–	–	<b>619</b>	861
Tangible fixed assets	24	<b>2,839</b>	4,252	<b>1,235</b>	1,284
Investment in subsidiary undertakings	25	–	–	<b>16,137</b>	18,527
Other assets	27	<b>5,046</b>	4,662	<b>2,163</b>	1,966
<b>Total assets</b>		<b>353,543</b>	345,664	<b>288,960</b>	237,341

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

The directors approved the financial statements on 21 February 2008.

**Sir Victor Blank**  
Chairman

**J Eric Daniels**  
Chief Executive

**Helen A Weir**  
Finance Director

Balance sheets  
at 31 December 2007

	Note	The Group		The Bank	
		2007 £ million	2006 £ million	2007 £ million	2006 £ million
<b>Equity and liabilities</b>					
<b>Liabilities</b>					
Deposits from banks	28	<b>39,091</b>	36,394	<b>48,940</b>	44,070
Customer accounts	29	<b>156,713</b>	140,767	<b>163,245</b>	127,938
Items in course of transmission to banks		<b>668</b>	781	<b>613</b>	660
Trading and other liabilities at fair value through profit or loss	30	<b>3,206</b>	1,184	<b>3,206</b>	1,184
Derivative financial instruments	15	<b>7,751</b>	5,877	<b>8,365</b>	6,405
Debt securities in issue	31	<b>49,828</b>	54,118	<b>36,647</b>	32,719
Liabilities arising from insurance contracts and participating investment contracts	32	<b>38,192</b>	41,602	–	–
Liabilities arising from non-participating investment contracts	33	<b>18,197</b>	24,370	–	–
Unallocated surplus within insurance businesses	34	<b>554</b>	683	–	–
Other liabilities	35	<b>9,751</b>	11,034	<b>4,123</b>	3,280
Retirement benefit obligations	36	<b>2,144</b>	2,462	<b>1,623</b>	1,845
Current tax liabilities		<b>414</b>	735	–	–
Deferred tax liabilities	37	<b>949</b>	1,416	–	–
Other provisions	38	<b>209</b>	259	<b>165</b>	196
Subordinated liabilities	39	<b>12,437</b>	11,506	<b>11,903</b>	10,281
<b>Total liabilities</b>		<b>340,104</b>	333,188	<b>278,830</b>	228,578
<b>Equity</b>					
Share capital	40	<b>1,542</b>	1,542	<b>1,542</b>	1,542
Share premium account	41	<b>2,960</b>	2,960	<b>2,960</b>	2,960
Other reserves	42	<b>(411)</b>	(15)	<b>(44)</b>	4
Retained profits	43	<b>9,064</b>	7,637	<b>5,672</b>	4,257
<b>Shareholders' equity</b>		<b>13,155</b>	12,124	<b>10,130</b>	8,763
Minority interests		<b>284</b>	352	–	–
<b>Total equity</b>		<b>13,439</b>	12,476	<b>10,130</b>	8,763
<b>Total equity and liabilities</b>		<b>353,543</b>	345,664	<b>288,960</b>	237,341

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

## Statement of changes in equity

**The Group**

	Attributable to equity shareholders					Total £m
	Share capital and premium £m	Other reserves £m	Retained profits £m	Total £m	Minority interests £m	
<b>Balance at 1 January 2006</b>	4,502	44	6,639	11,185	435	11,620
Movement in available-for-sale financial assets, net of tax:						
– change in fair value	–	(10)	–	(10)	–	(10)
– transferred to income statement in respect of disposals	–	(21)	–	(21)	–	(21)
Movement in cash flow hedges, net of tax	–	1	–	1	–	1
Currency translation differences	–	(29)	–	(29)	(4)	(33)
Net income recognised directly in equity	–	(59)	–	(59)	(4)	(63)
Profit for the year	–	–	2,916	2,916	104	3,020
Total recognised income for 2006	–	(59)	2,916	2,857	100	2,957
Dividends	–	–	(1,918)	(1,918)	(32)	(1,950)
Repayment of capital to minority shareholders	–	–	–	–	(151)	(151)
<b>Balance at 31 December 2006</b>	4,502	(15)	7,637	12,124	352	12,476
Movement in available-for-sale financial assets, net of tax:						
– change in fair value	–	(436)	–	(436)	–	(436)
– transferred to income statement in respect of disposals	–	(5)	–	(5)	–	(5)
– transferred to income statement in respect of impairment	–	49	–	49	–	49
– disposal of businesses	–	(6)	–	(6)	–	(6)
Movement in cash flow hedges, net of tax	–	(15)	–	(15)	–	(15)
Currency translation differences	–	17	–	17	(1)	16
Net income recognised directly in equity	–	(396)	–	(396)	(1)	(397)
Profit for the year	–	–	3,384	3,384	32	3,416
Total recognised income for 2007	–	(396)	3,384	2,988	31	3,019
Dividends	–	–	(1,957)	(1,957)	(19)	(1,976)
Repayment of capital to minority shareholders	–	–	–	–	(80)	(80)
<b>Balance at 31 December 2007</b>	<b>4,502</b>	<b>(411)</b>	<b>9,064</b>	<b>13,155</b>	<b>284</b>	<b>13,439</b>

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

## Statement of changes in equity

**The Bank**

Attributable to equity shareholders

	Share capital and premium £m	Other reserves £m	Retained profits £m	Total £m
<b>Balance at 1 January 2006</b>	4,502	55	3,726	8,283
Movement in available-for-sale financial assets, net of tax:				
– change in fair value	–	(7)	–	(7)
– transferred to income statement in respect of disposals	–	(22)	–	(22)
Movement in cash flow hedges, net of tax	–	1	–	1
Currency translation differences	–	(23)	–	(23)
Net income recognised directly in equity	–	(51)	–	(51)
Profit for the year	–	–	2,449	2,449
Total recognised income for 2006	–	(51)	2,449	2,398
Dividends	–	–	(1,918)	(1,918)
<b>Balance at 31 December 2006</b>	4,502	4	4,257	8,763
Movement in available-for-sale financial assets, net of tax:				
– change in fair value	–	(84)	–	(84)
– transferred to income statement in respect of disposals	–	(5)	–	(5)
– transferred to income statement in respect of impairment	–	49	–	49
– disposal of businesses	–	(6)	–	(6)
Movement in cash flow hedges, net of tax	–	(15)	–	(15)
Currency translation differences	–	13	–	13
Net income recognised directly in equity	–	(48)	–	(48)
Profit for the year	–	–	2,799	2,799
Total recognised income for 2007	–	(48)	2,799	2,751
Dividends	–	–	(1,957)	(1,957)
Adjustment arising on transfer of C&G business (note 26)	–	–	573	573
<b>Balance at 31 December 2007</b>	<b>4,502</b>	<b>(44)</b>	<b>5,672</b>	<b>10,130</b>

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



**Cash flow statements**  
for the year ended 31 December 2007

	Note	The Group		The Bank	
		2007 £ million	2006 £ million	2007 £ million	2006 £ million
<b>Profit before tax</b>		<b>4,089</b>	4,282	<b>3,256</b>	2,730
Adjustments for:					
Change in operating assets	51a	<b>(15,113)</b>	(32,194)	<b>(13,548)</b>	(21,601)
Change in operating liabilities	51b	<b>18,607</b>	34,164	<b>19,443</b>	21,939
Non-cash and other items	51c	<b>2,689</b>	1,632	<b>757</b>	(155)
Tax paid		<b>(827)</b>	(844)	<b>(273)</b>	(231)
<b>Net cash provided by operating activities</b>		<b>9,445</b>	7,040	<b>9,635</b>	2,682
<b>Cash flows from investing activities:</b>					
Purchase of available-for-sale financial assets		<b>(21,667)</b>	(23,448)	<b>(8,197)</b>	(9,917)
Proceeds from sale and maturity of available-for-sale financial assets		<b>19,468</b>	18,106	<b>8,022</b>	10,353
Purchase of fixed assets		<b>(1,334)</b>	(1,724)	<b>(300)</b>	(312)
Proceeds from sale of fixed assets		<b>982</b>	1,257	<b>44</b>	28
Additional capital injections to subsidiaries		–	–	<b>(313)</b>	(2,444)
Capital repayments by subsidiaries		–	–	<b>977</b>	3
Acquisition of businesses, net of cash acquired	51f	<b>(8)</b>	(20)	<b>(18)</b>	(8)
Disposal of businesses, net of cash disposed	51g	<b>1,476</b>	936	<b>518</b>	936
<b>Net cash (used in) generated by investing activities</b>		<b>(1,083)</b>	(4,893)	<b>733</b>	(1,361)
<b>Cash flows from financing activities:</b>					
Dividends paid to equity shareholders		<b>(1,957)</b>	(1,918)	<b>(1,957)</b>	(1,918)
Dividends paid to minority interests	51e	<b>(19)</b>	(32)	–	–
Interest paid on subordinated liabilities		<b>(733)</b>	(704)	<b>(695)</b>	(619)
Proceeds from issue of subordinated liabilities	51e	<b>1,098</b>	–	<b>1,098</b>	–
Repayment of subordinated liabilities	51e	<b>(300)</b>	(509)	<b>(300)</b>	(509)
Repayment of capital to minority shareholders	51e	<b>(80)</b>	(151)	–	–
<b>Net cash used in financing activities</b>		<b>(1,991)</b>	(3,314)	<b>(1,854)</b>	(3,046)
Effect of exchange rate changes on cash and cash equivalents		<b>82</b>	(148)	<b>78</b>	(147)
Change in cash and cash equivalents		<b>6,453</b>	(1,315)	<b>8,592</b>	(1,872)
Cash and cash equivalents at beginning of year		<b>25,438</b>	26,753	<b>15,435</b>	17,307
Cash and cash equivalents at end of year	51d	<b>31,891</b>	25,438	<b>24,027</b>	15,435

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

## Notes to the accounts

### 1 Accounting policies

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The following relevant IFRS pronouncements have been adopted in these financial statements:

- (i) IFRS 7 'Financial Instruments: Disclosures'. This standard, which was effective from 1 January 2007, requires more detailed qualitative and quantitative disclosures about exposure to risks arising from financial instruments. As a disclosure standard, the application of this new standard has not had any impact on amounts recognised in the financial statements. The IFRS 7 disclosures are set out in these financial statements. IFRS 7 supersedes IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions' and the disclosure requirements previously contained in IAS 32 'Financial Instruments: Presentation'.
- (ii) Amendment to IAS 1 'Presentation of Financial Statements – Capital Disclosures'. This standard, which was effective from 1 January 2007, requires additional disclosures of the objectives, policies and processes for managing capital, quantitative data about what the Group regards as capital, and compliance with capital requirements. These disclosures are set out in note 49.

Details of those IFRS pronouncements which will be relevant to the Group and the Bank but which were not effective at 31 December 2007 and which have not been applied in preparing these financial statements are given in note 52.

The accounting policies are set out below:

#### a Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include all entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Group undertakings are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Open Ended Investment Companies (OEICs) where the Group, through the Group's life funds, has a controlling interest are consolidated; the unitholders' interest is reported in other liabilities. Intra-Group transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

#### b Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets and contingent liabilities of the acquired entity at the date of acquisition. Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a Group undertaking, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

#### c Other intangible assets

Other intangible assets comprise capitalised software enhancements and customer lists. Capitalised software enhancements are amortised over periods not exceeding five years, being their estimated useful lives, using the straight-line method. Customer lists are amortised over periods not exceeding 15 years, being their estimated useful lives, in line with the income expected to arise from those customers and are subject to annual reassessment. All other intangible assets are reviewed for impairment whenever events or any changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount, it is written down immediately.

#### d Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by the Group including expected early redemptions and related penalties and premiums and discounts that are an integral part of the overall return as well as direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see j).

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

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

Revenue recognition policies specific to life assurance and general insurance business are detailed below (see s).

## Notes to the accounts

### 1 Accounting policies (continued)

#### e Trading securities, other financial assets and liabilities at fair value through profit or loss, and available-for-sale financial assets

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

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

Financial assets and liabilities are designated as at fair value through profit or loss on acquisition:

- When doing so results in more relevant information because either:
  - it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on them on a different basis; or
  - the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy with management information also prepared on this basis, or
- Where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

Debt securities and equity shares, other than those classified as trading securities or at fair value through profit or loss, are classified as available-for-sale and recognised in the balance sheet at their fair value; available-for-sale investments are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in equity, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in equity is recognised in the income statement. Interest calculated using the effective interest method is recognised in the income statement.

Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset. Trading securities and other financial assets and liabilities at fair value through profit or loss are initially recognised at fair value. Available-for-sale financial assets are initially recognised at fair value inclusive of transaction costs. These financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

#### f Loans and advances to banks and customers

Loans and advances to banks and customers are accounted for at amortised cost using the effective interest method, except those which the Group intends to sell in the near term and which are accounted for at fair value, with the gains and losses arising from changes in their fair value reflected in the income statement. Loans and advances are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs. Loans and advances are derecognised when the rights to receive cash flows from them have expired or where the Group has transferred substantially all risks and rewards of ownership.

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. Such financial assets continue to be recognised by the Group, together with a corresponding liability for the funding except in those cases where substantially all of the risks and rewards associated with the assets have been transferred or a significant proportion but not all of the risks and rewards have been transferred and the transferee has the ability to sell the assets when the assets are derecognised in full. If a fully proportional share of all, or of specifically identified, cash flows have been transferred, then that proportion of the assets is derecognised.

#### g Sale and repurchase agreements

Securities sold subject to repurchase agreements ('repos') are recognised on the balance sheet where all of the risks and rewards are retained; the counterparty liability is included in deposits from banks or customer accounts, as appropriate. Securities purchased under agreements to resell ('reverse repos') are recorded as loans and advances to banks or customers, as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

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

#### h Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

The method of recognising the movements in the fair value of the derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Derivatives may only be designated as hedges provided certain strict criteria are met. At the inception of a hedge its terms must be clearly documented and there must be an expectation that the derivative will be highly effective in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship must be tested throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its objective the hedge relationship is terminated.

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

## Notes to the accounts

### 1 Accounting policies (continued)

#### (1) Fair value hedges

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value attributable to the hedged risk are no longer recognised in the income statement; the adjustment that has been made to the carrying amount of a hedged item is amortised to the income statement over the period to maturity.

#### (2) Cash flow hedges

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

#### (3) Net investment hedges

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

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

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

#### i Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

#### j Impairment of financial assets

##### (1) Assets accounted for at amortised cost

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

The criteria that the Group uses to determine that there is objective evidence of an impairment loss may include:

- Delinquency in contractual payments of principal and/or interest;
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty;
- Restructuring of debt to reduce the burden on the borrower;
- Breach of loan covenants or conditions; and
- Initiation of bankruptcy proceedings.

The estimated period between a loss occurring and its identification is determined by local management for each identified portfolio. In general, the periods used vary between three months and nine months.

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. For the Group's portfolios of smaller balance homogenous loans, such as the residential mortgage, personal lending and credit card portfolios, allowances are calculated for groups of assets taking into account historical cash flow experience. For the Group's other lending portfolios, allowances are established on a case-by-case basis. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

If there is no objective evidence of individual impairment the asset is included in a group of financial assets with similar credit risk characteristics and collectively assessed for impairment. Segmentation takes into account such factors as the type of asset, industry, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the Group and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

## Notes to the accounts

**1 Accounting policies** (continued)*(2) Available-for-sale financial assets*

The Group assesses at each balance sheet date whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost, reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer and assessing the future cash flows expected to be realised. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

*(3) Renegotiated loans*

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans. In subsequent years, the asset is considered to be past due and disclosed only if further renegotiated.

**k Investment property**

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

**l Tangible fixed assets**

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

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease
- Leasehold improvements: shorter of 10 years or the remaining period of the lease

Equipment:

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

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

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

**m Leases***(1) As lessee*

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

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

*(2) As lessor*

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee; all other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments is recognised as a receivable within loans and advances to banks and customers. Finance lease income is recognised over the term of the lease using the net investment method (before tax) reflecting a constant periodic rate of return.

Operating lease assets are included within tangible fixed assets at cost and depreciated over the life of the lease after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

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

**n Investment in subsidiary undertakings**

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

**o Borrowings**

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

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

**p Pensions and other post-retirement benefits**

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as

## Notes to the accounts

### 1 Accounting policies (continued)

age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries, or in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

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

The Group's balance sheet includes the net surplus or deficit, being the fair value of scheme assets less the discounted value of scheme liabilities adjusted for the corridor. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

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

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

#### q Share-based compensation

The Lloyds TSB Group operates a number of equity-settled, share-based compensation plans. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity except where the charge is levied by the parent company. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement over the remaining vesting period.

#### r Taxation

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

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

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

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax is provided on temporary differences arising from investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the difference will not reverse in the foreseeable future. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to fair value re-measurement of available-for-sale investments and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred gain or loss.

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

#### s Insurance

The Group undertakes both life assurance and general insurance business.

For accounting purposes the life assurance business issues three types of contract:

Insurance contracts – these contracts contain significant insurance risk, which the Group defines as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur.

Investment contracts containing a discretionary participation feature – these contracts do not contain significant insurance risk, but contain features which entitle the holder to receive, in addition to the guaranteed benefits, further amounts that are likely to be a significant proportion of the total benefits and the amount and timing of which is at the discretion of the Group and based upon the performance of specified assets. Contracts with a discretionary participation feature are referred to as participating investment contracts.

Non-participating investment contracts – these contracts do not contain significant insurance risk or a discretionary participation feature.

## Notes to the accounts

**1 Accounting policies** (continued)

For accounting purposes the general insurance business only issues insurance contracts.

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

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due, except as detailed below in respect of unit-linked contracts.

Claims are recorded as an expense when they are incurred.

*Liabilities**– insurance or participating investment contracts in the Group's With Profit Fund*

Liabilities of the Group's With Profit Fund, including guarantees and options embedded within products written by that fund, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime. Further details on the realistic capital regime are given in note 49.

*– insurance or participating investment contracts which are not unit-linked or in the Group's With Profit Fund*

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

*– insurance or participating investment contracts which are unit-linked*

Allocated premiums in respect of unit-linked contracts that are either insurance or participating investment contracts are recognised as liabilities. These liabilities are increased or reduced by the change in the unit prices and are reduced by policy administration fees, mortality and surrender charges and any withdrawals. The mortality charges deducted in each period from the policyholders as a group are considered adequate to cover the expected total death benefit claims in excess of the contract account balances in each period and hence no additional liability is established for these claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges. Interest or changes in the unit prices credited to the account balances and excess benefit claims in excess of the account balances incurred in the period are charged as expenses in the income statement.

*Unallocated surplus*

Any amounts in the With Profit Fund not yet determined as being due to policyholders are recognised as an unallocated surplus which is shown separately from other liabilities.

*Value of in-force business*

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

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

All of the Group's non-participating investment contracts are unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

Deposits and withdrawals are accounted for directly in the balance sheet as adjustments to the liability.

The Group receives investment management fees in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the instrument. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them on a straight-line basis over the estimated lives of the contracts.

Directly incremental commissions that vary with and are related to either securing new or renewing existing non-participating investment contracts are deferred; all other costs are recognised as expenses when incurred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately.

*(2) General insurance business*

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

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

## Notes to the accounts

### 1 Accounting policies (continued)

#### (3) *Liability adequacy test*

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

#### (4) *Reinsurance*

Contracts entered into by the Group with reinsurers under which the Group is compensated for losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held. Insurance contracts entered into by the Group under which the contract holder is another insurer (inwards reinsurance) are included with insurance contracts.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured insurance contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured insurance contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Reinsurance liabilities are primarily premiums payable for reinsurance contracts and are recognised as an expense when due.

### t Foreign currency translation

#### (1) *Functional and presentation currency*

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

#### (2) *Transactions and balances*

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

#### (3) *Group companies*

The results and financial position of all the Group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- (i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- (ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- (iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities are taken to shareholders' equity. When a foreign operation is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

### u Provisions

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

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

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

### v Dividends

Dividends on ordinary shares are recognised in equity in the period in which they are paid.

### w Cash and cash equivalents

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

### 2 Critical accounting estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, are discussed below.



## Notes to the accounts

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

#### Impairment of financial assets

##### *Loan impairment allowances*

The Group regularly reviews its loan portfolios to assess for impairment. Impairment allowances are established to recognise incurred impairment losses in its loan portfolios carried at amortised cost. In determining whether an impairment has occurred at the balance sheet date the Group considers whether there is any observable data indicating that there has been a measurable decrease in the estimated future cash flows or their timings; such observable data includes whether there has been an adverse change in the payment status of borrowers or changes in economic conditions that correlate with defaults on loan repayment obligations. Where this is the case, the impairment loss is the difference between the carrying value of the loan and the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

At 31 December 2007 gross loans and advances to customers and banks totalled £247,067 million (2006: £232,967 million) against which impairment allowances of £2,408 million (2006: £2,194 million) had been made.

There are two components of the Group's loan impairment allowances: individual and collective. All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. The determination of these allowances often requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer and the value of the security held, for which there may not be a readily accessible market. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Impairment allowances for portfolios of smaller balance homogenous loans, such as residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis. Collective impairment allowances are calculated on a portfolio basis using formulae which take into account factors such as the length of time that the customer's account has been out of order, historical loss rates, the credit quality of the portfolios and the value of any security held. The variables used in the formulae are kept under regular review to ensure that as far as possible they reflect current economic circumstances; however changes in interest rates, unemployment levels and bankruptcy trends, particularly in the UK, could result in actual losses differing from reported impairment allowances.

##### *Impairment of available-for-sale financial assets*

In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value is a result of a change in the quality of the asset or from a downward movement in the market as a whole. An assessment is performed of the expected future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying securities and credit protection available. The movement in available-for-sale financial assets is shown in note 19. The reduction in the fair value of available-for-sale financial assets during the year was £483 million (2006: £10 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £70 million (2006: £nil).

#### Pensions

The net liability recognised in the balance sheet at 31 December 2007 in respect of the Group's retirement benefit obligations was £2,144 million (2006: £2,462 million) of which £2,033 million (2006: £2,362 million) related to defined benefit pension schemes. This liability excludes actuarial gains of £1,350 million (2006: £263 million) which the Group is permitted to leave unrecognised. The defined benefit pension schemes' gross deficit totalled £683 million (2006: £2,099 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The schemes' liabilities are calculated using the projected unit credit method, which takes into account projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. The resulting estimated cash flows are discounted at a rate equivalent to the market yield at the balance sheet date on high quality bonds with a similar duration and currency to the schemes' liabilities. In order to estimate the future cash flows, a number of financial and non-financial assumptions are made by management, changes to which could have a material impact upon the overall deficit or the net cost recognised in the income statement.

Two important assumptions are the rate of inflation and the expected lifetime of the schemes' members. The assumed rate of inflation affects the rate at which salaries are projected to grow and therefore the size of the pension that employees receive upon retirement and also the rate at which pensions in payment increase. Over the longer term rates of inflation can vary significantly; at 31 December 2007 it was assumed that the rate of inflation would be 3.3 per cent per annum (2006: 2.9 per cent), although if this was increased by 0.2 per cent the overall deficit would increase by approximately £550 million and the annual cost by approximately £20 million. A reduction of 0.2 per cent would reduce the overall deficit by approximately £500 million and the annual cost by approximately £40 million.

The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rates of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. An increase of one year in the expected lifetime of scheme members would increase the overall deficit by approximately £400 million and the annual cost by approximately £30 million; a reduction of one year would reduce the overall deficit by approximately £400 million and the annual cost by approximately £40 million.

The size of the overall deficit is also sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variations. At 31 December 2007 the discount rate used was 5.8 per cent (2006: 5.1 per cent); a reduction of 0.2 per cent would increase the overall deficit by approximately £550 million and the annual cost by approximately £15 million, while an increase of 0.2 per cent would reduce the net deficit by approximately £550 million and the annual cost by approximately £40 million.

#### Goodwill

At 31 December 2007 the Group carried goodwill on its balance sheet totalling £2,358 million (2006: £2,377 million), substantially all of which relates to acquisitions made a number of years ago.

## Notes to the accounts

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

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affects the amount and timing of future cash flows, goodwill may become impaired in future periods.

#### Insurance

##### Life assurance business

The Group carries in its balance sheet an asset representing the value of in-force business in respect of life insurance and participating investment contracts of £2,218 million at 31 December 2007 (2006: £2,723 million). This asset, which is presented gross of attributable tax, represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. This is determined using appropriate allowance for economic conditions and appropriate assumptions for future mortality rates and future persistency rates, making allowance for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets, including an explicit allowance for non-market risk. These factors are inherently uncertain. If actual experience differs from that assumed this could significantly affect the value attributed. The process for determining key assumptions that have been made at 31 December 2007 is detailed in note 22.

At 31 December 2007 the Group also carried substantial liabilities to holders of life insurance policies in its balance sheet. The methodology used to value the liabilities is described in note 1 (s) (1). Liabilities arising from insurance contracts and participating investment contracts were £22,655 million and £14,874 million respectively (2006: £25,920 million and £15,095 million) and those arising from non-participating investment contracts totalled £18,197 million (2006: £24,370 million). Elements of the liabilities require assumptions about future investment returns, future mortality rates and future policyholder behaviour. The process for determining the key assumptions that have been made at 31 December 2007 and the impact on profit before tax of changes in key assumptions is detailed in note 32.

##### General insurance business

At 31 December 2007 the Group held a provision of £207 million (2006: £149 million) in respect of the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date.

While management believes that the liability carried at year end is adequate, the application of statistical techniques requires significant judgment. An increase of 10 per cent in the cost of claims would result in the recognition of an additional loss of approximately £20 million. Similarly, an increase of 10 per cent in the ultimate number of such claims would lead to an additional loss of approximately £20 million; some relief would arise from reinsurance contracts held.

#### Taxation

Significant judgement is required in determining the Group's income tax liabilities. In arriving at the current tax liability of £414 million and deferred tax liability of £949 million at 31 December 2007 (2006: current tax liability of £735 million and deferred tax liability of £1,416 million), the Group has taken account of tax issues that are subject to ongoing discussions with HM Revenue & Customs and other tax authorities. Calculations of these liabilities have been based on management's assessment of legal and professional advice, case law and other relevant guidance. In these situations, the various risks are categorised and approximate weightings applied in arriving at the assessment of the expected liability. Where the expected tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the current and deferred tax amounts in the period in which such determination is made.

#### Valuation of financial instruments

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. Changes in assumptions about these factors could affect reported fair values of financial instruments. The fair value movement on assets and liabilities held at fair value through profit or loss and gains in respect of instruments held for trading are disclosed in note 6. Movements in respect of available-for-sale financial assets, including those arising from changes in their fair value, are disclosed in note 19. The fair values of the Group's financial assets and liabilities are disclosed within note 48 together with an indication of the valuation technique used for each major asset or liability category.

### 3 Segmental analysis

Lloyds TSB Bank Group is a leading financial services group, whose businesses provide a wide range of banking and financial services predominantly in the UK.

The Group's activities are organised into three segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking. Services provided by UK Retail Banking encompass the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offers life assurance, pensions and savings products, general insurance and asset management services. Wholesale and International Banking provides banking and related services for major UK and multinational companies, banks and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages the Group's activities in financial markets through its treasury function and provides banking and financial services in some overseas locations.

Under the Group's transfer pricing arrangements, inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged.

## Notes to the accounts

**3 Segmental analysis** (continued)

Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For those derivative contracts entered into by business units for risk management purposes, the business unit retains the amount that would have been recognised on an accrual accounting basis (an amount equal to the interest element of the next payment on the swap) and transfers the remainder of the fair value of the swap to the central group segment where the resulting accounting volatility is managed through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results, records volatility where it is managed and provides a fair presentation of the segments' operating performance. It is the basis on which the segments are managed and measured internally and is the basis of the Group's internal segmental reporting to the board.

	UK Retail Banking £m	General insurance £m	Life, pensions and asset management £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Inter-segment eliminations £m	Total £m
<b>Year ended 31 December 2007</b>								
Interest and similar income	8,018	23	1,040	1,063	9,834	1,097	(3,138)	16,874
Interest and similar expense	(4,235)	–	(527)	(527)	(7,316)	(1,801)	3,138	(10,741)
Net interest income	3,783	23	513	536	2,518	(704)	–	6,133
Other income (net of fee and commission expense)	1,797	554	7,643	8,197	1,773	378	–	12,145
Total income	5,580	577	8,156	8,733	4,291	(326)	–	18,278
Insurance claims	–	(302)	(7,220)	(7,522)	–	–	–	(7,522)
Total income, net of insurance claims	5,580	275	936	1,211	4,291	(326)	–	10,756
Operating expenses	(2,624)	(154)	(501)	(655)	(2,282)	33	–	(5,528)
Trading surplus (deficit)	2,956	121	435	556	2,009	(293)	–	5,228
Impairment	(1,224)	–	–	–	(572)	–	–	(1,796)
Profit on sale of businesses	–	–	272	272	385	–	–	657
Profit (loss) before tax	1,732	121	707	828	1,822	(293)	–	4,089
External revenue	9,132	1,235	8,854	10,089	10,082	316	–	29,619
Inter-segment revenue	1,012	49	181	230	1,559	1,302	(4,103)	–
Segment revenue	10,144	1,284	9,035	10,319	11,641	1,618	(4,103)	29,619
External assets	115,012	1,164	72,213	73,377	163,294	1,860	–	353,543
Inter-segment assets	5,093	361	3,777	4,138	91,246	64,654	(165,131)	–
Total assets	120,105	1,525	75,990	77,515	254,540	66,514	(165,131)	353,543
External liabilities	96,166	870	65,304	66,174	162,376	15,388	–	340,104
Inter-segment liabilities	20,321	12	5,930	5,942	86,159	52,709	(165,131)	–
Total liabilities	116,487	882	71,234	72,116	248,535	68,097	(165,131)	340,104
Other segment items:								
Capital expenditure	80	11	452	463	613	178	–	1,334
Depreciation and amortisation	205	14	37	51	374	–	–	630
Defined benefit scheme charges	114	3	26	29	92	(60)	–	175

## Notes to the accounts

**3 Segmental analysis** (continued)

	UK Retail Banking £m	General insurance £m	Life, pensions and asset management £m	Insurance and Investments £m	Wholesale and International Banking £m	Central group items £m	Inter-segment eliminations £m	Total £m
<b>Year ended 31 December 2006</b>								
Interest and similar income	6,913	24	820	844	8,598	997	(3,241)	14,111
Interest and similar expense	(3,271)	–	(741)	(741)	(6,421)	(1,588)	3,241	(8,780)
Net interest income	3,642	24	79	103	2,177	(591)	–	5,331
Other income (net of fee and commission expense)	1,621	594	9,893	10,487	2,035	194	–	14,337
Total income	5,263	618	9,972	10,590	4,212	(397)	–	19,668
Insurance claims	–	(200)	(8,369)	(8,569)	–	–	–	(8,569)
Total income, net of insurance claims	5,263	418	1,603	2,021	4,212	(397)	–	11,099
Operating expenses	(2,476)	(157)	(481)	(638)	(2,264)	116	–	(5,262)
Trading surplus (deficit)	2,787	261	1,122	1,383	1,948	(281)	–	5,837
Impairment	(1,238)	–	–	–	(308)	(9)	–	(1,555)
Profit (loss) before tax	1,549	261	1,122	1,383	1,640	(290)	–	4,282
External revenue	8,136	1,249	10,888	12,137	8,659	154	–	29,086
Inter-segment revenue	698	19	199	218	2,276	910	(4,102)	–
Segment revenue	8,834	1,268	11,087	12,355	10,935	1,064	(4,102)	29,086
External assets	108,381	1,115	84,959	86,074	147,836	3,373	–	345,664
Inter-segment assets	3,331	502	4,050	4,552	80,995	53,588	(142,466)	–
Total assets	111,712	1,617	89,009	90,626	228,831	56,961	(142,466)	345,664
External liabilities	87,327	875	77,633	78,508	150,779	16,574	–	333,188
Inter-segment liabilities	20,980	54	5,595	5,649	72,793	43,044	(142,466)	–
Total liabilities	108,307	929	83,228	84,157	223,572	59,618	(142,466)	333,188
Other segment items:								
Capital expenditure	82	7	845	852	647	143	–	1,724
Depreciation and amortisation	202	9	29	38	379	–	–	619
Defined benefit scheme charges	121	4	24	28	100	(140)	–	109

As the activities of the Group are predominantly carried out in the UK, no geographical analysis is presented.

**4 Net interest income**

	Weighted average effective interest rate			
	2007 %	2006 %	2007 £m	2006 £m
Interest receivable:				
Loans and advances to customers	<b>6.88</b>	6.21	<b>13,209</b>	10,856
Loans and advances to banks	<b>5.14</b>	4.72	<b>2,025</b>	1,826
Lease and hire purchase receivables	<b>6.34</b>	5.97	<b>602</b>	622
Interest receivable on loans and receivables	<b>6.58</b>	5.94	<b>15,836</b>	13,304
Available-for-sale financial assets	<b>4.83</b>	4.39	<b>1,038</b>	807
Total interest receivable	<b>6.43</b>	5.82	<b>16,874</b>	14,111
Interest payable:				
Deposits from banks	<b>5.00</b>	4.67	<b>(1,919)</b>	(1,680)
Customer accounts	<b>3.55</b>	2.91	<b>(5,097)</b>	(3,756)
Debt securities in issue	<b>5.11</b>	4.67	<b>(2,620)</b>	(1,983)
Subordinated liabilities	<b>6.16</b>	5.56	<b>(755)</b>	(677)
Liabilities under sale and repurchase agreements	<b>4.81</b>	4.35	<b>(155)</b>	(260)
Interest payable on liabilities held at amortised cost	<b>4.24</b>	3.70	<b>(10,546)</b>	(8,356)
Other	<b>4.28</b>	9.68	<b>(195)</b>	(424)
Total interest payable	<b>4.24</b>	3.82	<b>(10,741)</b>	(8,780)
Net interest income			<b>6,133</b>	5,331

Included within interest receivable is £395 million (2006: £297 million) in respect of impaired financial assets. Net interest income also includes a credit of £1 million (2006: charge of £1 million) transferred from the cash flow hedging reserve (note 42).

## Notes to the accounts

<b>5 Net fee and commission income</b>	<b>2007 £m</b>	2006 £m
Fee and commission income:		
Current accounts	<b>693</b>	652
Insurance broking	<b>648</b>	629
Credit and debit card fees	<b>536</b>	493
Trust and other fiduciary fees	<b>362</b>	331
Other	<b>988</b>	1,014
	<b>3,227</b>	3,119
Fee and commission expense	<b>(600)</b>	(638)
Net fee and commission income	<b>2,627</b>	2,481

As discussed in note 1(d), fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 4. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 6.

Certain fees payable by the Group's asset finance business have been reclassified to interest income as part of the effective yield of the related lending; there is no impact upon profit before tax. Comparative figures have been restated accordingly.

<b>6 Net trading income</b>	<b>2007 £m</b>	2006 £m
Foreign exchange translation gains	<b>33</b>	32
Gains on foreign exchange trading transactions	<b>159</b>	98
Total foreign exchange	<b>192</b>	130
Investment property (losses) gains (note 20)	<b>(321)</b>	631
Securities and other gains (see below)	<b>3,265</b>	5,570
	<b>3,136</b>	6,331

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

	<b>2007 £m</b>	2006 £m
Net income arising on assets held at fair value through profit or loss:		
Loans and advances to banks and customers	<b>23</b>	29
Debt securities	<b>673</b>	1,181
Equity shares	<b>2,419</b>	4,049
Total net income arising on assets held at fair value through profit or loss	<b>3,115</b>	5,259
Net (expense) income arising on liabilities held at fair value through profit or loss – debt securities in issue	<b>(153)</b>	21
Total net gains arising on assets and liabilities held at fair value through profit or loss	<b>2,962</b>	5,280
Net gains on financial instruments held for trading	<b>303</b>	290
Securities and other gains	<b>3,265</b>	5,570

## Notes to the accounts

**7 Insurance premium income**

	2007 £m	2006 £m
<i>Life insurance</i>		
Gross premiums	4,937	4,308
Ceded reinsurance premiums	(98)	(189)
Net earned premiums	4,839	4,119
<i>Non-life insurance</i>		
Gross premiums written	632	608
Ceded reinsurance premiums	(23)	(17)
Net premiums	609	591
Change in provision for unearned premiums	(18)	9
Net earned premiums	591	600
Total net earned premiums	5,430	4,719

Life insurance gross written premiums can be further analysed as follows:

	2007 £m	2006 £m
Life	1,998	1,831
Pensions	2,235	1,780
Annuities	689	681
Other	15	16
Gross premiums	4,937	4,308

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

	2007 £m	2006 £m
Credit protection	212	203
Home	412	394
Health	8	11
	632	608

**8 Other operating income**

	2007 £m	2006 £m
Operating lease rental income	393	422
Rental income from investment property (note 20)	227	313
Other rents receivable	31	28
Gains less losses on disposal of available-for-sale financial assets (note 42)	5	22
Movement in value of in-force business (note 22)	(93)	(199)
Other income	389	220
	952	806

## Notes to the accounts

<b>9 Insurance claims</b>	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
Insurance claims comprise:		
<i>Life insurance and participating investment contracts</i>		
Claims and surrenders:		
Gross	<b>5,432</b>	5,375
Reinsurers' share	<b>(73)</b>	(76)
	<b>5,359</b>	5,299
Change in liabilities:		
Gross	<b>1,955</b>	2,923
Reinsurers' share	<b>20</b>	(18)
	<b>1,975</b>	2,905
Change in unallocated surplus (note 34)	<b>(114)</b>	165
Total life insurance and participating investment contracts	<b>7,220</b>	8,369
<i>Non-life insurance</i>		
Claims and claims paid:		
Gross	<b>250</b>	198
Reinsurers' share	<b>-</b>	-
	<b>250</b>	198
Change in liabilities:		
Gross	<b>58</b>	2
Reinsurers' share	<b>(6)</b>	-
	<b>52</b>	2
Total non-life insurance	<b>302</b>	200
Total insurance claims expense	<b>7,522</b>	8,569
Life insurance gross claims can also be analysed as follows:		
Deaths	<b>296</b>	286
Maturities	<b>1,516</b>	1,385
Surrenders	<b>2,994</b>	3,081
Annuities	<b>568</b>	558
Other	<b>58</b>	65
	<b>5,432</b>	5,375

A non-life insurance claims development table is included in note 32.

## Notes to the accounts

<b>10 Operating expenses</b>	<b>2007 £m</b>	2006 £m
Salaries	<b>2,127</b>	2,117
Social security costs	<b>167</b>	161
Pensions and other post-retirement benefit schemes (note 36)	<b>238</b>	165
Other staff costs	<b>372</b>	298
<b>Staff costs</b>	<b>2,904</b>	2,741
Other administrative expenses:		
Operating lease rentals	<b>250</b>	254
Repairs and maintenance	<b>154</b>	165
Communications and data processing	<b>462</b>	499
Advertising	<b>192</b>	184
Professional fees	<b>279</b>	230
Settlement of overdraft claims (see below)	<b>76</b>	–
Other	<b>581</b>	570
	<b>1,994</b>	1,902
Depreciation of tangible fixed assets (note 24)	<b>594</b>	602
Amortisation of other intangible assets (note 23)	<b>36</b>	17
<b>Total operating expenses</b>	<b>5,528</b>	5,262

During the year ended 31 December 2007, operating expenses include a charge of £76 million (2006: £nil) relating to the settlement of customer claims for the repayment of overdraft fees, together with related costs.

The average number of persons on a headcount basis employed by the Group during the year was 69,553 (2006: 76,092) of which 67,616 (2006: 74,079) were employed in the UK and 1,937 (2006: 2,013) overseas.

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

During the year the auditors earned the following fees:

	<b>2007 £m</b>	2006 £m
Fees payable for the audit of the Bank's annual report	<b>6.7</b>	5.9
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	<b>2.5</b>	2.9
Other services supplied pursuant to legislation	<b>2.7</b>	4.7
Other services relating to taxation	<b>0.7</b>	0.6
Services relating to corporate finance transactions	<b>0.7</b>	1.0
All other services	<b>1.2</b>	1.8
<b>Total fees payable to the Bank's auditors</b>	<b>14.5</b>	16.9

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

	<b>2007 £m</b>	2006 £m
Audits of the Group pension schemes	<b>0.2</b>	0.2
Audits of unconsolidated Open Ended Investment Companies managed by the Group	<b>0.4</b>	0.4
Reviews of the financial position of corporate and other borrowers	<b>2.8</b>	1.6
Acquisition due diligence and other work performed in respect of potential venture capital investments	<b>0.6</b>	1.0



## Notes to the accounts

<b>11 Impairment</b>	<b>2007 £m</b>	2006 £m
Impairment losses on loans and advances (note 18)	<b>1,721</b>	1,560
Other credit risk provisions (note 38)	<b>5</b>	(5)
	<b>1,726</b>	1,555
Impairment of available-for-sale financial assets (note 19)	<b>70</b>	–
Total impairment charged to the income statement	<b>1,796</b>	1,555

<b>12 Profit on sale of businesses</b>	<b>2007 £m</b>	2006 £m
Profit on sale of Lloyds TSB Registrars	<b>407</b>	–
Profit on sale of Abbey Life	<b>272</b>	–
Other, including adjustments in respect of businesses sold in prior years	<b>(22)</b>	–
	<b>657</b>	–

During 2007 the Group completed the following transactions:

- The sale, announced on 21 May 2007, of the business and assets of the Bank's company registration business, Lloyds TSB Registrars.
- The sale, announced on 31 July 2007, of Abbey Life Assurance Company Limited, a UK life operation which has been closed to new business since 2000.
- The sale, announced on 3 October 2007, of The Dutton-Forshaw Group Limited, a medium-size car dealership.

In addition, provision has been made for payments under an indemnity given in relation to a business sold in an earlier year.

The businesses sold in 2007 did not represent separate material lines of business and consequently they have not been treated as discontinued operations.

<b>13 Taxation</b>	<b>2007 £m</b>	2006 £m
<b>a Analysis of charge for the year</b>		
UK corporation tax:		
Current tax on profit for the year	<b>778</b>	1,006
Adjustments in respect of prior years	<b>(67)</b>	(155)
	<b>711</b>	851
Double taxation relief	<b>(60)</b>	(195)
	<b>651</b>	656
Foreign tax:		
Current tax on profit for the year	<b>97</b>	83
Adjustments in respect of prior years	<b>(3)</b>	(8)
	<b>94</b>	75
Current tax charge	<b>745</b>	731
Deferred tax (note 37)	<b>(72)</b>	531
	<b>673</b>	1,262

The charge for tax on the profit for the year is based on a UK corporation tax rate of 30 per cent (2006: 30 per cent).

The Group, as a proxy for policyholders in the UK, is required to record taxes on investment income, gains and losses each year. Accordingly, the tax attributable to UK life insurance policyholder earnings is included in income tax expense. The tax credit attributable to policyholders was £243 million (2006: tax charge of £222 million), including a prior year tax charge of £5 million (2006: tax charge of £12 million).

In addition to the income statement current tax charge, a total of £128 million of current tax has been credited to equity (2006: a total of £32 million charged to equity); a credit of £103 million (2006: a charge of £33 million) in respect of foreign exchange differences and a net credit of £25 million (2006: a net credit of £1 million) in respect of the revaluation of available-for-sale financial assets.

## Notes to the accounts

**13 Taxation** (continued)**b Factors affecting the tax charge for the year**

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

	<b>2007</b>	2006
	<b>£m</b>	£m
Profit before tax	<b>4,089</b>	4,282
Tax charge thereon at UK corporation tax rate of 30%	<b>1,227</b>	1,285
Factors affecting charge:		
Disallowed and non-taxable items	<b>(20)</b>	(92)
Overseas tax rate differences	<b>(4)</b>	(2)
Gains exempted or covered by capital losses	<b>(274)</b>	(78)
Policyholder interests	<b>(173)</b>	123
UK corporation tax rate change	<b>(110)</b>	–
Other items	<b>27</b>	26
Tax on profit on ordinary activities	<b>673</b>	1,262
Effective rate	<b>16.5%</b>	29.5%

The effective tax rate of the Group excluding the gross policyholder and Open Ended Investment Company interests from profit before tax and the tax charge and, in 2007, the profit on disposal of businesses from profit before tax and the impact on the year end deferred tax position of the UK corporation tax rate change was 27.5 per cent (2006: 25.7 per cent).

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

	The Group		The Bank	
	<b>2007</b>	2006	<b>2007</b>	2006
	<b>£m</b>	£m	<b>£m</b>	£m
Trading assets	<b>4,663</b>	5,756	<b>4,663</b>	5,756
Other financial assets at fair value through profit or loss	<b>53,433</b>	62,172	<b>4,521</b>	3,063
	<b>58,096</b>	67,928	<b>9,184</b>	8,819

These assets are comprised as follows:

	2007		2006		2007		2006	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to banks	<b>29</b>	<b>1</b>	34	3	<b>29</b>	<b>1</b>	34	3
Loans and advances to customers	<b>756</b>	<b>403</b>	350	448	<b>756</b>	<b>403</b>	350	448
Debt securities:								
Government securities	<b>62</b>	<b>4,848</b>	180	8,626	<b>62</b>	<b>1</b>	180	11
Other public sector securities	–	–	–	44	–	–	–	–
Bank and building society certificates of deposit	–	<b>811</b>	–	573	–	–	–	–
Mortgage backed securities	<b>87</b>	<b>70</b>	451	87	<b>87</b>	<b>8</b>	451	7
Other asset backed securities	<b>122</b>	<b>1,805</b>	595	861	<b>122</b>	<b>282</b>	595	435
Corporate and other debt securities	<b>3,607</b>	<b>13,564</b>	4,146	13,170	<b>3,607</b>	<b>3,823</b>	4,146	2,150
	<b>3,878</b>	<b>21,098</b>	5,372	23,361	<b>3,878</b>	<b>4,114</b>	5,372	2,603
Equity shares:								
Listed	–	<b>23,783</b>	–	29,508	–	–	–	–
Unlisted	–	<b>8,148</b>	–	8,852	–	<b>3</b>	–	9
	–	<b>31,931</b>	–	38,360	–	<b>3</b>	–	9
	<b>4,663</b>	<b>53,433</b>	5,756	62,172	<b>4,663</b>	<b>4,521</b>	5,756	3,063

## Notes to the accounts

### 14 Trading and other financial assets at fair value through profit or loss (continued)

At 31 December 2007 £55,914 million (2006: £65,355 million) of trading and other financial assets at fair value through profit or loss of the Group and £8,111 million (2006: £7,601 million) of the Bank had a contractual residual maturity of greater than one year.

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

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

The maximum exposure to credit risk at 31 December 2007 of the loans and advances to banks and customers designated at fair value through profit or loss by the Bank and the Group was £404 million (31 December 2006: £451 million); the Bank and the Group do not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk; this is determined by reference to the publicly available credit ratings of the instruments involved.

The carrying value of assets of the Group that are subject to stocklending arrangements was £1,450 million at 31 December 2007 (2006: £1,781 million) all of which the secured party is permitted by contract or custom to sell or repledge.

### 15 Derivative financial instruments

The principal derivatives used by the Group and the Bank are interest rate and exchange rate contracts; particular attention is paid to the liquidity of the markets and products in which the Group and the Bank trade to ensure that there are no undue concentrations of activity and risk.

Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.

Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. As discussed in note 17, the Group also uses credit default swaps to synthetically securitise £1,572 million (Bank: £1,543 million) of its commercial banking loans (2006: Group £961 million; Bank £939 million), and, in combination with external funding, to securitise a further £2,753 million (Bank: £nil) of commercial banking loans (2006: £nil).

Equity derivatives are also used by the Group and the Bank as part of their equity based retail product activity to eliminate the Group's and the Bank's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group and the Bank the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

The principal amount of the contract does not represent the Group's and the Bank's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group or the Bank should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate.

## Notes to the accounts

## 15 Derivative financial instruments (continued)

The Group	2007			2006		
	Contract/ notional amount £m	Fair values		Contract/ notional amount £m	Fair values	
		Assets £m	Liabilities £m		Assets £m	Liabilities £m
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	150,450	1,759	1,285	116,255	794	1,432
Currency swaps	32,447	832	755	21,081	346	522
Options purchased	7,609	157	–	3,076	51	–
Options written	6,988	–	149	3,822	–	32
	<b>197,494</b>	<b>2,748</b>	<b>2,189</b>	144,234	1,191	1,986
Interest rate contracts:						
Interest rate swaps	334,159	2,765	3,344	333,617	2,980	3,237
Forward rate agreements	102,274	36	34	40,876	17	18
Options purchased	33,147	171	–	17,034	68	–
Options written	22,976	–	171	12,588	–	63
Futures	35,571	1	–	33,066	–	1
	<b>528,127</b>	<b>2,973</b>	<b>3,549</b>	437,181	3,065	3,319
Credit derivatives	63,444	1,838	1,057	13,212	25	39
Equity and other contracts	4,439	865	156	4,026	797	67
Total derivative assets/liabilities held for trading		<b>8,424</b>	<b>6,951</b>		5,078	5,411
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Cross currency interest rate swaps	–	–	–	80	10	–
Interest rate swaps (including swap options)	50,734	263	460	37,298	333	453
	<b>50,734</b>	<b>263</b>	<b>460</b>	37,378	343	453
Derivatives designated as cash flow hedges:						
Interest rate swaps	630	1	24	569	5	13
Derivatives designated as net investment hedges:						
Cross currency swaps	5,302	–	316	2,589	139	–
Total derivative assets/liabilities held for hedging		<b>264</b>	<b>800</b>		487	466
Total recognised derivative assets/liabilities		<b>8,688</b>	<b>7,751</b>		5,565	5,877

At 31 December 2007 £3,573 million of total recognised derivative assets of the Group and £4,281 million of total recognised derivative liabilities of the Group (2006: £3,068 million of assets and £3,526 million of liabilities) had a contractual residual maturity of greater than one year.

## Notes to the accounts

**15 Derivative financial instruments** (continued)**The Bank**

	2007			2006		
	Contract/ notional amount £m	Fair values		Contract/ notional amount £m	Fair values	
		Assets £m	Liabilities £m		Assets £m	Liabilities £m
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	155,435	1,804	1,306	119,409	822	1,437
Currency swaps	32,742	834	777	13,230	432	446
Options purchased	8,694	157	–	3,294	51	–
Options written	7,008	–	150	3,664	–	32
	<b>203,879</b>	<b>2,795</b>	<b>2,233</b>	139,597	1,305	1,915
Interest rate contracts:						
Interest rate swaps	347,033	2,777	3,365	348,065	3,094	3,228
Forward rate agreements	103,902	36	34	40,961	17	12
Options purchased	33,543	174	–	17,463	68	–
Options written	23,061	–	174	12,740	–	64
Futures	35,189	–	–	33,066	–	–
	<b>542,728</b>	<b>2,987</b>	<b>3,573</b>	452,295	3,179	3,304
Credit derivatives	63,195	1,838	1,053	13,212	25	39
Equity and other contracts	6,728	733	733	7,349	671	667
Total derivative assets/liabilities held for trading		<b>8,353</b>	<b>7,592</b>		5,180	5,925
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Cross currency interest rate swaps	–	–	–	80	10	–
Interest rate swaps (including swap options)	50,209	270	433	36,618	331	467
	<b>50,209</b>	<b>270</b>	<b>433</b>	36,698	341	467
Derivatives designated as cash flow hedges:						
Interest rate swaps	630	1	24	569	5	13
Derivatives designated as net investment hedges:						
Cross currency swaps	5,302	–	316	2,589	139	–
Total derivative assets/liabilities held for hedging		<b>271</b>	<b>773</b>		485	480
Total recognised derivative assets/liabilities		<b>8,624</b>	<b>8,365</b>		5,665	6,405

At 31 December 2007 £3,590 million of total recognised derivative assets of the Bank and £4,687 million of total recognised derivative liabilities of the Bank (2006: £3,181 million of assets and £4,103 million of liabilities) had a contractual residual maturity of greater than one year.

**16 Loans and advances to banks**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Lending to banks	5,892	5,966	8,474	62,562
Money market placements with banks	28,953	34,673	19,973	24,027
Total loans and advances to banks	34,845	40,639	28,447	86,589
Allowance for impairment losses (note 18)	–	(1)	–	(1)
	<b>34,845</b>	40,638	<b>28,447</b>	86,588

At 31 December 2007 £5,773 million (2006: £15,259 million) of loans and advances to banks of the Group and £4,312 million (2006: £43,389 million) of the Bank had a contractual residual maturity of greater than one year.

The Group and the Bank hold collateral with a fair value of £9,109 million (2006: £6,837 million), which they are permitted to sell or repledge, of which £8,482 million (2006: £6,209 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

## Notes to the accounts

**17 Loans and advances to customers**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Agriculture, forestry and fishing	<b>3,226</b>	2,905	<b>1,467</b>	1,355
Energy and water supply	<b>2,102</b>	2,024	<b>2,102</b>	2,024
Manufacturing	<b>8,385</b>	7,513	<b>6,788</b>	6,135
Construction	<b>2,871</b>	2,332	<b>2,531</b>	2,040
Transport, distribution and hotels	<b>11,573</b>	10,490	<b>10,158</b>	9,131
Postal and telecommunications	<b>946</b>	831	<b>907</b>	775
Property companies	<b>17,576</b>	12,896	<b>16,303</b>	12,164
Financial, business and other services	<b>29,707</b>	22,999	<b>21,952</b>	16,240
Personal:				
Mortgages	<b>102,739</b>	95,601	<b>90,217</b>	846
Other	<b>22,988</b>	23,025	<b>19,120</b>	19,038
Lease financing	<b>4,686</b>	4,802	-	-
Hire purchase	<b>5,423</b>	5,060	<b>388</b>	323
Due from fellow Group undertakings	-	1,850	<b>42,660</b>	38,205
	<b>212,222</b>	192,328	<b>214,593</b>	108,276
Allowance for impairment losses (note 18)	<b>(2,408)</b>	(2,193)	<b>(1,855)</b>	(1,700)
	<b>209,814</b>	190,135	<b>212,738</b>	106,576

At 31 December 2007 £153,302 million (2006: £141,272 million) of loans and advances to customers of the Group and £129,272 million (2006: £35,191 million) of the Bank had a contractual residual maturity of greater than one year.

The Group and the Bank hold collateral with a fair value of £1,975 million (2006: £444 million), which they are permitted to sell or repledge, of which £1,818 million (2006: £238 million) was repledged or sold to third parties for periods not exceeding three months from the transfer.

Of the Bank's amounts due from fellow Group undertakings at 31 December 2007, US\$5.5 billion (2006: US\$5.5 billion) has been pledged as security against a demand loan made to the Bank by another of its fellow Group undertakings.

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

	The Group	
	2007 £m	2006 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	<b>620</b>	637
Later than 1 year and not later than 5 years	<b>1,917</b>	2,358
Later than 5 years	<b>5,339</b>	5,358
	<b>7,876</b>	8,353
Unearned future finance income on finance leases	<b>(2,875)</b>	(2,945)
Rentals received in advance	<b>(131)</b>	(163)
Commitments for expenditure in respect of equipment to be leased	<b>(184)</b>	(443)
Net investment in finance leases	<b>4,686</b>	4,802

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

	The Group	
	2007 £m	2006 £m
Not later than 1 year	<b>340</b>	234
Later than 1 year and not later than 5 years	<b>1,004</b>	1,232
Later than 5 years	<b>3,342</b>	3,336
	<b>4,686</b>	4,802

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £16 million (2006: £7 million).

## Notes to the accounts

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

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

	2007 £m	2006 £m
Not later than 1 year	–	–
Later than 1 year and not later than 5 years	17	–
Later than 5 years	159	168
<b>Total</b>	<b>176</b>	<b>168</b>

**Securitisations**

Loans and advances to customers include balances that have been securitised but not derecognised, comprising both residential mortgages and commercial banking loans, the carrying values of which are set out below together with any related liabilities.

Residential mortgages are not derecognised because the Group remains exposed to the majority of the risk of any default in respect of them; 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.

Beneficial interests in certain residential mortgages have been transferred to special purpose entities which issue floating rate debt securities. Neither the Group nor any entities in the Group are obliged to support any losses that may be suffered by the note holders and do not intend to offer such support. The floating rate note holders only receive payments of interest and principal to the extent that the special purpose entities have received sufficient funds from the transferred mortgages and after certain expenses have been met. In the event of a deficiency, they have no recourse whatsoever to the Group.

At 31 December 2007 the total amount of residential mortgages subject to securitisation for the Group is £46,284 million (2006: £14,927 million) and for the Bank is £46,284 million (2006: £nil) in respect of which external funding at the year end amounted to £12,403 million (2006: £10,048 million) for the Group and £12,403 million (2006: £nil) for the Bank; external funding is shown in debt securities in issue (note 31).

The Group participates in the securitisation through the provision of administration and other services, the provision of interest rate and currency swaps and in the form of unsecured loan financing which is subordinate to the interests of the floating rate note holders.

In addition the Group has entered into two securitisations of its commercial banking loans as follows:

- a synthetic securitisation of £1,572 million (£1,543 million for the Bank; 2006: £961 million for the Group and £939 million for the Bank) utilising credit default swaps (CDSs);
- a securitisation of £2,753 million (£nil for the Bank; 2006: £nil) utilising a combination of CDSs and £98 million (2006: £nil) of external funding.

The CDSs are accounted for as derivatives and are included in derivative financial instruments (note 15) and the external funding is shown in debt securities in issue (note 31).

**18 Allowance for impairment losses on loans and advances****The Group**

	Loans and advances to customers				Loans and advances to banks £m	Total £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
Balance at 1 January 2006	36	1,655	381	2,072	1	2,073
Exchange and other adjustments	1	–	(14)	(13)	–	(13)
Adjustments on disposal of businesses and portfolios	–	(27)	–	(27)	–	(27)
Advances written off	(9)	(1,338)	(142)	(1,489)	–	(1,489)
Recoveries of advances written off in previous years	2	170	18	190	–	190
Unwinding of discount	–	(100)	–	(100)	–	(100)
Charge to the income statement	12	1,558	(10)	1,560	–	1,560
<b>At 31 December 2006</b>	<b>42</b>	<b>1,918</b>	<b>233</b>	<b>2,193</b>	<b>1</b>	<b>2,194</b>
Exchange and other adjustments	–	–	2	2	–	2
Advances written off	(25)	(1,439)	(78)	(1,542)	–	(1,542)
Recoveries of advances written off in previous years	2	133	2	137	–	137
Unwinding of discount	–	(101)	(3)	(104)	–	(104)
Charge to the income statement	18	1,518	186	1,722	(1)	1,721
<b>At 31 December 2007</b>	<b>37</b>	<b>2,029</b>	<b>342</b>	<b>2,408</b>	<b>–</b>	<b>2,408</b>

The analysis of allowances for impairment between retail and wholesale has been prepared based upon the type of exposure and not the business segment in which the exposure is recorded. Included within retail are exposures to personal customers and small businesses, whilst included within wholesale are exposures to corporate customers and other large institutions.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 1(j). All impaired loans which exceed a certain threshold, principally within the Group's corporate banking business, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security.

## Notes to the accounts

**18 Allowance for impairment losses on loans and advances** (continued)

Included in loans and advances to customers were loans and advances individually determined to be impaired whose gross amount before impairment allowances was £684 million (2006: £428 million) and in respect of which collateral with a fair value of £193 million (2006: £186 million) was held.

**The Bank**

	Loans and advances to customers				Loans and advances to banks	
	Retail – mortgages £m	Retail – other £m	Non-retail £m	Total £m	£m	Total £m
Balance at 1 January 2006	–	1,365	353	1,718	1	1,719
Exchange and other adjustments	–	–	(13)	(13)	–	(13)
Adjustments on disposal of businesses and portfolios	–	(27)	–	(27)	–	(27)
Advances written off	–	(1,177)	(126)	(1,303)	–	(1,303)
Recoveries of advances written off in previous years	–	143	14	157	–	157
Unwinding of discount	–	(100)	–	(100)	–	(100)
Charge to the income statement	–	1,295	(27)	1,268	–	1,268
<b>At 31 December 2006</b>	–	1,499	201	1,700	1	1,701
Exchange and other adjustments	–	–	1	1	–	1
Transfer of C&G business (note 26)	23	–	–	23	–	23
Advances written off	(4)	(1,246)	(35)	(1,285)	–	(1,285)
Recoveries of advances written off in previous years	–	113	1	114	–	114
Unwinding of discount	–	(101)	(3)	(104)	–	(104)
Charge to the income statement	13	1,256	137	1,406	(1)	1,405
<b>At 31 December 2007</b>	<b>32</b>	<b>1,521</b>	<b>302</b>	<b>1,855</b>	<b>–</b>	<b>1,855</b>

Included in loans and advances to customers were loans and advances individually determined to be impaired whose gross amount before impairment allowances was £646 million (2006: £147 million) and in respect of which collateral with a fair value of £147 million (2006: £127 million) was held.

**19 Available-for-sale financial assets**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Debt securities:				
Government securities	319	393	–	6
Other public sector securities	5	189	5	–
Bank and building society certificates of deposit	1,825	1,615	1,283	1,611
Mortgage backed securities	6,050	5,662	1,464	1,604
Other asset backed securities	4,071	4,721	413	433
Corporate and other debt securities	6,270	4,817	1,027	220
	<b>18,540</b>	17,397	<b>4,192</b>	3,874
Equity shares:				
Listed	1	1	1	1
Unlisted	28	14	28	14
	<b>29</b>	15	<b>29</b>	15
Treasury bills and other bills:				
Treasury bills and similar securities	1,608	1,743	20	60
Other bills	19	23	19	23
	<b>1,627</b>	1,766	<b>39</b>	83
	<b>20,196</b>	19,178	<b>4,260</b>	3,972

At 31 December 2007 £15,265 million (2006: £13,779 million) of available-for-sale financial assets of the Group and £2,294 million (2006: £2,069 million) of the Bank had a contractual residual maturity of greater than one year.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 1(j). Included in available-for-sale assets at 31 December 2007 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £75 million and in respect of which no collateral was held.



## Notes to the accounts

**19 Available-for-sale financial assets** (continued)

The movement in available-for-sale financial assets is summarised as follows:

	The Group			The Bank		
	Carrying value before allowances for impairment £m	Allowances for impairment £m	Balance sheet value £m	Carrying value before allowances for impairment £m	Allowances for impairment £m	Balance sheet value £m
At 1 January 2006	14,940	–	14,940	4,503	–	4,503
Exchange and other adjustments	(1,116)	–	(1,116)	(88)	–	(88)
Additions	23,448	–	23,448	9,917	–	9,917
Disposals	(18,106)	–	(18,106)	(10,353)	–	(10,353)
Amortisation of premiums and discounts	22	–	22	–	–	–
Changes in fair value (note 42)	(10)	–	(10)	(7)	–	(7)
<b>At 31 December 2006</b>	<b>19,178</b>	<b>–</b>	<b>19,178</b>	<b>3,972</b>	<b>–</b>	<b>3,972</b>
Exchange and other adjustments	(715)	–	(715)	249	–	249
Additions	21,667	–	21,667	8,197	–	8,197
Disposals	(19,468)	–	(19,468)	(8,022)	–	(8,022)
Amortisation of premiums and discounts	36	–	36	–	–	–
Changes in fair value (note 42)	(483)	–	(483)	(130)	–	(130)
Impairment transferred from reserves (note 42)	70	(70)	–	70	(70)	–
Disposal of businesses	(19)	–	(19)	(6)	–	(6)
<b>At 31 December 2007</b>	<b>20,266</b>	<b>(70)</b>	<b>20,196</b>	<b>4,330</b>	<b>(70)</b>	<b>4,260</b>

At 31 December 2007, the Bank had sold £607 million (2006: £621 million) of debt securities to one of its subsidiary undertakings; however the related agreements are such that the Bank has retained substantially all of the risks and rewards of ownership and, as a consequence, the debt securities continue to be recognised on the Bank's balance sheet.

**20 Investment property of the Group**

	2007 £m	2006 £m
At 1 January	4,739	4,260
Exchange and other adjustments	5	–
Additions:		
Acquisitions of new properties	302	675
Additional expenditure on existing properties	181	75
Total additions	483	750
Disposals	(271)	(902)
Adjustments on deconsolidation of OEICs	(881)	–
Changes in fair value (note 6)	(321)	631
Disposal of businesses	(32)	–
At 31 December	3,722	4,739

During the year the percentage ownership of certain OEICs changed so that the Group no longer has control; as a consequence these OEICs have been deconsolidated.

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

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

	2007 £m	2006 £m
Rental income	227	313
Direct operating expenses arising from investment properties that generate rental income	24	24
Capital expenditure in respect of investment properties:		
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	111	85

## Notes to the accounts

**21 Goodwill**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 January	<b>2,377</b>	2,373	<b>8</b>	8
Acquisitions (note 50)	–	4	–	–
Disposals	<b>(19)</b>	–	<b>(8)</b>	–
At 31 December	<b>2,358</b>	2,377	–	8
Cost*	<b>2,364</b>	2,383	–	8
Accumulated impairment losses	<b>(6)</b>	(6)	–	–
	<b>2,358</b>	2,377	–	8

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,358 million (2006: £2,377 million), £1,836 million (or 78 per cent of the total) has been allocated to Scottish Widows and £510 million (or 22 per cent of the total) to Asset Finance.

The recoverable amount of Scottish Widows has been based on a value in use calculation. The calculation uses projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 11 per cent (gross of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of Asset Finance has also been based on a value in use calculation using cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 12 per cent (gross of tax). The discount rate has been set at a premium over the Lloyds TSB Group's weighted average cost of capital to take into account the specific risk profile of the Asset Finance business. The cash flows for each of the businesses of Asset Finance beyond the five-year period are extrapolated using steady growth rates, in each case not exceeding 4 per cent nor the long-term average growth rates for the markets in which the respective businesses of Asset Finance participate.

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

The asset in the consolidated balance sheet and movement recognised in the income statement are as follows:

	2007 £m	2006 £m
At 1 January	<b>2,723</b>	2,922
Movement in value of in-force business	<b>(93)</b>	(199)
Disposal of business	<b>(412)</b>	–
At 31 December	<b>2,218</b>	2,723

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

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

A market consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date.

The risk-free rate assumed in valuing in-force business is 10 basis points over the 15-year gilt yield. In valuing financial options and guarantees the risk-free rate is derived from gilt yields plus 10 basis points, in line with Scottish Widows' FSA realistic balance sheet assumptions.

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

	2007 %	2006 %
Risk-free rate (value of in-force)	<b>4.65</b>	4.72
Risk-free rate (financial options and guarantees)	<b>4.28 to 4.81</b>	3.91 to 5.41
Retail price inflation	<b>3.28</b>	3.23
Expense inflation	<b>4.18</b>	4.13

- *Non-market risk.* An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk and the with-profits fund there are asymmetries in the range of potential outcomes for which an explicit allowance is made.

- *Non-economic assumptions.* Future maintenance expenses, mortality, morbidity, lapse and paid-up rate assumptions are based on an analysis of past experience and represent management's best estimate of likely future experience.

## Notes to the accounts

**23 Other intangible assets**

	The Group		The Bank	
	Customer lists £m	Software enhancements £m	Total £m	Software enhancements £m
Cost:				
At 1 January 2006	–	147	147	103
Additions	54	51	105	24
At 31 December 2006	54	198	252	127
Additions	<b>3</b>	<b>47</b>	<b>50</b>	<b>29</b>
Disposals	–	<b>(5)</b>	<b>(5)</b>	–
<b>At 31 December 2007</b>	<b>57</b>	<b>240</b>	<b>297</b>	<b>156</b>
Accumulated amortisation:				
At 1 January 2006	–	97	97	80
Charge for the year	–	17	17	10
At 31 December 2006	–	114	114	90
Charge for the year	<b>5</b>	<b>31</b>	<b>36</b>	<b>13</b>
Disposals	–	<b>(2)</b>	<b>(2)</b>	–
<b>At 31 December 2007</b>	<b>5</b>	<b>143</b>	<b>148</b>	<b>103</b>
<b>Balance sheet amount at 31 December 2007</b>	<b>52</b>	<b>97</b>	<b>149</b>	<b>53</b>
Balance sheet amount at 31 December 2006	54	84	138	37

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

## Notes to the accounts

**24 Tangible fixed assets**

	The Group				The Bank		
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Total tangible fixed assets £m
Cost:							
At 1 January 2006	1,421	2,667	2,961	7,049	1,005	2,112	3,117
Exchange and other adjustments	–	(3)	(96)	(99)	–	(3)	(3)
Additions	92	286	552	930	82	262	344
Disposals	(25)	(101)	(551)	(677)	(6)	(48)	(54)
At 31 December 2006	1,488	2,849	2,866	7,203	1,081	2,323	3,404
Exchange and other adjustments	–	2	(24)	(22)	–	1	1
Adjustments on disposal of businesses	(53)	(89)	–	(142)	(6)	(56)	(62)
Adjustments on deconsolidation of subsidiaries	–	–	(1,015)	(1,015)	–	–	–
Additions	60	286	549	895	55	266	321
Disposals	(58)	(177)	(945)	(1,180)	(47)	(108)	(155)
<b>At 31 December 2007</b>	<b>1,437</b>	<b>2,871</b>	<b>1,431</b>	<b>5,739</b>	<b>1,083</b>	<b>2,426</b>	<b>3,509</b>
Accumulated depreciation and impairment:							
At 1 January 2006	601	1,796	361	2,758	529	1,345	1,874
Exchange and other adjustments	(1)	(1)	(63)	(65)	(1)	(2)	(3)
Charge for the year	82	248	272	602	70	215	285
Disposals	(7)	(83)	(254)	(344)	(3)	(33)	(36)
At 31 December 2006	675	1,960	316	2,951	595	1,525	2,120
Exchange and other adjustments	–	2	(3)	(1)	–	1	1
Adjustments on disposal of businesses	(11)	(35)	–	(46)	(4)	(6)	(10)
Adjustments on deconsolidation of subsidiaries	–	–	(86)	(86)	–	–	–
Charge for the year	83	242	269	594	72	214	286
Disposals	(29)	(162)	(321)	(512)	(26)	(97)	(123)
<b>At 31 December 2007</b>	<b>718</b>	<b>2,007</b>	<b>175</b>	<b>2,900</b>	<b>637</b>	<b>1,637</b>	<b>2,274</b>
<b>Balance sheet amount at 31 December 2007</b>	<b>719</b>	<b>864</b>	<b>1,256</b>	<b>2,839</b>	<b>446</b>	<b>789</b>	<b>1,235</b>
Balance sheet amount at 31 December 2006	813	889	2,550	4,252	486	798	1,284

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

	2007 £m	2006 £m
Receivable within 1 year	259	431
1 to 5 years	271	747
Over 5 years	9	30
	<b>539</b>	<b>1,208</b>

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2006 and 2007 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £113 million for the Group and £104 million for the Bank at 31 December 2007 (£120 million for the Group and £103 million for the Bank at 31 December 2006) is expected to be received under non-cancellable sub-leases of premises.

During the year the Group entered into an agreement which transferred control over a number of its leasing subsidiaries to third parties. These subsidiaries have been deconsolidated and, consequently, operating lease assets and related accumulated depreciation in the amounts of £1,015 million and £86 million respectively have been derecognised.

**25 Investment in subsidiary undertakings**

	2007 £m	2006 £m
At 1 January	18,527	16,078
Additions	2,933	8
Additional capital injections and transfers	313	2,444
Capital repayments	(5,628)	(3)
Disposals	(8)	–
At 31 December	<b>16,137</b>	<b>18,527</b>

## Notes to the accounts

**25 Investment in subsidiary undertakings** (continued)

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

	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Commercial Finance Limited	England	100%	Credit factoring
Lloyds TSB Leasing Limited	England	100%	Financial leasing
Lloyds TSB Private Banking Limited	England	100%	Private banking
The Agricultural Mortgage Corporation PLC	England	100%	Long-term agricultural finance
Lloyds TSB Offshore Limited	Jersey	100%*	Banking and financial services
Lloyds TSB Scotland plc	Scotland	100%	Banking and financial services
Lloyds TSB General Insurance Limited	England	100%*	General insurance
Scottish Widows Investment Partnership Group Limited	England	100%*	Investment management
Lloyds TSB Insurance Services Limited	England	100%*	Insurance broking
Lloyds TSB Asset Finance Division Limited	England	100%	Consumer credit, leasing and related services
Black Horse Limited	England	100%*	Consumer credit, leasing and related services
Scottish Widows plc	Scotland	100%*	Life assurance
Scottish Widows Annuities Limited	Scotland	100%*	Life assurance

\*Indirect interest.

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

None of the Bank's subsidiaries has experienced any significant restrictions in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

**26 Transfer of mortgage and banking business of Cheltenham & Gloucester plc**

The mortgage and banking business of the Bank's wholly-owned subsidiary, Cheltenham & Gloucester plc (C&G), was transferred to the Bank on 1 October 2007 under a Court approved scheme pursuant to Part VII of the Financial Services and Markets Act 2000. Consideration for the transfer was nil and the reserve arising on transfer was reduced by the carrying value of most of the Bank's investment in C&G. The assets and liabilities transferred were as follows:

	£m
Loans and advances to customers (net of impairment allowances of £23 million)	87,142
Customer accounts	(14,826)
Debt securities in issue	(13,255)
Subordinated liabilities	(700)
Funding from the Bank no longer required	(55,374)
Other net liabilities	(669)
	<b>2,318</b>
Consideration paid	-
	<b>2,318</b>
Reduction in the Bank's investment in C&G	(1,745)
Net amount arising from transfer credited to retained profits	<b>573</b>

## Notes to the accounts

**27 Other assets**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Assets arising from reinsurance contracts held	350	451	-	-
Deferred acquisition costs	212	443	-	-
Settlement balances	205	285	54	55
Other assets and prepayments	4,279	3,483	2,109	1,911
	<b>5,046</b>	<b>4,662</b>	<b>2,163</b>	<b>1,966</b>

At 31 December 2007 £1,785 million (2006: £1,519 million) of other assets of the Group and £226 million (2006: £421 million) of the Bank had a contractual residual maturity of greater than one year.

	2007 £m	2006 £m
Deferred acquisition costs of the Group:		
At 1 January	443	429
Acquisition costs deferred, net of amounts amortised to the income statement	(22)	14
Disposal of businesses and other adjustments	(209)	-
At 31 December	<b>212</b>	<b>443</b>

**28 Deposits from banks**

The breakdown of deposits from banks between domestic and international offices is set out below:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Domestic:				
Non-interest bearing	101	89	104	89
Interest bearing	32,335	28,405	42,107	35,945
	<b>32,436</b>	<b>28,494</b>	<b>42,211</b>	<b>36,034</b>
International:				
Non-interest bearing	46	31	46	31
Interest bearing	6,609	7,869	6,683	8,005
	<b>6,655</b>	<b>7,900</b>	<b>6,729</b>	<b>8,036</b>
	<b>39,091</b>	<b>36,394</b>	<b>48,940</b>	<b>44,070</b>

At 31 December 2007 £25 million (2006: £2,760 million) of deposits from banks of the Group and £563 million (2006: £2,290 million) of the Bank had a contractual residual maturity of greater than one year.

Included in deposits from banks, for both the Group and the Bank, were deposits of £1,509 million (2006: £582 million) held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

## Notes to the accounts

**29 Customer accounts**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Non-interest bearing current accounts	<b>3,807</b>	4,338	<b>3,588</b>	4,103
Interest bearing current accounts	<b>45,726</b>	43,064	<b>42,586</b>	40,699
Savings and investment accounts	<b>71,905</b>	66,151	<b>62,178</b>	42,627
Other customer deposits	<b>35,275</b>	27,214	<b>54,893</b>	40,509
	<b>156,713</b>	140,767	<b>163,245</b>	127,938

The breakdown of customer accounts between domestic and international offices is set out below:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Domestic:				
Non-interest bearing	<b>3,476</b>	4,069	<b>5,717</b>	4,183
Interest bearing	<b>149,501</b>	133,139	<b>151,654</b>	119,615
	<b>152,977</b>	137,208	<b>157,371</b>	123,798
International:				
Non-interest bearing	<b>400</b>	336	<b>699</b>	337
Interest bearing	<b>3,336</b>	3,223	<b>5,175</b>	3,803
	<b>3,736</b>	3,559	<b>5,874</b>	4,140
	<b>156,713</b>	140,767	<b>163,245</b>	127,938

At 31 December 2007 £1,950 million (2006: £3,255 million) of customer accounts of the Group and £12,199 million (2006: £6,650 million) of the Bank had a contractual residual maturity of greater than one year.

Included in customer accounts were deposits of £777 million (2006: £462 million) of the Group and £629 million (2006: £428 million) of the Bank held as collateral, principally in relation to derivative contracts. The fair value of those deposits approximates the carrying amount.

**30 Trading and other liabilities at fair value through profit or loss**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Liabilities held at fair value through profit or loss (debt securities)	<b>3,107</b>	1,156	<b>3,107</b>	1,156
Trading liabilities	<b>99</b>	28	<b>99</b>	28
	<b>3,206</b>	1,184	<b>3,206</b>	1,184

At 31 December 2007, for both the Group and the Bank, £2,032 million (2006: £1,144 million) of trading and other liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2007 was £3,131 million (2006: £1,200 million), which was £24 million higher (2006: £44 million higher) than the balance sheet carrying value. There was an £8 million (2006: £nil) decrease in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of the Bank.

Liabilities held at fair value through profit or loss represent designated debt securities in issue which contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities.

**31 Debt securities in issue**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Euro medium-term note programme	<b>4,692</b>	5,650	<b>4,692</b>	5,650
Other bonds and medium-term notes	<b>12,753</b>	10,157	<b>12,403</b>	–
Certificates of deposit issued	<b>14,995</b>	25,244	<b>14,501</b>	24,729
Commercial paper	<b>17,388</b>	13,067	<b>5,051</b>	2,340
Total debt securities in issue	<b>49,828</b>	54,118	<b>36,647</b>	32,719

At 31 December 2007 £16,860 million (2006: £15,020 million) of debt securities in issue of the Group and £16,565 million (2006: £5,825 million) of the Bank had a contractual residual maturity of greater than one year.

Debt securities in issue for the Group at 31 December 2007 included £12,403 million (2006: £10,048 million) of notes issued by the mortgage securitisation vehicles (note 17); debt securities in issue for the Bank at 31 December 2007 included £12,403 million (2006: £nil) of funding provided by those vehicles. Debt securities in issue for the Group at 31 December 2007 also included £98 million (2006: £nil) in respect of the securitisation of commercial banking loans (note 17).

## Notes to the accounts

<b>32 Liabilities of the Group arising from insurance contracts and participating investment contracts</b>	<b>2007 £m</b>	2006 £m
Insurance contract liabilities	<b>23,318</b>	26,507
Participating investment contract liabilities	<b>14,874</b>	15,095
	<b>38,192</b>	41,602

At 31 December 2007 £35,732 million (2006: £38,454 million) of liabilities arising from insurance contracts and participating investment contracts had a contractual residual maturity of greater than one year.

**Insurance contract liabilities**

Insurance contract liabilities, substantially all of which relate to business written in the United Kingdom, are comprised as follows:

	2007			2006		
	Gross £m	Reinsurance* £m	Net £m	Gross £m	Reinsurance* £m	Net £m
Life insurance	<b>22,655</b>	<b>(340)</b>	<b>22,315</b>	25,920	(425)	25,495
Non-life insurance:						
Unearned premiums	<b>456</b>	–	<b>456</b>	438	–	438
Claims outstanding	<b>207</b>	<b>(10)</b>	<b>197</b>	149	(4)	145
	<b>663</b>	<b>(10)</b>	<b>653</b>	587	(4)	583
	<b>23,318</b>	<b>(350)</b>	<b>22,968</b>	26,507	(429)	26,078

\*Reinsurance balances receivable are reported within other assets (note 27).

**Life insurance**

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

	Gross £m	Reinsurance* £m	Net £m
At 1 January 2006	26,022	(511)	25,511
New business	1,045	(98)	947
Changes in existing business	(1,147)	184	(963)
At 31 December 2006	25,920	(425)	25,495
New business	<b>2,428</b>	<b>(18)</b>	<b>2,410</b>
Changes in existing business	<b>(1,344)</b>	<b>15</b>	<b>(1,329)</b>
Disposal of businesses	<b>(4,349)</b>	<b>88</b>	<b>(4,261)</b>
<b>At 31 December 2007</b>	<b>22,655</b>	<b>(340)</b>	<b>22,315</b>

\*Reinsurance balances receivable are reported within other assets (note 27).

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

	£m
At 1 January 2006	14,068
New business	1,815
Changes in existing business	(788)
At 31 December 2006	15,095
New business	<b>491</b>
Changes in existing business	<b>(712)</b>
<b>At 31 December 2007</b>	<b>14,874</b>

*Process for determining key assumptions*

The process for determining the key assumptions for insurance contracts and participating investment contracts is set out below.

These policy liabilities can be split into With Profit Fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and Non-Profit Fund liabilities, accounted for using a traditional prospective actuarial discounted cash flow methodology as described in the accounting policies.

*With Profit Fund realistic liabilities*

The Group's With Profit Fund contains life insurance contracts and participating investment contracts. The calculation of With Profit Fund realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 22. The persistency rates used for the realistic valuation of the With Profit Fund liabilities make an allowance for potential changes in future experience as the guarantees and options within with-profits contracts become more valuable under adverse market conditions.



## Notes to the accounts

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

Other key assumptions are:

- *Investment returns and discount rates.* The realistic capital regime dictates that With Profit Fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The With Profit Fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as 0.1 per cent higher than the spot yields derived from the UK gilt yield curve.
- *Guaranteed annuity option take-up rates.* The guaranteed annuity option take up rates are set with regard to the Group's actual experience and make allowance for potential increases in take-up rates when the Guaranteed Annuity Options become more valuable to the policyholder.
- *Investment volatility.* The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2007, the 10 year equity-implied at-the-money assumption was set at 25.5 per cent (31 December 2006: 20 per cent). The assumption for property volatility was 15 per cent (31 December 2006: 15 per cent), with swaption volatility of broadly 11 per cent (31 December 2006: broadly 13 per cent).
- *Mortality.* The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.
- *Lapse rates.* Lapse rates refer to the rate of policy termination and the rate at which policyholders stop paying regular premiums. These rates are based on a combination of historical experience and management's views on future experience taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions.

*Non-Profit Fund liabilities*

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

- *Interest rates.* The rates used are derived in accordance with the FSA Rules. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the FSA Rules, including reductions made to the available yields to allow for default risk based upon the credit rating of each stock.

- *Mortality and morbidity.* The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation.
- *Lapse rates.* Lapse rates, set with regard to the Group's actual experience and with a margin for adverse deviation, are allowed for on some Non-Profit Fund contracts.
- *Maintenance expenses.* Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

*Key changes in assumptions*

During 2007, following a detailed review of the Group's current and expected experience, there has been a change in the key assumption in respect of lapse rates. The impact of this change has been to decrease profit before tax by £52 million; this amount includes movements in liabilities and value of the in-force business in respect of insurance contracts and participating investment contracts.

## Notes to the accounts

**32 Liabilities of the Group arising from insurance contracts and participating investment contracts** (continued)*Sensitivity analysis*

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

	Change in variable	Increase/(reduction) in profit before tax £m
Non-annuitant mortality	<b>5% reduction</b>	<b>28</b>
Annuitant mortality	<b>5% reduction</b>	<b>(90)</b>
Lapse rates	<b>10% reduction</b>	<b>47</b>
Maintenance expenses	<b>10% reduction</b>	<b>79</b>
Risk-free rate <sup>1</sup>	<b>0.25% deduction</b>	<b>42</b>
Guaranteed annuity option take up <sup>2</sup>	<b>5% addition</b>	<b>(4)</b>
Equity investment volatility <sup>3</sup>	<b>1% addition</b>	<b>(5)</b>
Widening of credit spreads <sup>4</sup>	<b>0.1% addition</b>	<b>(65)</b>

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

For the above sensitivities a 5 per cent reduction means a reduction to 95 per cent of the expected rate.

<sup>1</sup>This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

<sup>2</sup>This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

<sup>3</sup>This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

<sup>4</sup>This sensitivity shows the impact of a 10 basis point increase in corporate bond yields and the corresponding reduction in market values. Government bond yields and the risk free rate are assumed to be unchanged.

**Non-life insurance**

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

	2007 £m	2006 £m
Credit protection	<b>274</b>	268
Home	<b>385</b>	314
Health	<b>4</b>	5
	<b>663</b>	587

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

The reserving methodology and associated assumptions are set out below:

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

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

## Notes to the accounts

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

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

*Provisions for unearned premiums*

	Gross £m	Reinsurance* £m	Net £m
At 1 January 2006	447	–	447
Increase in the year	608	(17)	591
Release in the year	(617)	17	(600)
At 31 December 2006	438	–	438
Increase in the year	<b>632</b>	<b>(23)</b>	<b>609</b>
Release in the year	<b>(614)</b>	<b>23</b>	<b>(591)</b>
<b>At 31 December 2007</b>	<b>456</b>	<b>–</b>	<b>456</b>

\*Reinsurance balances receivable are reported within other assets (note 27).

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

*Claims and loss adjustment expenses*

	Gross £m	Reinsurance* £m	Net £m
Notified claims	120	(4)	116
Incurred but not reported	27	–	27
At 1 January 2006	147	(4)	143
Cash paid for claims settled in the year	(223)	–	(223)
Increase/(decrease) in liabilities:			
Arising from current year claims	231	–	231
Arising from prior year claims	(6)	–	(6)
At 31 December 2006	149	(4)	145
Cash paid for claims settled in the year	<b>(275)</b>	–	<b>(275)</b>
Increase/(decrease) in liabilities:			
Arising from current year claims	<b>341</b>	<b>(9)</b>	<b>332</b>
Arising from prior year claims	<b>(8)</b>	<b>3</b>	<b>(5)</b>
<b>At 31 December 2007</b>	<b>207</b>	<b>(10)</b>	<b>197</b>
Notified claims	<b>188</b>	<b>(10)</b>	<b>178</b>
Incurred but not reported	<b>19</b>	–	<b>19</b>
<b>At 31 December 2007</b>	<b>207</b>	<b>(10)</b>	<b>197</b>
Notified claims	127	(4)	123
Incurred but not reported	22	–	22
At 31 December 2006	149	(4)	145

\*Reinsurance balances receivable are reported within other assets (note 27).

## Notes to the accounts

**32 Liabilities of the Group arising from insurance contracts and participating investment contracts** (continued)*Non-life insurance claims development table*

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

Non-life insurance all risks – gross

	Accident year					Total £m
	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	
Estimate of ultimate claims costs:						
At end of accident year	234	227	211	208	<b>317</b>	<b>1,197</b>
One year later	220	209	207	206		
Two years later	223	207	204			
Three years later	221	206				
Four years later	220					
Current estimate of cumulative claims	<b>220</b>	<b>206</b>	<b>204</b>	<b>206</b>	<b>317</b>	<b>1,153</b>
Cumulative payments to date	<b>(216)</b>	<b>(202)</b>	<b>(194)</b>	<b>(186)</b>	<b>(164)</b>	<b>(962)</b>
Liability recognised in the balance sheet	<b>4</b>	<b>4</b>	<b>10</b>	<b>20</b>	<b>153</b>	<b>191</b>
Liability in respect of prior years						<b>6</b>
<b>Total liability included in the balance sheet</b>						<b>197</b>

The liability of £197 million shown in the above table excludes £10 million of unallocated claims handling expenses.

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

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

	Gross £m	Reinsurance* £m	Net £m
At 31 December 2006	21,839	(33)	21,806
New business	2,316	–	2,316
Changes in existing business	215	11	226
At 31 December 2006	24,370	(22)	24,348
New business	<b>2,413</b>	–	<b>2,413</b>
Changes in existing business	<b>(1,303)</b>	<b>22</b>	<b>(1,281)</b>
Disposal of businesses	<b>(7,283)</b>	–	<b>(7,283)</b>
<b>At 31 December 2007</b>	<b>18,197</b>	–	<b>18,197</b>

\*Reinsurance balances receivable are reported within other assets (note 27).

At 31 December 2007 £17,929 million (2006: £23,449 million) of liabilities arising from non-participating investment contracts had a contractual residual maturity of greater than one year.

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

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

	2007 £m	2006 £m
At 1 January	<b>683</b>	518
Change in unallocated surplus recognised in the income statement (note 9)	<b>(114)</b>	165
Disposal of businesses	<b>(15)</b>	–
At 31 December	<b>554</b>	683

## Notes to the accounts

**35 Other liabilities**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Settlement balances	445	475	51	81
Unitholders' interest in OEICs	3,441	4,583	-	-
Other creditors and accruals	5,865	5,976	4,072	3,199
	<b>9,751</b>	<b>11,034</b>	<b>4,123</b>	<b>3,280</b>

At 31 December 2007 £4,369 million (2006: £6,410 million) of other liabilities of the Group and £36 million (2006: £328 million) of the Bank had a contractual residual maturity of greater than one year.

**36 Retirement benefit obligations**

Charge to the Group income statement:

	2007 £m	2006 £m
Defined benefit pension schemes	158	104
Other post-retirement benefit schemes	17	5
Total defined benefit schemes	175	109
Defined contribution pension schemes	63	56
	<b>238</b>	<b>165</b>

Amounts recognised in the balance sheet:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Defined benefit pension schemes	2,033	2,362	1,512	1,745
Other post-retirement benefit schemes	111	100	111	100
	<b>2,144</b>	<b>2,462</b>	<b>1,623</b>	<b>1,845</b>

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

**Pension schemes***Defined benefit schemes*

The Group has established a number of defined benefit pension schemes in the UK and overseas. The majority of the Group's and the Bank's employees are members of the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2. These schemes provide retirement benefits calculated as a percentage of final salary depending upon the length of service; the minimum retirement age under the rules of the schemes is 50.

The latest full valuations of the schemes were carried out as at 30 June 2005; these have been updated to 31 December 2007 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2007 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's and the Bank's obligations in respect of defined benefit schemes are funded. The Group expects to pay contributions of some £500 million (the Bank: some £400 million) to its defined benefit schemes in 2008.

Amounts included in the balance sheet:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Present value of funded obligations	16,795	17,378	12,899	13,166
Fair value of scheme assets	(16,112)	(15,279)	(12,410)	(11,579)
	683	2,099	489	1,587
Unrecognised actuarial gains	1,350	263	1,023	158
Liability in the balance sheet	<b>2,033</b>	<b>2,362</b>	<b>1,512</b>	<b>1,745</b>

## Notes to the accounts

**36 Retirement benefit obligations** (continued)

Movements in the defined benefit obligation:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 January	<b>17,378</b>	17,320	<b>13,166</b>	13,134
Current service cost	<b>302</b>	325	<b>219</b>	236
Interest cost	<b>866</b>	817	<b>666</b>	623
Actuarial gains	<b>(971)</b>	(434)	<b>(751)</b>	(324)
Benefits paid	<b>(555)</b>	(555)	<b>(436)</b>	(429)
Past service cost	<b>25</b>	32	<b>23</b>	32
Curtailement	–	(129)	–	(108)
Disposal of businesses	<b>(262)</b>	–	–	–
Exchange and other adjustments	<b>12</b>	2	<b>12</b>	2
At 31 December	<b>16,795</b>	17,378	<b>12,899</b>	13,166

Changes in the fair value of scheme assets:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 January	<b>15,279</b>	14,026	<b>11,579</b>	10,619
Expected return	<b>1,035</b>	942	<b>799</b>	717
Employer contributions	<b>446</b>	550	<b>342</b>	426
Actuarial gains	<b>139</b>	314	<b>114</b>	244
Benefits paid	<b>(555)</b>	(555)	<b>(436)</b>	(429)
Disposal of businesses	<b>(244)</b>	–	–	–
Exchange and other adjustments	<b>12</b>	2	<b>12</b>	2
At 31 December	<b>16,112</b>	15,279	<b>12,410</b>	11,579
Actual return on scheme assets	<b>1,174</b>	1,256	<b>913</b>	961

**Assumptions**

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

	2007 %	2006 %
Discount rate	<b>5.80</b>	5.10
Rate of inflation	<b>3.30</b>	2.90
Rate of salary increases	<b>4.00</b>	3.93
Rate of increase for pensions in payment and deferred pensions	<b>3.10</b>	2.70
	<b>Years</b>	<b>Years</b>
Life expectancy for member aged 60, on the valuation date:		
Men	<b>25.9</b>	25.8
Women	<b>27.9</b>	27.8
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	<b>27.1</b>	27.0
Women	<b>29.0</b>	28.9

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2007 is assumed to live for, on average, 25.9 years for a male and 27.9 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

An analysis of the impact of a reasonable change in these assumptions is provided in note 2.

## Notes to the accounts

**36 Retirement benefit obligations** (continued)

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

	<b>2007</b>	2006
	%	%
Equities	<b>8.0</b>	8.0
Fixed interest gilts	<b>4.6</b>	4.1
Index linked gilts	<b>4.2</b>	3.9
Non-government bonds	<b>5.1</b>	4.8
Property	<b>6.5</b>	6.4
Cash	<b>3.9</b>	3.7

The expected return on scheme assets in 2008 will be calculated using the following assumptions:

	<b>2008</b>
	%
Equities and alternative assets	<b>8.2</b>
Fixed interest gilts	<b>4.5</b>
Index linked gilts	<b>4.4</b>
Non-government bonds	<b>6.0</b>
Property	<b>6.7</b>
Money market instruments and cash	<b>4.8</b>

Composition of scheme assets:

	The Group		The Bank	
	<b>2007</b>	2006	<b>2007</b>	2006
	£m	£m	£m	£m
Equities	<b>8,537</b>	9,677	<b>6,557</b>	7,376
Fixed interest gilts	<b>2,041</b>	1,114	<b>1,629</b>	845
Index linked gilts	<b>1,433</b>	921	<b>1,093</b>	679
Non-government bonds	<b>1,990</b>	1,543	<b>1,543</b>	1,148
Property	<b>1,666</b>	1,333	<b>1,342</b>	1,052
Money market instruments and cash	<b>445</b>	691	<b>246</b>	479
At 31 December	<b>16,112</b>	15,279	<b>12,410</b>	11,579

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

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

## Notes to the accounts

**36 Retirement benefit obligations** (continued)

Experience adjustments history (since the date of adoption of IAS 19):

<b>The Group</b>	<b>2007</b> £m	2006 £m	2005 £m	2004 £m
Present value of defined benefit obligation	<b>16,795</b>	17,378	17,320	14,866
Fair value of scheme assets	<b>(16,112)</b>	(15,279)	(14,026)	(11,648)
	<b>683</b>	2,099	3,294	3,218
Experience losses on scheme liabilities	<b>(185)</b>	(50)	(69)	(126)
Experience gains on scheme assets	<b>139</b>	314	1,538	361

<b>The Bank</b>	<b>2007</b> £m	2006 £m	2005 £m	2004 £m
Present value of defined benefit obligation	<b>12,899</b>	13,166	13,134	11,282
Fair value of scheme assets	<b>(12,410)</b>	(11,579)	(10,619)	(8,839)
	<b>489</b>	1,587	2,515	2,443
Experience losses on scheme liabilities	<b>(150)</b>	(42)	(53)	(124)
Experience gains on scheme assets	<b>114</b>	243	1,166	282

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

	<b>2007</b> £m	2006 £m
Current service cost	<b>302</b>	325
Interest cost	<b>866</b>	817
Expected return on scheme assets	<b>(1,035)</b>	(942)
Curtailment	<b>-</b>	(128)
Past service cost	<b>25</b>	32
Total defined benefit pension expense	<b>158</b>	104

Following changes in age discrimination legislation in 2006, the Group ceased to augment the pension entitlement of employees taking early retirement; this change reduced the Group's defined benefit pension liability at 31 December 2006 by £129 million (£1 million of which was unrecognised) and resulted in a one-off credit to the 2006 income statement of £128 million.

*Defined contribution schemes*

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally the defined contribution sections of the Lloyds TSB Group Pension Schemes No's 1 and 2.

During the year ended 31 December 2007 the charge to the income statement in respect of these schemes was £63 million (2006: £56 million), representing the contributions payable by the employer in accordance with each scheme's rules.

**Other post-retirement benefit schemes**

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

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2007; this valuation has been updated to 31 December 2007 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 7.43 per cent (2006: 7.02 per cent).

Amount included in the balance sheet:

	The Group		The Bank	
	<b>2007</b> £m	2006 £m	<b>2007</b> £m	2006 £m
Present value of unfunded obligations	<b>123</b>	110	<b>123</b>	110
Unrecognised actuarial losses	<b>(12)</b>	(10)	<b>(12)</b>	(10)
Liability in the balance sheet	<b>111</b>	100	<b>111</b>	100



## Notes to the accounts

**36 Retirement benefit obligations** (continued)

Movements in the other post-retirement benefits obligation:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 January	110	112	110	112
Actuarial loss (gain)	2	(1)	2	(1)
Insurance premiums paid	(6)	(6)	(6)	(6)
Charge for the year	17	5	17	5
At 31 December	123	110	123	110

**37 Deferred tax balances**

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

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Liability (asset) at 1 January	1,416	1,170	(861)	(984)
Exchange and other adjustments	1	(4)	–	–
Disposals	(389)	(281)	–	–
Income statement (credit) charge:				
Due to change in UK corporation tax rate	(110)	–	46	–
Other	38	531	202	123
	(72)	531	248	123
Amount credited to equity:				
Available-for-sale financial assets (note 42)	(1)	–	–	–
Cash flow hedges (note 42)	(6)	–	(6)	–
	(7)	–	(6)	–
Liability (asset) at 31 December	949	1,416	(619)	(861)

The 2007 Finance Act reduction in corporation tax rate from 30 per cent to 28 per cent resulted in a decrease in the provision for deferred tax at 31 December 2007 of £110 million for the Group and increased the provision by £46 million for the Bank.

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

	2007 £m	2006 £m
Accelerated capital allowances	(32)	(106)
Pensions and other post-retirement benefits	137	157
Investment reserve	(30)	59
Allowances for impairment losses	42	22
Unrealised gains	(91)	162
Tax on value of in-force business	(108)	(59)
Other temporary differences	10	296
	(72)	531

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Deferred tax assets:				
Pensions and other post-retirement benefits	(620)	(736)	(453)	(563)
Allowances for impairment losses	(101)	(143)	(97)	(136)
Other provisions	(15)	(39)	(12)	(27)
Derivatives	(185)	(168)	(115)	(132)
Tax losses carried forward	(409)	(326)	–	–
Other temporary differences	(144)	(247)	(87)	(107)
	(1,474)	(1,659)	(764)	(965)

## Notes to the accounts

**37 Deferred tax balances** (continued)

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Deferred tax liabilities:				
Accelerated capital allowances	979	1,252	61	58
Investment reserve	119	149	-	-
Unrealised gains	342	500	-	-
Tax on value of in-force business	652	875	-	-
Other temporary differences	331	299	84	46
	<b>2,423</b>	<b>3,075</b>	<b>145</b>	<b>104</b>

*Deferred tax assets*

Deferred tax assets are recognised for tax losses and foreign tax credit carry forwards to the extent that the realisation of the related tax benefit through future taxable profits is probable.

Deferred tax assets of £33 million for the Group and £nil for the Bank (2006: £567 million for the Group and £305 million for the Bank) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of Eligible Unrelieved Foreign Tax (EUFT) and other foreign tax credits carried forward as at 31 December 2007 of £104 million for the Group and £34 million for the Bank (2006: £138 million for the Group and £49 million for the Bank), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. EUFT can be carried forward indefinitely.

*Deferred tax liabilities*

Deferred tax liabilities have not been recognised for tax that may be payable if earnings of certain subsidiaries were remitted to the UK. Such amounts are either reinvested for the foreseeable future or can be remitted free of tax. Unremitted earnings totalled £928 million for the Group and £111 million for the Bank (2006: £682 million for the Group and £27 million for the Bank).

Future transfers from Scottish Widows plc's long-term business funds to its Shareholder Fund will be subject to a shareholder tax charge. Under IAS 12, no provision is required to be made to the extent that the timing of such transfers is under Scottish Widows plc's control. Accordingly, deferred tax liabilities of £90 million (2006: £110 million) have not been recognised.

**38 Other provisions****The Group**

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2007	27	101	131	259
Exchange and other adjustments	-	-	6	6
Provisions applied	(3)	(54)	(13)	(70)
Amortisation of discount	-	-	3	3
Charge for the year	5	-	10	15
Disposal of businesses	-	(4)	-	(4)
<b>At 31 December 2007</b>	<b>29</b>	<b>43</b>	<b>137</b>	<b>209</b>

**The Bank**

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Vacant leasehold property and other £m	Total £m
At 1 January 2007	27	81	88	196
Exchange and other adjustments	-	-	6	6
Provisions applied	(3)	(48)	(7)	(58)
Amortisation of discount	-	-	1	1
Charge for the year	5	-	9	14
Transfer of C&G business (note 26)	-	6	-	6
<b>At 31 December 2007</b>	<b>29</b>	<b>39</b>	<b>97</b>	<b>165</b>

## Notes to the accounts

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### 38 Other provisions (continued)

#### *Provisions for contingent liabilities and commitments*

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

#### *Customer remediation provisions*

In previous years the Group has established provisions for the estimated cost of making redress payments to customers in respect of past product sales, in those cases where the original sales processes have been found to be deficient. During 2007 management have reviewed the adequacy of the provisions held having regard to current complaint volumes and the level of payments being made and are satisfied that no additional charge is required (no charge was made in 2006). At 31 December 2007 the remaining provisions held relate to past sales of a number of products, including mortgage endowment policies, sold through the branch networks of Lloyds TSB Bank, Lloyds TSB Scotland and Cheltenham & Gloucester and underwritten by life assurance companies within the Group and also by third parties. The principal assumptions that are made in the assessment of the adequacy of the provision relate to the number of cases that are likely to require redress taking into account any time barring, and the estimated average cost per case. The ultimate cost and timing of the payments remains highly uncertain and will be influenced by external factors beyond the control of management, such as regulatory actions, media interest and the performance of the financial markets. However, it is expected that the majority of the remaining expenditure will be incurred over the next year.

#### *Vacant leasehold property and other*

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

The Group also carries provisions in respect of its obligations relating to UIC Insurance Company Limited (UIC), which is in provisional liquidation. The Group has indemnified a third party against losses in the event that UIC does not honour its obligations under a reinsurance contract, which is subject to asbestosis and pollution claims in the US. The ultimate cost of settling the Group's exposure in respect of the insurance business of UIC and the timing remains uncertain. The provision held represents management's current best estimate of the cost after having regard to the financial condition of UIC and actuarial estimates of future claims.

## Notes to the accounts

**39 Subordinated liabilities****The Group**

	Note	2007 £m	2006 £m
<b>Preferred securities</b>			
6.90% Perpetual Capital Securities (US\$1,000 million)	a,d	471	483
6% Non-cumulative Redeemable Preference Shares	l	–	–
Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	a,j	335	312
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	a,c,h	365	345
Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	a,k	248	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	a,c,h	504	478
		<b>1,923</b>	<b>1,866</b>
<b>Undated subordinated liabilities</b>			
Primary Capital Undated Floating Rate Notes:	a,b		
Series 1 (US\$750 million)		374	383
Series 2 (US\$500 million)		249	255
Series 3 (US\$600 million)		299	306
11 <sup>3</sup> / <sub>4</sub> % Perpetual Subordinated Bonds (£100 million)		100	100
5 <sup>5</sup> / <sub>8</sub> % Undated Subordinated Step-up Notes callable 2009 (€1,250 million)	a,h	915	845
Undated Step-up Floating Rate Notes callable 2009 (€150 million)	a,b	110	101
6 <sup>5</sup> / <sub>8</sub> % Undated Subordinated Step-up Notes callable 2010 (£410 million)	a,g	408	408
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million)	a,e	534	525
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20 billion)	a,i	111	107
Undated Subordinated Floating Rate Loan callable 2015 (£600 million)		600	–
Undated Subordinated Floating Rate Loan callable 2016 (US\$1,000 million)		498	–
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	a,g	449	475
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2019 (£270 million)	a,g	238	255
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	a,g	188	189
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2029 (£450 million)	a,g	444	447
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	a,g	453	470
		<b>5,970</b>	<b>4,866</b>
<b>Dated subordinated liabilities</b>			
7 <sup>3</sup> / <sub>4</sub> % Subordinated Bonds 2007 (£300 million)		–	300
5 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2008 (DM 750 million)		281	260
10 <sup>5</sup> / <sub>8</sub> % Guaranteed Subordinated Loan Stock 2008 (£100 million)	f	102	104
9 <sup>1</sup> / <sub>2</sub> % Subordinated Bonds 2009 (£100 million)		100	99
6 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2010 (€400 million)		302	283
12% Guaranteed Subordinated Bonds 2011 (£100 million)	f	110	113
4 <sup>3</sup> / <sub>4</sub> % Subordinated Notes 2011 (€850 million)		609	562
Subordinated Floating Rate Notes 2011 (£150 million)		150	150
Subordinated Floating Rate Notes 2011 (£100 million)		100	100
Subordinated Floating Rate Notes 2012 (£200 million)		200	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		464	464
5 <sup>7</sup> / <sub>8</sub> % Subordinated Notes 2014 (£150 million)		149	149
6 <sup>5</sup> / <sub>8</sub> % Subordinated Notes 2015 (£350 million)		316	330
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	b	300	300
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	b	371	336
Subordinated Floating Rate Notes 2020 (€100 million)	b	73	67
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		305	328
9 <sup>5</sup> / <sub>8</sub> % Subordinated Bonds 2023 (£300 million)		312	329
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
		<b>4,544</b>	<b>4,774</b>
<b>Total subordinated liabilities</b>		<b>12,437</b>	<b>11,506</b>

At 31 December 2007 £12,054 million (2006: £11,206 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

## Notes to the accounts

**39 Subordinated liabilities** (continued)**The Bank**

	Note	2007 £m	2006 £m
<b>Preferred securities</b>			
6.90% Perpetual Capital Securities (US\$1,000 million)	a,d	471	483
6% Non-cumulative Redeemable Preference Shares	l	–	–
Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	a,j	335	312
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	a,c,h	365	345
Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	a,k	248	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	a,c,h	504	478
		<b>1,923</b>	<b>1,866</b>
<b>Undated subordinated liabilities</b>			
Primary Capital Undated Floating Rate Notes:	a,b		
Series 1 (US\$750 million)		374	383
Series 2 (US\$500 million)		249	255
Series 3 (US\$600 million)		299	306
11 <sup>3</sup> / <sub>4</sub> % Perpetual Subordinated Bonds (£100 million)	m	100	–
5 <sup>5</sup> / <sub>8</sub> % Undated Subordinated Step-up Notes callable 2009 (€1,250 million)	a,h	915	845
Undated Step-up Floating Rate Notes callable 2009 (€150 million)	a,b	110	101
6 <sup>5</sup> / <sub>8</sub> % Undated Subordinated Step-up Notes callable 2010 (£410 million)	a,g	408	408
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20 billion)	a,i	111	107
Undated Subordinated Floating Rate Loan callable 2015 (£600 million)		600	–
Undated Subordinated Floating Rate Loan callable 2016 (US\$1,000 million)		498	–
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	a,g	449	475
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2019 (£270 million)	a,g	238	255
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	a,g	188	189
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2029 (£450 million)	a,g	444	447
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	a,g	453	470
		<b>5,436</b>	<b>4,241</b>
<b>Dated subordinated liabilities</b>			
7 <sup>3</sup> / <sub>4</sub> % Subordinated Bonds 2007 (£300 million)		–	300
5 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2008 (DM 750 million)		281	260
10 <sup>5</sup> / <sub>8</sub> % Guaranteed Subordinated Loan Stock 2008 (£100 million)	f	102	104
9 <sup>1</sup> / <sub>2</sub> % Subordinated Bonds 2009 (£100 million)		100	99
6 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2010 (€400 million)		302	283
12% Guaranteed Subordinated Bonds 2011 (£100 million)	f	110	113
4 <sup>3</sup> / <sub>4</sub> % Subordinated Notes 2011 (€850 million)		609	562
Subordinated Floating Rate Notes 2011 (£150 million)	m	150	–
Subordinated Floating Rate Notes 2011 (£100 million)	m	100	–
Subordinated Floating Rate Notes 2012 (£200 million)	m	200	–
Subordinated Floating Rate Notes 2013 (£150 million)	m	150	–
Subordinated Floating Rate Notes 2014 (£464 million)		464	464
5 <sup>7</sup> / <sub>8</sub> % Subordinated Notes 2014 (£150 million)		149	149
6 <sup>3</sup> / <sub>8</sub> % Subordinated Notes 2015 (£350 million)		316	330
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	b	300	300
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	b	371	336
Subordinated Floating Rate Notes 2020 (€100 million)	b	73	67
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		305	328
9 <sup>5</sup> / <sub>8</sub> % Subordinated Bonds 2023 (£300 million)		312	329
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
		<b>4,544</b>	<b>4,174</b>
<b>Total subordinated liabilities</b>		<b>11,903</b>	<b>10,281</b>

At 31 December 2007 £11,520 million (2006: £9,981 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2006: nil).

- In certain circumstances, these notes, bonds and securities would acquire the characteristics of preference share capital. Any repayments of undated subordinated liabilities would require the prior consent of the Financial Services Authority. They are accounted for as liabilities as coupon payments are mandatory as a consequence of the terms of the 6% Non-cumulative Redeemable Preference Shares.
- These notes bear interest at rates fixed periodically in advance based on London Interbank rates.
- In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds TSB Group plc can declare or pay a dividend until any deferred payments have been made. In the event of a winding up of Lloyds TSB Bank plc, these securities will acquire the characteristics of preference shares.
- In certain circumstances the interest payments on these securities can be deferred although in this case neither Lloyds TSB Bank plc nor Lloyds TSB Group plc can declare or pay a dividend until payments are resumed. Any deferred payments will be made good on redemption of the securities. The securities can be redeemed at par at the option of Lloyds TSB Bank plc on any coupon date after 22 November 2007.

## Notes to the accounts

**39 Subordinated liabilities** (continued)

- e) In certain circumstances the interest payments on these securities can be deferred although in this case Scottish Widows plc cannot declare or pay a dividend until any deferred payments have been made.
- f) Guaranteed by Lloyds TSB Group plc on a subordinated basis.
- g) At the callable date the coupon on these notes will be reset by reference to the applicable five year benchmark gilt rate.
- h) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a floating rate.
- i) In the event that these notes are not redeemed at the callable date, the coupon will be reset to a margin of 1.60 per cent over the five year Yen swap rate.
- j) These securities constitute limited partnership interests in Lloyds TSB Capital 1 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.375 per cent per annum up to 7 February 2012; thereafter they will accrue at a margin of 2.33 per cent over EURIBOR, to be set annually. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds TSB Group plc. Lloyds TSB Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- k) These securities constitute limited partnership interests in Lloyds TSB Capital 2 L.P., a Jersey limited partnership in which Lloyds TSB (General Partner) Limited, a wholly owned subsidiary, is the general partner. Non-cumulative income distributions accrue at a fixed rate of 7.834 per cent per annum up to 7 February 2015; thereafter they will accrue at a margin of 3.50 per cent over a rate based on the yield of specified UK government stock. This issue was made under the limited subordinated guarantee of Lloyds TSB Bank plc. In certain circumstances these preferred securities will be mandatorily exchanged for preference shares in Lloyds TSB Group plc. Lloyds TSB Group plc has entered into an agreement whereby dividends may only be paid on its ordinary shares if sufficient distributable profits are available for distributions due in the financial year on these preferred securities.
- l) Throughout 2007 and 2006, the Bank has had in issue 100 6 per cent non-cumulative redeemable preference shares of £1 each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Bank.
- m) These subordinated liabilities have been assumed by the Bank as part of the transfer of the C&G business (note 26).

**40 Share capital**

	Group and Bank	
	2007 £m	2006 £m
<b>Authorised share capital</b>		
1,650 million ordinary shares of £1 each	1,650	1,650
1 cumulative floating rate preference share of £1	-	-
100 6 per cent Non-Cumulative Redeemable Preference shares of £1 each	-	-
<b>Issued and fully paid ordinary shares</b>		
Ordinary shares of £1 each		
At 1 January and 31 December	1,542	1,542
Cumulative floating rate preference share of £1		
At 1 January and 31 December	-	-

**Issued and fully paid preference shares**

Throughout 2007 and 2006, the Bank has had in issue 100 6 per cent non-cumulative redeemable preference shares of £1 each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Bank. In accordance with the requirements of International Financial Reporting Standards, these shares are reported within liabilities (note 39).

**41 Share premium account**

	Group and Bank	
	2007 £m	2006 £m
At 1 January and 31 December	2,960	2,960

## Notes to the accounts

**42 Other reserves**

Other reserves comprise:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Revaluation reserve in respect of available-for-sale financial assets	(399)	–	(49)	(3)
Cash flow hedging reserve	(3)	12	(3)	12
Foreign currency translation reserve	(9)	(27)	8	(5)
	<b>(411)</b>	<b>(15)</b>	<b>(44)</b>	<b>4</b>

Movements in other reserves were as follows:

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Revaluation reserve in respect of available-for-sale financial assets:				
At 1 January	–	29	(3)	26
Exchange and other adjustments	(1)	2	–	–
Change in fair value of available-for-sale financial assets	(483)	(10)	(130)	(7)
Current tax	46	–	46	–
Deferred tax	1	–	–	–
	<b>(436)</b>	<b>(10)</b>	<b>(84)</b>	<b>(7)</b>
Income statement transfer				
Disposals	(5)	(22)	(5)	(22)
Impairment	70	–	70	–
Current tax	(21)	1	(21)	–
	<b>44</b>	<b>(21)</b>	<b>44</b>	<b>(22)</b>
Disposal of businesses	(6)	–	(6)	–
At 31 December	<b>(399)</b>	<b>–</b>	<b>(49)</b>	<b>(3)</b>
Cash flow hedging reserve:				
At 1 January	12	11	12	11
Change in fair value of hedging derivatives	(20)	–	(20)	–
Deferred tax	6	–	6	–
	<b>(14)</b>	<b>–</b>	<b>(14)</b>	<b>–</b>
Income statement transfer	(1)	1	(1)	1
At 31 December	<b>(3)</b>	<b>12</b>	<b>(3)</b>	<b>12</b>
Foreign currency translation reserve:				
At 1 January	(27)	4	(5)	18
Currency translation differences arising in the year	257	(108)	13	(23)
Foreign currency (losses) gains on net investment hedges	(342)	110	–	–
Current tax	103	(33)	–	–
	<b>(239)</b>	<b>77</b>	<b>–</b>	<b>–</b>
At 31 December	<b>(9)</b>	<b>(27)</b>	<b>8</b>	<b>(5)</b>

## Notes to the accounts

**43 Retained profits**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 January	7,637	6,639	4,257	3,726
Profit for the year*	3,384	2,916	2,799	2,449
Dividends	(1,957)	(1,918)	(1,957)	(1,918)
Transfer of C&G business (note 26)	-	-	573	-
At 31 December	9,064	7,637	5,672	4,257

\*No income statement has been shown for the Bank, as permitted by Section 230 of the Companies Act 1985.

**44 Ordinary dividends**

	2007 £m	2006 £m
Second interim dividend in respect of previous year, declared during the current year	1,325	1,316
First interim dividend in respect of current year	632	602
	1,957	1,918

The directors have proposed a second interim dividend of £1,621 million (2006: £1,325 million) which will be paid on 7 May 2008; this is equivalent to 105.14 pence per ordinary share (2006: 85.94 pence).

**45 Share based payments****Charge to the income statement**

The charge to the income statement is set out below:

	2007 £m	2006 £m
Executive and SAYE schemes:		
Options granted in the year	6	6
Options granted in prior years	24	25
	30	31
Share incentive plan:		
Shares granted in the year	12	12
Shares granted in prior years	17	15
	29	27
	59	58

During the year ended 31 December 2007 Lloyds TSB Group plc operated the following share based payment schemes, all of which are equity settled.

**Executive schemes**

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between April 2001 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5. Prior to 18 April 2001, the normal limit was equal to one year's remuneration and no performance multiplier was applied.



## Notes to the accounts

**45 Share based payments** (continued)**Performance conditions for executive options****For options granted up to March 2001**

Options granted	Performance conditions
March 1997 – August 1999	Growth in earnings per share which is equal to the aggregate percentage change in the Retail Price Index plus two percentage points for each complete year of the relevant period together with a further condition that Lloyds TSB Group plc's ranking based on shareholder return (calculated by reference to both dividends and growth in share price) over the relevant period should be in the top fifty companies of the FTSE 100.
March 2000 – March 2001	As for March 1997 – August 1999 except that there must have been growth in the earnings per share equal to the change in the Retail Price Index plus three percentage points for each complete year of the relevant period.

In respect of options granted between March 1997 and March 2001, the relevant period for the performance conditions begins at the end of the financial year preceding the date of grant and will continue until the end of the third subsequent year following commencement or, if not met, the end of such later year in which the conditions are met. Once the conditions have been satisfied the options will remain exercisable without further conditions. If they are not satisfied by the tenth anniversary of the grant the option will lapse.

**For options granted from August 2001 to August 2004**

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

The performance condition is measured over a three year period commencing at the end of the financial year preceding the grant of the option and continuing until the end of the third subsequent year. If the performance condition is not then met, it will be measured at the end of the fourth financial year. If the condition has not then been met, the options will lapse.

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

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

**For options granted in 2005**

The same conditions apply as for grants made up to August 2004, except that:

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

Movements in the number of share options outstanding under the Executive share option schemes during 2006 and 2007 are set out below:

	2007 Number of options	2007 Weighted average exercise price (pence)	2006 Number of options	2006 Weighted average exercise price (pence)
Outstanding at 1 January	32,459,593	459.84	43,977,411	485.35
Exercised	(267,650)	509.10	(328,218)	437.03
Forfeited	(11,570,169)	421.76	(11,189,600)	560.77
Outstanding at 31 December	20,621,774	480.57	32,459,593	459.84
Exercisable at 31 December	423,300	876.37	819,139	744.90

The weighted average share price at the time that the options were exercised during 2007 was 574.39 pence (2006: 552.29 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 6.2 years (2006: 6.8 years).

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

Eligible employees may enter into contracts through the Save-As-You-Earn (SAYE) schemes to save up to £250 per month and, at the expiry of a fixed term of three or five years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in Lloyds TSB Group plc at a price equal to 80 per cent of the market price at the date the options were granted. Grants in periods up to 31 December 2001 also had options exercising after seven years.

## Notes to the accounts

**45 Share based payments** (continued)

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

	2007 Number of options	2007 Weighted average exercise price (pence)	2006 Number of options	2006 Weighted average exercise price (pence)
Outstanding at 1 January	90,220,144	335.94	114,459,474	314.17
Granted	10,759,688	432.00	19,301,716	418.00
Exercised	(9,473,792)	351.28	(35,148,982)	294.84
Forfeited	(3,447,524)	363.45	(3,440,257)	339.47
Cancelled	(1,822,417)	397.98	(3,984,599)	427.14
Expired	(562,872)	547.46	(967,208)	503.13
Outstanding at 31 December	<b>85,673,227</b>	<b>342.49</b>	90,220,144	335.94
Exercisable at 31 December	<b>1,560,472</b>	<b>459.01</b>	889,479	475.41

The weighted average share price at the time that the options were exercised during 2007 was 552.20 pence (2006: 524.36 pence). The weighted average remaining contractual life of options outstanding at the end of the year was 1.7 years (2006: 2.2 years).

The weighted average fair value of SAYE options granted during the year was £1.07 (2006: £1.00). The values for the SAYE options have been determined using a standard Black-Scholes model.

**Other share option plans****Lloyds TSB Group Executive Share Plan 2003**

The plan was adopted in December 2003 and under the plan share options may be granted to senior employees. Options granted to date under this scheme were granted specifically to facilitate recruitment. Options granted under this plan are not subject to any performance conditions.

	2007 Number of options	2007 Weighted average exercise price (pence)	2006 Number of options	2006 Weighted average exercise price (pence)
Outstanding at 1 January	357,123	Nil	268,918	Nil
Granted	214,444	Nil	165,395	Nil
Exercised	(203,170)	Nil	(77,190)	Nil
Forfeited	(59,679)	Nil	–	Nil
Outstanding at 31 December	<b>308,718</b>	<b>Nil</b>	357,123	Nil

The weighted average fair value of options granted in the year was £5.27 (2006: £4.58). The weighted average share price at the time that the options were exercised during 2007 was 539.77 pence (2006: 557.25 pence). No options outstanding at 31 December were exercisable. The weighted average remaining contractual life of options outstanding at the end of the year was 1.8 years (2006: 2.0 years).

**Lloyds TSB Group executive share plan 2005**

This plan was adopted by the Group in 2005, specifically to facilitate the recruitment of Ms Dial. Ms Dial is the only participant in the plan. Options granted under this plan are not subject to any performance conditions and will normally become exercisable only if Ms Dial remains as an employee, and has not given notice of resignation, on 31 May 2008, or if Ms Dial ceases to be an employee before that date in certain circumstances described in her service agreement: in both cases the options will be exercisable for six months and then lapse.

	2007 Number of options	2007 Weighted average exercise price (pence)	2006 Number of options	2006 Weighted average exercise price (pence)
Outstanding at 1 January and 31 December	<b>242,825</b>	<b>Nil</b>	242,825	Nil

No options outstanding at 31 December were exercisable. The weighted average remaining contractual life of options outstanding at the end of the year was 0.9 years (2006: 1.9 years).

**Long-Term Incentive Plan**

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

The performance conditions for awards made in May and August 2006 are as follows:

- (i) For 50 per cent of the award (the 'EPS Award') – the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period must be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the Retail Price Index over the same period. If it is less than 3 per cent per annum the EPS Award will lapse. If the increase is more than 3 per cent but less than 6 per cent per annum then the proportion of shares released will be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2006 and ends on 31 December 2008.

## Notes to the accounts

**45 Share based payments** (continued)

- (ii) For the other 50 per cent of the award (the 'TSR Award') – it will be necessary for the Group's total shareholder return (calculated by reference to both dividends and growth in share price) to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award will vest where the Group's total shareholder return is equal to median and vesting will occur on a straight line basis in between these points. Where the Group's total shareholder return is below the median of the comparator group, the TSR Award will lapse. The relevant period commenced on 1 January 2006 and ends on 31 December 2008.

The performance conditions for awards made in March and August 2007 are as follows:

- (i) For 50 per cent of the award (the 'EPS Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 1 January 2007 and ending on 31 December 2009.
- (ii) For the other 50 per cent of the award (the 'TSR Award') – the performance condition is as described for May 2006 with the relevant performance period commencing on 8 March 2007 (the date of award) and ending on 7 March 2010.

	<b>2007</b> Number of shares	2006 Number of shares
Outstanding at 1 January	<b>5,788,108</b>	–
Granted	<b>7,884,787</b>	5,852,386
Forfeited	<b>(463,814)</b>	(64,278)
Outstanding at 31 December	<b>13,209,081</b>	5,788,108

The fair value of the share awards granted in 2007 was £3.13 (2006: £2.96).

**Performance share plan**

Under the performance share plan, introduced during 2005, participating executives will be eligible for an award of free shares, known as performance shares, to match the bonus shares awarded as part of their 2004 and 2005 bonus. The maximum match will be two performance shares for each bonus share, awarded at the end of a three year period. The actual number of Lloyds TSB Group plc's shares awarded will depend on Lloyd TSB Group's total shareholder return performance measured over a three year period, compared to other companies in the comparator group. The maximum of two performance shares for each bonus share will be awarded only if the Group's total shareholder return performance places it first in the comparator group; one performance share for each bonus share will be granted if the Group is placed fifth; and one performance share for every two bonus shares if the Group is placed eighth (median). Between first and fifth position and fifth and eighth position sliding scales will apply. If the total shareholder return performance is below median, no performance shares will be awarded. There will be no retest. Whilst income tax is deducted from the bonus before deferral into the plan, where a match of performance shares is justified, these shares will be awarded as if income tax had not been deducted.

	<b>2007</b> Number of shares	2006 Number of shares
Outstanding at 1 January	<b>1,849,102</b>	826,438
Granted	–	1,035,564
Forfeited	<b>(81,508)</b>	(12,900)
Outstanding at 31 December	<b>1,767,594</b>	1,849,102

The fair value of the matching element of the performance shares awarded during 2006 was £1.92.

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
<b>31 December 2007</b>									
Exercise price range									
£0 to £2	–	–	–	–	–	–	Nil	1.4	551,543
£2 to £3	–	–	–	284.00	0.9	42,651,925	–	–	–
£3 to £4	–	–	–	353.10	1.9	15,775,539	–	–	–
£4 to £5	449.34	6.8	17,898,897	424.23	2.9	26,525,262	–	–	–
£5 to £6	551.09	2.2	815,965	563.65	0.1	720,501	–	–	–
£6 to £7	652.47	3.1	1,114,912	–	–	–	–	–	–
£7 to £8	–	–	–	–	–	–	–	–	–
£8 to £9	871.54	0.7	792,000	–	–	–	–	–	–

## Notes to the accounts

## 45 Share based payments (continued)

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
31 December 2006									
Exercise price range									
£0 to £2	–	–	–	–	–	–	Nil	1.9	599,948
£2 to £3	–	–	–	284.00	1.8	45,234,578	–	–	–
£3 to £4	394.25	6.2	6,265,105	345.97	2.3	23,320,638	–	–	–
£4 to £5	444.24	7.7	22,497,465	422.94	3.1	20,125,284	–	–	–
£5 to £6	541.32	2.6	1,424,507	571.24	0.7	1,522,876	–	–	–
£6 to £7	652.98	4.2	1,332,177	–	–	–	–	–	–
£7 to £8	–	–	–	718.00	0.2	16,768	–	–	–
£8 to £9	873.12	1.7	940,339	–	–	–	–	–	–

The fair value calculations are based on the following assumptions:

	SAYE	Other option schemes	Other share plans
Risk-free interest rate	5.35%	5.46%	5.19%
Expected life	3.7 years	1.4 years	3.0 years
Expected volatility	21%	17%	17%
Expected dividend yield	6.3%	6.0%	6.3%
Weighted average share price	£5.40	£5.73	£5.41
Weighted average exercise price	£4.32	Nil	Nil
Expected forfeitures	6%	4%	4%

Expected volatility is a measure of the amount by which Lloyds TSB Group plc's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in Lloyds TSB Group plc's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

**Share incentive plan****Free shares**

An award of Lloyds TSB Group plc shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to maximum of £3,000. The percentage is normally announced concurrently with Lloyds TSB Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employees' behalf. The award is subject to a non-market based condition: if an employee leaves the Lloyds TSB Group within this three year period for other than a 'good' reason, all of the shares awarded would be forfeited (for awards made up to April 2005, only a portion of the shares will be forfeited: 75 per cent within one year of the award, 50 per cent within two years and 25 per cent within three years).

The number of shares awarded relating to free shares in 2007 was 6,784,201 (2006: 7,725,195), with an average fair value of £5.82 (2006: £5.28), based on the market price at the date of award.

**Matching shares**

Lloyds TSB Group undertakes to match shares purchased by employees up to the value of £30 per month, these shares are held in trust for a mandatory period of three years on the employees' behalf. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason or the accompanying partnership shares are sold within that time, 100 per cent of the matching shares are forfeited (or the portion relating to the shares sold).

The number of shares awarded relating to matching shares in 2007 was 2,073,018 (2006: 2,036,423), with an average fair value of £5.49 (2006: £5.40), based on market prices at the date of award.

## Notes to the accounts

**46 Related party transactions****Key management personnel**

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity, the Group's key management personnel are the members of the Lloyds TSB Group plc group executive committee together with its non-executive directors.

The table below details, on an aggregated basis, key management personnel compensation:

	2007 £m	2006 £m
<i>Compensation</i>		
Salaries and other short-term benefits	15	14
Post-employment benefits	4	3
Termination benefits	–	–
Share based payments	4	3
Total	<b>23</b>	<b>20</b>

The aggregate of the emoluments of the directors was £12,055,000 (2006: £11,257,000).

The aggregate of the amount of the gains made by directors on the exercise of Lloyds TSB Group plc share options was £nil (2006: £125,175).

The number of directors to whom retirement benefits were accruing under defined contribution and defined benefit pension schemes were two and three respectively (2006: two and four). Aggregate company contributions in respect of directors to defined contribution pension schemes were £173,000 (2006: £122,000).

The total for the highest paid director (Mr Daniels), including the £nil (2006: £7,702) gain on the exercise of Lloyds TSB Group plc share options, was £2,884,000 (2006: £2,452,000). The amount of his accrued pension at the year end was £147,000, being his pension entitlement based on pensionable service with the Group to 31 December 2007 but payable at normal retirement age.

	2007 millions	2006 millions
<i>Share options over Lloyds TSB Group plc shares</i>		
At 1 January	11	12
Granted (including options of appointed directors)	–	–
Exercised/lapsed (including options of retired directors)	(4)	(1)
At 31 December	<b>7</b>	<b>11</b>
<i>Share incentive plans over Lloyds TSB Group plc shares</i>		
At 1 January	4	1
Granted (including entitlements of appointees)	2	3
Exercised/lapsed (including entitlements of retirees)	–	–
At 31 December	<b>6</b>	<b>4</b>

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Group and its key management personnel:

	2007 £m	2006 £m
<i>Loans</i>		
At 1 January	2	3
Advanced	1	–
Repayments	(1)	(1)
At 31 December	<b>2</b>	<b>2</b>

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 4.95 per cent and 30.0 per cent in 2007 (2006: 5.1 per cent and 19.9 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2006: £nil).

	2007 £m	2006 £m
<i>Deposits</i>		
At 1 January	5	5
Placed	21	12
Withdrawn	(21)	(12)
At 31 December	<b>5</b>	<b>5</b>

## Notes to the accounts

**46 Related party transactions** (continued)

Deposits placed by key management personnel attracted interest rates of up to 8.0 per cent (2006: 5.2 per cent).

At 31 December 2007, the Group provided guarantees totalling £6,154 in respect of one director (2006: £19,744 in respect of one director).

At 31 December 2007, transactions, arrangements and agreements entered into by the Group and its banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £2 million with five directors and three connected persons (2006: £2 million with four directors and four connected persons).

**Balances and transactions with fellow Lloyds TSB Group undertakings**

*Balances and transactions between members of the Lloyds TSB Bank group*

In accordance with IAS 27, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

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

	<b>2007</b> <b>£m</b>	2006 £m
Assets, included within:		
Derivative financial instruments	<b>203</b>	273
Loans and advances to banks	<b>6,575</b>	60,804
Loans and advances to customers	<b>42,660</b>	37,301
Other assets	<b>264</b>	477
	<b>49,702</b>	98,855
Liabilities, included within:		
Deposits from banks	<b>10,015</b>	9,513
Customer accounts	<b>25,348</b>	18,294
Derivative financial instruments	<b>702</b>	706
Subordinated liabilities	<b>583</b>	560
Other liabilities	<b>519</b>	510
	<b>37,167</b>	29,583

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2007 the Bank earned interest income on the above asset balances of £4,269 million (2006: £4,585 million) and incurred interest expense on the above liability balances of £1,513 million (2006: £940 million).

In addition, the Bank raised recharges of £476 million (2006: £517 million) on its subsidiaries in respect of costs incurred and also received fees of £705 million (2006: £583 million), and paid fees of £125 million (2006: £14 million), for various services provided between the Bank and its subsidiaries.

Details of contingent liabilities and commitments entered into on behalf of fellow Lloyds TSB Group undertakings are given in note 47.

*Balances and transactions with Lloyds TSB Group plc*

The Bank and its subsidiaries have balances due to and from the Bank's parent company, Lloyds TSB Group plc, which are included on the balance sheet as follows:

	The Group		The Bank	
	<b>2007</b> <b>£m</b>	2006 £m	<b>2007</b> <b>£m</b>	2006 £m
Assets, included within:				
Derivative financial instruments	<b>29</b>	–	<b>29</b>	–
Loans and advances to customers	–	1,850	–	904
	<b>29</b>	1,850	<b>29</b>	904
Liabilities, included within:				
Customer accounts	<b>158</b>	1,425	<b>81</b>	1,349
Derivative financial instruments	<b>169</b>	114	<b>169</b>	114
Subordinated liabilities	<b>2,765</b>	1,714	<b>2,765</b>	1,114
Other liabilities	<b>17</b>	–	<b>17</b>	–
	<b>3,109</b>	3,253	<b>3,032</b>	2,577

These balances include Lloyds TSB Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2007 the Group earned interest income on the above asset balances of £1 million and the Bank earned interest income of £nil (2006: Group £3 million; Bank £nil); the Group incurred an interest expense on the above liability balances of £176 million and the Bank incurred an interest expense of £148 million (2006: Group £105 million; Bank £73 million).

## Notes to the accounts

**46 Related party transactions** (continued)**Other related party disclosures**

At 31 December 2007, the Group's pension funds had call deposits with Lloyds TSB Bank plc amounting to £23 million (2006: £19 million).

The Group manages 107 (2006: 89) Open Ended Investment Companies (OEICs), and of these 40 (2006: 38) are consolidated. The Group invested £1,961 million (2006: £372 million) and redeemed £1,526 million (2006: £237 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £2,233 million (2006: £1,746 million) at 31 December. The Group earned fees of £200 million from the unconsolidated OEICs (2006: £149 million). The Bank held no investments in OEICs at any time during 2006 or 2007.

The Group has a number of associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2007, these companies had total assets of approximately £3,184 million (2006: £1,625 million), liabilities of approximately £3,182 million (2006: £1,609 million) and for the year ended 31 December 2007 had turnover of approximately £2,136 million (2006: £2,409 million) and made a net profit of approximately £9 million (2006: net loss of £5 million). In addition the Group has provided £609 million (2006: £460 million) of financing to these companies on which it received £23 million (2006: £20 million) of interest income in the year.

**47 Contingent liabilities and commitments***Legal proceedings*

During the ordinary course of business the Group is subject to threatened or actual legal proceedings. All such material cases are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management's best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case. No provisions are held against such cases; however the Group does not currently expect the final outcome of these cases to have a material adverse effect on its financial position.

On 27 July 2007, following agreement between the UK Office of Fair Trading (OFT) and a number of UK financial institutions, the OFT issued High Court legal proceedings against those institutions, including Lloyds TSB Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to requests for unplanned overdrafts. A preliminary issues hearing has now taken place and judgement is currently awaited. It is likely that further hearings will be required and, if appeals are pursued, the proceedings may take a number of years to conclude. Pending resolution, the Financial Services Authority has agreed, subject to certain conditions, that the handling of customer complaints on this issue can be suspended until the proceedings are concluded unless in the light of prevailing circumstances this would be inappropriate. The Group intends strongly to defend its position. Accordingly, no provision in relation to the outcome of this litigation has been made. Depending on the Court's determinations, a range of outcomes is possible, some of which could have a significant financial impact on the Group. The ultimate impact of the litigation on the Group can only be known at its conclusion.

There has been increased scrutiny of the financial institutions sector, especially in the US, with respect to combating money laundering and terrorist financing and enforcing compliance with economic sanctions. The Office of Foreign Assets Control (OFAC) administers US laws and regulations in relation to US economic sanctions against designated foreign countries, nationals and others and the Group has been conducting a review of its conduct with respect to historic US dollar payments involving countries, persons or entities subject to those sanctions. The Group has provided information relating to its review of such historic payments to a number of authorities including OFAC, the US Department of Justice and the New York County District Attorney's office which, along with other authorities, have been reported to be conducting a broader review of sanctions compliance by non-US financial institutions. The Group is involved in ongoing discussions with these authorities with respect to agreeing a resolution of their investigations. No provision has been made in respect of this matter. The Group does not expect the final outcome to have a material adverse effect on its financial position.

*Contingent liabilities and commitments arising from the banking business*

Acceptances and endorsements arise where the Group or the Bank agrees to guarantee payment on a negotiable instrument drawn up by a customer.

Other items serving as direct credit substitutes include standby letters of credit, or other irrevocable obligations, where the Group or the Bank has an irrevocable obligation to pay a third party beneficiary if the customer fails to repay an outstanding commitment; they also include acceptances drawn under letters of credit or similar facilities where the acceptor does not have specific title to an identifiable underlying shipment of goods.

Performance bonds and other transaction-related contingencies (which include bid or tender bonds, advance payment guarantees, VAT Customs & Excise bonds and standby letters of credit relating to a particular contract or non-financial transaction) are undertakings where the requirement to make payment under the guarantee depends on the outcome of a future event.

The Group's and the Bank's maximum exposure to loss is represented by the contractual nominal amount detailed in the table below. Consideration has not been taken of any possible recoveries from customers for payments made in respect of such guarantees under recourse provisions or from collateral held.





## Notes to the accounts

### 48 Financial risk management

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

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

#### Credit risk

##### Definition

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

##### Risk appetite

Credit risk appetite is expressed both in terms of credit risk economic equity and in terms of the impact of credit risk on earnings volatility.

Credit risk appetite is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio model parameters which in turn use the various credit risk rating systems as inputs. These metrics are supplemented by a variety of policies, sector caps and limits to manage concentration risk at an acceptable level.

##### Exposures

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out within this note.

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 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 commitments to extend credit can be cancelled and the credit-worthiness of customers is monitored continually. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards.

Credit risk can also arise from debt securities, derivatives and foreign exchange activities. Note 15 shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2007. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers.

##### 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 client or 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 recovery ratio on the defaulted obligations (the 'loss given default').

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. For its retail lending, exposure at default and loss given default models are also in use. All rating models, which are authorised by executive management, comply with the Group's standard methodology. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and/or credit officer judgement. Each rating model is subject to a rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible.

Each probability of default rating model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. The outputs of different rating approaches are also mapped on to either a retail or a wholesale master scale (an analysis of the portfolio is set out within this note). Exposures migrate between classifications if the assessment of the obligor probability of default changes, or, in the case of mortgages, if the obligor probability of default changes or the assessment of loan-to-value changes.

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (note 18). 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 model that is used for internal operational management and banking regulation purposes.

The Group's debt securities holdings, which are the subject of external agency ratings, are marked to market and independently checked by the middle office function within the products and markets business. Similarly, debt security investments within Scottish Widows are independently marked to market.

The Group also employs a statistically-based credit portfolio model, which models portfolio credit risk based on defaults and calculates the economic equity employed and credit value at risk for each portfolio.

##### Mitigation

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

##### Internal control

- Credit principles and policy: Lloyds TSB Group Risk sets out the group credit principles and policy according to which credit risk is 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. Business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. Credit policy also specifies maximum holding period limits for the credit trading portfolios.

## Notes to the accounts

### 48 Financial risk management (continued)

- Counterparty limits: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit approval criteria for counterparty underwriting is the same as that for assets intended to be held over the period to maturity.
- Credit scoring: In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Divisional risk departments review scorecard effectiveness and approve changes, with material changes subject to Lloyds TSB Group Risk approval.
- Cross-border and cross-currency exposures: Country limits are authorised and managed by a dedicated unit taking into account economic and political factors.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines that reflect risk appetite. Credit policy is aligned to our risk appetite and restricts exposure to certain high risk and more vulnerable sectors. Note 17 provides an analysis of loans and advances to customers by industry (for wholesale) and product (for retail). Exposures are monitored to prevent excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. Amongst these controls is a series of sector caps to manage residual value risk exposure, seeking to ensure an acceptable distribution of risk. The Group's large exposures are managed in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress-testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a groupwide level, at divisional and business unit level and by portfolio, for example, for a specific industry sector.
- Specialist units: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

#### Collateral

The principal collateral types for loans and advances are:

- Mortgages over residential properties;
- Charges over business assets such as premises, inventory and accounts receivable;
- Charges over financial instruments such as debt securities and equities;
- Guarantees received from third parties.

The Group has implemented 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 instruments. 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.

It is Group policy that collateral should always be realistically valued by an appropriately qualified source, independent of 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. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are noticed for the relevant individual loans and advances.

#### Master netting agreements

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

#### Derivatives

Credit risk exposure on individual derivative transactions is managed as part of the overall lending limit with customers, together with potential exposures from market movements. Collateral or other security is not usually obtained for credit risk exposures on these instruments, except where the Group requires margin deposits from counterparties.

#### Other credit risk transfers

The Group also undertakes asset sales, securitisations 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.

## Notes to the accounts

**48 Financial risk management** (continued)*Monitoring*

- Portfolio monitoring and reporting: In conjunction with group risk, businesses and divisions 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. Lloyds TSB Group Risk in turn produces an aggregated review of credit risk, throughout the Group, including reports on significant credit exposures, which are presented to the Lloyds TSB Group Business Risk Committee.
- Risk assurance and oversight: Divisional and group level 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. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.
- Term to maturity: The Group monitors the term to maturity of credit commitments because longer-term commitments generally have a greater degree of credit risk than shorter-term commitments.

**Market risk***Definition*

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

*Risk appetite*

Market risk appetite is defined as the quantum and composition of market risk that exists currently in the Group and the direction in which the Group wishes to manage this.

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the board. The group chief executive allocates this risk appetite across the Group. Individual members of the Lloyds TSB Group Executive Committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

*Exposures*

The Group's banking activities expose it to the risk of adverse movements in interest rates, exchange rates and equity prices, with little or no exposure to commodity risk.

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

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

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

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

- The management of with-profits funds leads to assets and liabilities that are mismatched with the aim of generating a higher rate of return on assets to meet policyholders' expectations.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets.
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in three portfolios: the surplus in the non-profit fund within the long-term fund of Scottish Widows plc, assets in shareholder funds of life assurance companies and an investment portfolio within the general insurance business.

The Group's defined benefit pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 36.

*Measurement*

The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group's overall market risk appetite and for the high level allocation of risk appetite across the Group. Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. The use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. VaR can also be less well suited to non-linear positions, for example options. The Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

**Banking – trading and other financial assets at fair value through profit or loss**

Based on the commonly used 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 2007 and 2006 based on the Group's global trading positions was as detailed in the table below (the table also aggregates potential loss measures from options portfolios). VaR is calculated daily for trading and other fair valued portfolios in the products and markets business.

## Notes to the accounts

**48 Financial risk management** (continued)

The risk of loss measured by the VaR model is the potential loss in earnings. The total and average trading VaR does not assume any diversification benefit across the four risk types. 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.

	31 December 2007				31 December 2006			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	<b>1.63</b>	<b>2.20</b>	<b>4.66</b>	<b>1.27</b>	3.67	2.47	4.71	0.61
Foreign exchange risk	<b>0.08</b>	<b>0.23</b>	<b>0.53</b>	<b>0.04</b>	0.26	0.31	0.72	0.04
Equity risk	<b>0.00</b>	<b>0.29</b>	<b>3.02</b>	<b>0.00</b>	0.00	0.00	0.00	0.00
Credit spread risk	<b>4.21</b>	<b>3.60</b>	<b>8.30</b>	<b>2.06</b>	2.31	1.52	2.46	0.00
Total VaR	<b>5.92</b>	<b>6.32</b>	<b>11.00</b>	<b>4.28</b>	6.24	4.30	6.30	0.89

**Banking – non-trading**

The estimated impacts of an immediate 200 basis point increase in interest rates on economic value for the years ended 31 December 2007 and 2006 are shown below. Economic value is defined as the present value of the non-trading portfolios concerned. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. No currency breakdown has been provided due to the relatively low overall sensitivity. These calculations are made monthly using assumptions regarding the maturity of interest rate insensitive assets and liabilities. The portfolio is updated monthly to reflect any changes in the relationship between customer behaviour and the level of interest rates. This non-trading disclosure is now value based rather than income based (as in 2006) in line with market risk reporting used internally.

Internal reporting shows this sensitivity as a percentage of the Group's regulatory capital base, and as at December 2007 the relevant percentage was 0.3 per cent (2006: 3.1 per cent). The sensitivity has fallen as a result of changes to balance sheet management strategy. This is a risk based disclosure which would be amortised in the income statement over the duration of the portfolio.

	31 December 2007 £m	31 December 2006 £m
Reduction in value	<b>67</b>	476

**Insurance portfolios**

The Group's market risk exposure in respect of insurance activities described above is measured using European Embedded Value (EEV) as a proxy for economic value. The pre-tax sensitivity of EEV to standardised market stresses is shown below for the years ended 31 December 2007 and 2006. Foreign exchange risk arises predominantly from overseas equity holdings. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile or tracked on a daily basis. This disclosure has been amended to reflect other internal reporting for market risk in the insurance portfolio, in accordance with IFRS7.

	31 December 2007 £m	31 December 2006 £m
Equity risk (impact of 10% fall pre-tax)	<b>(248)</b>	(277)
Interest rate risk (impact of 25bp reduction pre-tax)	<b>58</b>	85

**Mitigation**

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

**Banking – non-trading activities**

Interest rate risk arising from the different repricing characteristics of the Group's non-trading assets and liabilities, and from the mismatch between interest rate insensitive liabilities and interest rate sensitive assets, is managed centrally. Matching assets and liabilities are offset against each other and internal interest rate swaps are also used.

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.

**Insurance activities**

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative sizes of large individual exposures are monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid.

**Monitoring**

The Lloyds TSB Group Asset and Liability Committee regularly reviews high level market risk exposure including, but not limited to, the data described above. It also makes recommendations to the group chief executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Lloyds TSB Group Risk. Where appropriate, escalation procedures are in place.

## Notes to the accounts

### 48 Financial risk management (continued)

#### Banking activities

Trading is restricted to a number of specialist centres, the most important centre being the products and markets 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 within limits defined in the detailed group policy for interest rate risk in the banking book, which is reviewed and approved annually.

#### Insurance activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and limits set with reference to the Group's overall risk appetite and regularly reviewed by the Lloyds TSB Group Asset and Liability Committee:

- With-profits funds are managed in accordance with the relevant fund's principles and practices of financial management.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the regulatory and internal business requirements for capital to be held to support the business now and in the future.

The Group also agrees strategies for the overall mix of pension assets with the pension scheme trustees.

#### Insurance risk

##### Definition

The risk of reductions in earnings and/or value, through financial or reputational loss, due to fluctuations in the timing, frequency and severity of insured/underwritten events and to fluctuations in the timing and amount of claim settlements. This includes fluctuations in profits due to customer behaviour.

##### Risk appetite

Insurance risk appetite is defined as the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Group wishes to manage this.

##### Exposures

The major sources of insurance risk within the Group are the insurance businesses and the Group's defined benefit pension schemes. The nature of insurance business involves the accepting of insurance risks which relate primarily to mortality, morbidity, persistency, expenses, property damage and unemployment. The prime insurance risk carried by the Group's pension schemes is related to mortality.

##### Measurement

Insurance risks are measured using a variety of techniques including stress and scenario testing; and, where appropriate, stochastic modelling.

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate.

##### Mitigation

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level committees/boards. For the life assurance businesses the key control body is the board of Scottish Widows Group Limited with the more significant risks also being subject to approval by the Lloyds TSB group executive committee and/or the Lloyds TSB Group board. For the general insurance businesses the key control body is the Lloyds TSB Insurance executive committee with the more significant risks again being subject to Lloyds TSB Group Executive Committee and/or Lloyds TSB Group board approval. All group pension schemes issues are covered by the Lloyds TSB Group Asset and Liability Committee and the Lloyds TSB Group Business Risk Committee.

The overall insurance risk is mitigated through pooling and through diversification across large numbers of uncorrelated individuals, geographical areas, and different types of risk exposure.

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals would usually be priced in accordance with the underwriting assessment)
- Claims management
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

Some insurance risks are retained while others are reinsured with external underwriters. The retained risk level is carefully controlled and monitored, with close attention being paid to underwriting, claims management, product design, policy wordings, adequacy of reserves, solvency management and regulatory requirements.

## Notes to the accounts

### 48 Financial risk management (continued)

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the probable maximum loss under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present.

In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees and that risk management is in line with the Group's risk appetite.

#### *Monitoring*

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk.

Expenses are monitored by an analysis of the Group's experience relative to budget. Reasons for any significant divergence from expectation are investigated and remedial action taken.

Persistency rates of life assurance policies, which relate to the rate of policy termination and the rate at which policies cease to pay regular premiums, are regularly assessed by reference to appropriate risk factors.

#### **Liquidity risk**

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost. Funding risk is further defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

#### *Risk appetite*

Risk appetite is set and reported through various metrics that enable the Group to manage liquidity constraints.

#### *Exposure*

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows in that period such that the Group is unable to meet its financial obligations as they fall due, or can only secure them at excessive cost. Liquidity is considered from both an internal and regulatory perspective.

#### *Measurement*

A series of measures are used across the Group to monitor both short and long-term liquidity including ratios, cash outflow triggers and stress test survival period triggers.

An analysis of financial instrument liabilities of the Group, excluding those arising from insurance contracts, on an undiscounted future cash flow basis according to contractual maturity into relevant maturity groupings based on the remaining period at the balance sheet date is shown in this note. An analysis of insurance contracts on a behavioural basis is also shown in this note.

#### *Mitigation*

The Group mitigates the risk of a liquidity mismatch which is outside of its appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term strategic funding.

Short-term liquidity management is considered from two perspectives, business as usual and crisis liquidity, both of which relate to funding in the less than one year time horizon.

Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as an original maturity of more than one year.

The Group's funding and liquidity management is fundamentally based on a significant retail deposit base, accompanied by appropriate funding from the wholesale markets. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to provide inter-bank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group's short-term money market funding is based on an analysis of the market's capacity for the Group's credit, based on quantitative data. The Group has developed strong relationships with certain wholesale market segments, for example central banks and corporate customers, to supplement its retail deposit base.

During 2007, amounts deposited by customers increased by £15,946 million from £140,767 million at 31 December 2006 to £156,713 million at 31 December 2007. These customer deposits were supplemented by short-term wholesale market operations, the use of sale and repurchase agreements and the issue of subordinated loan capital and wholesale funding sources in the capital markets; these comprised Euro Medium-Term Note programmes, of which £7,090 million had been utilised for senior funding at 31 December 2007, and commercial paper programmes, under which £5,051 million had been utilised at 31 December 2007. The Group also raised wholesale funding via the issuance of Residential Mortgage Backed Securities: £12,403 million was outstanding at 31 December 2007.

The ability to sell assets quickly is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of marketable debt securities which can be sold to provide additional short-term funding should the need arise.

Within the insurance businesses, non-linked funds investments are arranged to minimise the possibility of being a distressed seller whilst at the same time investing to meet policyholder obligations. For unit-linked business, deferral provisions are designed to give time to realise linked assets without being a forced seller.

## Notes to the accounts

**48 Financial risk management** (continued)

The Group is able to raise funds by issuing subordinated liabilities or equity. As at 31 December 2007, the Group had £12,437 million of subordinated debt in issuance. The cost and availability of subordinated liability finance are influenced by credit ratings. A reduction in these ratings could increase the cost and could reduce market access. At 31 December 2007, the credit ratings of the Bank, the primary issuer in the Group, were as follows:

	Senior debt
Moody's	Aaa
Standard & Poor's	AA
Fitch	AA+

The ratings outlook from Moody's, Standard & Poor's and Fitch for the Bank is stable. These credit ratings are not a recommendation to buy, hold or sell any security; and each rating should be evaluated independently of every other rating.

The Group maintains a system of internal controls, consistently applied, providing reasonable assurance that transactions are recorded and undertaken in accordance with delegated authorities that permit the preparation and disclosure of financial statements, prudential regulatory reporting and tax returns in accordance with IFRS, statutory and regulatory requirements.

**Monitoring**

Liquidity is actively monitored at business unit and group level at an appropriate frequency. Routine reporting is in place to senior management and through the Lloyds TSB Group's committee structure, in a particular the Lloyds TSB Group Asset and Liability Committee. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the event. Liquidity policies and procedures are subject to independent oversight.

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds TSB Group Asset and Liability Committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Lloyds TSB Group undertakes a programme of work designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of s.404 of the US Sarbanes-Oxley Act of 2002; to identify and maintain tax liabilities and to assess emerging regulation and legislation.

**Measurement basis of financial assets and liabilities**

The accounting policies in note 1 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

**The Group**

	At fair value through profit or loss							Total £m
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	
<b>As at 31 December 2007</b>								
<b>Financial assets</b>								
Cash and balances at central banks	-	-	-	-	-	4,330	-	4,330
Items in the course of collection from banks	-	-	-	-	-	1,242	-	1,242
Trading and other financial assets at fair value through profit or loss	-	4,663	53,433	-	-	-	-	58,096
Derivative financial instruments	264	8,424	-	-	-	-	-	8,688
Loans and advances to banks	-	-	-	-	34,845	-	-	34,845
Loans and advances to customers	-	-	-	-	209,814	-	-	209,814
Available-for-sale financial assets	-	-	-	20,196	-	-	-	20,196
<b>Total financial assets</b>	<b>264</b>	<b>13,087</b>	<b>53,433</b>	<b>20,196</b>	<b>244,659</b>	<b>5,572</b>	<b>-</b>	<b>337,211</b>
<b>Financial liabilities</b>								
Deposits from banks	-	-	-	-	-	39,091	-	39,091
Customer accounts	-	-	-	-	-	156,713	-	156,713
Items in course of transmission to banks	-	-	-	-	-	668	-	668
Trading and other liabilities at fair value through profit or loss	-	99	3,107	-	-	-	-	3,206
Derivative financial instruments	800	6,951	-	-	-	-	-	7,751
Debt securities in issue	-	-	-	-	-	49,828	-	49,828
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	38,192	38,192
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	18,197	18,197
Unallocated surplus within insurance businesses	-	-	-	-	-	-	554	554
Subordinated liabilities	-	-	-	-	-	12,437	-	12,437
<b>Total financial liabilities</b>	<b>800</b>	<b>7,050</b>	<b>3,107</b>	<b>-</b>	<b>-</b>	<b>258,737</b>	<b>56,943</b>	<b>326,637</b>

## Notes to the accounts

## 48 Financial risk management (continued)

## The Group

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
<b>As at 31 December 2006</b>								
<b>Financial assets</b>								
Cash and balances at central banks	–	–	–	–	–	1,898	–	1,898
Items in the course of collection from banks	–	–	–	–	–	1,431	–	1,431
Trading and other financial assets at fair value through profit or loss	–	5,756	62,172	–	–	–	–	67,928
Derivative financial instruments	487	5,078	–	–	–	–	–	5,565
Loans and advances to banks	–	–	–	–	40,638	–	–	40,638
Loans and advances to customers	–	–	–	–	190,135	–	–	190,135
Available-for-sale financial assets	–	–	–	19,178	–	–	–	19,178
<b>Total financial assets</b>	<b>487</b>	<b>10,834</b>	<b>62,172</b>	<b>19,178</b>	<b>230,773</b>	<b>3,329</b>	<b>–</b>	<b>326,773</b>
<b>Financial liabilities</b>								
Deposits from banks	–	–	–	–	–	36,394	–	36,394
Customer accounts	–	–	–	–	–	140,767	–	140,767
Items in course of transmission to banks	–	–	–	–	–	781	–	781
Trading and other liabilities at fair value through profit or loss	–	28	1,156	–	–	–	–	1,184
Derivative financial instruments	466	5,411	–	–	–	–	–	5,877
Debt securities in issue	–	–	–	–	–	54,118	–	54,118
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	41,602	41,602
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	24,370	24,370
Unallocated surplus within insurance businesses	–	–	–	–	–	–	683	683
Subordinated liabilities	–	–	–	–	–	11,506	–	11,506
<b>Total financial liabilities</b>	<b>466</b>	<b>5,439</b>	<b>1,156</b>	<b>–</b>	<b>–</b>	<b>243,566</b>	<b>66,655</b>	<b>317,282</b>

## The Bank

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
<b>As at 31 December 2007</b>							
<b>Financial assets</b>							
Cash and balances at central banks	–	–	–	–	–	4,211	4,211
Items in the course of collection from banks	–	–	–	–	–	1,196	1,196
Trading and other financial assets at fair value through profit or loss	–	4,663	4,521	–	–	–	9,184
Derivative financial instruments	271	8,353	–	–	–	–	8,624
Loans and advances to banks	–	–	–	–	28,447	–	28,447
Loans and advances to customers	–	–	–	–	212,738	–	212,738
Available-for-sale financial assets	–	–	–	4,260	–	–	4,260
<b>Total financial assets</b>	<b>271</b>	<b>13,016</b>	<b>4,521</b>	<b>4,260</b>	<b>241,185</b>	<b>5,407</b>	<b>268,660</b>
<b>Financial liabilities</b>							
Deposits from banks	–	–	–	–	–	48,940	48,940
Customer accounts	–	–	–	–	–	163,245	163,245
Items in course of transmission to banks	–	–	–	–	–	613	613
Trading and other liabilities at fair value through profit or loss	–	99	3,107	–	–	–	3,206
Derivative financial instruments	773	7,592	–	–	–	–	8,365
Debt securities in issue	–	–	–	–	–	36,647	36,647
Subordinated liabilities	–	–	–	–	–	11,903	11,903
<b>Total financial liabilities</b>	<b>773</b>	<b>7,691</b>	<b>3,107</b>	<b>–</b>	<b>–</b>	<b>261,348</b>	<b>272,919</b>



## Notes to the accounts

## 48 Financial risk management (continued)

## The Bank

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
<b>As at 31 December 2006</b>							
<b>Financial assets</b>							
Cash and balances at central banks	–	–	–	–	–	1,678	1,678
Items in the course of collection from banks	–	–	–	–	–	1,358	1,358
Trading and other financial assets at fair value through profit or loss	–	5,756	3,063	–	–	–	8,819
Derivative financial instruments	485	5,180	–	–	–	–	5,665
Loans and advances to banks	–	–	–	–	86,588	–	86,588
Loans and advances to customers	–	–	–	–	106,576	–	106,576
Available-for-sale financial assets	–	–	–	3,972	–	–	3,972
<b>Total financial assets</b>	<b>485</b>	<b>10,936</b>	<b>3,063</b>	<b>3,972</b>	<b>193,164</b>	<b>3,036</b>	<b>214,656</b>
<b>Financial liabilities</b>							
Deposits from banks	–	–	–	–	–	44,070	44,070
Customer accounts	–	–	–	–	–	127,938	127,938
Items in course of transmission to banks	–	–	–	–	–	660	660
Trading and other liabilities at fair value through profit or loss	–	28	1,156	–	–	–	1,184
Derivative financial instruments	480	5,925	–	–	–	–	6,405
Debt securities in issue	–	–	–	–	–	32,719	32,719
Subordinated liabilities	–	–	–	–	–	10,281	10,281
<b>Total financial liabilities</b>	<b>480</b>	<b>5,953</b>	<b>1,156</b>	<b>–</b>	<b>–</b>	<b>215,668</b>	<b>223,257</b>

## Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to Wholesale and International Banking Market and Liquidity Risk. Associated VaR and the closing, average, maximum and minimum for 2006 and 2007 are disclosed on page 74.

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

The Group and the Bank hedge part of the currency translation risk of the net investments in certain foreign operations using cross currency swaps. At 31 December 2007 the notional principal of these cross currency swaps was £5,302 million with a net fair value liability of £316 million (2006: £2,589 million with a net fair value asset of £139 million) (note 15) and they were designated on an after-tax basis as hedges of net investments in foreign operations. In 2007 there is no ineffectiveness recognised in the income statement that arises from net investment hedges (2006: nil).

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

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Functional currency of Group operations:				
Euro	95	76	61	48
US dollar	7	97	37	35
Swiss franc	70	70	51	45
Other non-sterling	208	188	175	161
	<b>380</b>	<b>431</b>	<b>324</b>	<b>289</b>

## Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There are a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

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

## Notes to the accounts

**48 Financial risk management** (continued)

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio. At 31 December 2007 the aggregate notional principal of interest rate swaps designated as fair value hedges was £50,734 million (2006: £37,378 million) for the Group and £50,209 million (2006: £36,698 million) for the Bank with a net fair value liability of £197 million (2006: £110 million) for the Group and £163 million (2006: £126 million) for the Bank (note 15). The gains recognised by the Group on the hedging instruments were £94 million (2006: losses of £288 million). The Group's losses on the hedged items attributable to the hedged risk were £117 million (2006: gains of £266 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2007 was £630 million (2006: £569 million) for the Group and the Bank with a net fair value liability of £23 million (2006: £8 million) for the Group and the Bank (note 15). In 2007, there is no ineffectiveness recognised in the Group's income statement that arises from cash flow hedges (2006: £nil). There were no transactions for which cash flow hedge accounting had to be ceased in 2007 or 2006 as a result of the highly probable cash flows no longer being expected to occur.

**Credit risk**

At 31 December 2007, the maximum credit risk exposure of the Group and the Bank in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Loans and advances to banks	<b>34,845</b>	40,639	<b>28,447</b>	86,589
Loans and advances to customers	<b>212,222</b>	192,328	<b>214,593</b>	108,276
Deposit amounts available for offset <sup>1</sup>	<b>(6,206)</b>	(6,392)	<b>(5,819)</b>	(6,040)
Impairment losses	<b>(2,408)</b>	(2,194)	<b>(1,855)</b>	(1,701)
	<b>238,453</b>	224,381	<b>235,366</b>	187,124
Available-for-sale debt securities and treasury and other bills	<b>20,167</b>	19,163	<b>4,231</b>	3,958
Trading and other financial assets at fair value through profit or loss	<b>26,165</b>	29,568	<b>9,181</b>	8,810
Derivative assets, before netting	<b>8,688</b>	5,565	<b>8,624</b>	5,665
Amounts available for offset under master netting arrangements <sup>1</sup>	<b>(3,287)</b>	(2,761)	<b>(3,287)</b>	(2,761)
	<b>5,401</b>	2,804	<b>5,337</b>	2,904
Assets arising from reinsurance contracts held	<b>350</b>	451	–	–
Financial guarantees	<b>9,753</b>	8,139	<b>10,056</b>	8,633
Irrevocable loan commitments and other credit-related contingencies <sup>2</sup>	<b>56,600</b>	54,065	<b>50,322</b>	55,255
Maximum credit risk exposure	<b>356,889</b>	338,571	<b>314,493</b>	266,684
Maximum credit risk exposure before offset items	<b>366,382</b>	347,724	<b>323,599</b>	275,485

<sup>1</sup> Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

<sup>2</sup> See note 47 – Contingent liabilities and commitments for further information.

A general description of collateral held in respect of financial instruments is disclosed on page 72.

**Loans and advances to banks** – the Group may require collateral before entering into a credit commitment with another bank, depending on the type of the financial product and the counterparty involved, and netting agreements are obtained whenever possible and to the extent that such agreements are legally enforceable.

**Available-for-sale debt securities, treasury and other bills, and trading and other financial assets at fair value through profit or loss** – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 14 and a similar analysis for available-for-sale financial assets is included in note 19. The Group's non-participating investment contracts are all unit-linked. Movements in the fair values of trading and other financial assets at fair value through profit or loss which back those investment contracts, including movements arising from credit risk, are borne by the contract holders.

**Derivative assets** – the Group reduces exposure to credit risk by using master netting agreements and by obtaining cash collateral. An analysis of derivative assets is given in note 15. Of the net derivative assets of £5,401 million for the Group and £5,337 million for the Bank (2006: £2,804 million for the Group and £2,904 million for the Bank), cash collateral of £2,004 million (2006: £912 million) was held for both the Group and the Bank, and a further £1,459 million for the Group and £1,385 million for the Bank was due from OECD banks (2006: £1,251 million for the Group and £1,209 million for the Bank).

**Assets arising from reinsurance contracts held** – of the assets arising from reinsurance contracts held of £350 million (2006: £451 million), £341 million (2006: £447 million) are due from insurers with a credit rating of AA or above.

## Notes to the accounts

**48 Financial risk management** (continued)

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

**Reverse repo and repo transactions** – for reverse repo transactions which are accounted for as collateralised loans. It is the Group's policy to seek collateral which is at least equal to the amount loaned. At 31 December 2007, the fair value of collateral accepted under reverse repo transactions that the Group is permitted by contract or custom to sell or repledge was £10,300 million (2006: £6,446 million) and for the Bank was £10,300 million (2006: £6,446 million). Of this, £10,299 million (2006: £6,445 million) for the Group and £10,299 million (2006: £6,445 million) for the Bank was sold or repledged as at 31 December 2007 including £768 million (2006: £1,099 million) for the Group and £768 million (2006: £99 million) for the Bank in respect of repo transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to sell or repledge. The remainder has been held for continuing use within the business.

**Loans and advances – The Group**

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
Neither past due nor impaired	99,828	29,850	73,475	203,153	1,189	34,845
Past due but not impaired	2,153	966	639	3,758	–	–
Impaired – no provision required	415	100	293	808	–	–
– provision held	343	3,600	560	4,503	–	–
Gross	102,739	34,516	74,967	212,222	1,189	34,845
Allowance for impairment losses (note 18)	(37)	(2,029)	(342)	(2,408)	–	–
Net	102,702	32,487	74,625	209,814	1,189	34,845

No amounts were due from fellow Lloyds TSB Group undertakings at 31 December 2007.

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2006</b>						
Neither past due nor impaired	92,873	29,364	60,005	182,242	835	40,638
Past due but not impaired	1,943	1,005	374	3,322	–	–
Impaired – no provision required	658	92	158	908	–	–
– provision held	127	3,580	299	4,006	–	1
Gross	95,601	34,041	60,836	190,478	835	40,639
Allowance for impairment losses (note 18)	(42)	(1,918)	(233)	(2,193)	–	(1)
Net	95,559	32,123	60,603	188,285	835	40,638
Due from fellow Lloyds TSB Group undertakings				1,850	–	–
Total				190,135	835	40,638

No impairment allowances have been raised in respect of amounts due from fellow Lloyds TSB Group undertakings.

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

## Notes to the accounts

## 48 Financial risk management (continued)

## Loans and advances which are neither past due nor impaired – The Group

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
Good quality	99,407	18,157	46,240		191	34,647
Satisfactory quality	378	8,964	25,013		670	190
Lower quality	1	665	2,034		327	7
Below standard, but not impaired	42	2,064	188		1	1
<b>Total</b>	<b>99,828</b>	<b>29,850</b>	<b>73,475</b>	<b>203,153</b>	<b>1,189</b>	<b>34,845</b>
<b>31 December 2006</b>						
Good quality	92,472	16,940	35,659		513	40,418
Satisfactory quality	359	9,667	21,797		314	201
Lower quality	–	663	2,249		3	17
Below standard, but not impaired	42	2,094	300		5	2
<b>Total</b>	<b>92,873</b>	<b>29,364</b>	<b>60,005</b>	<b>182,242</b>	<b>835</b>	<b>40,638</b>

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models. Good quality lending includes the lower assessed default probabilities and all loans with low expected losses in the event of default, with other categories reflecting progressively higher risks and lower expected recoveries.

## Loans and advances which are past due but not impaired – The Group

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
0-30 days	1,123	781	266	2,170	–	–
30-60 days	445	155	107	707	–	–
60-90 days	260	29	129	418	–	–
90-180 days	325	1	67	393	–	–
Over 180 days	–	–	70	70	–	–
<b>Total</b>	<b>2,153</b>	<b>966</b>	<b>639</b>	<b>3,758</b>	<b>–</b>	<b>–</b>
Fair value of collateral held	2,111	n/a	n/a	n/a		
<b>31 December 2006</b>						
0-30 days	1,104	797	156	2,057	–	–
30-60 days	341	182	60	583	–	–
60-90 days	216	26	38	280	–	–
90-180 days	280	–	70	350	–	–
Over 180 days	2	–	50	52	–	–
<b>Total</b>	<b>1,943</b>	<b>1,005</b>	<b>374</b>	<b>3,322</b>	<b>–</b>	<b>–</b>
Fair value of collateral held	1,907	n/a	n/a	n/a		

A financial asset is 'past due' if a counterparty has failed to make a payment when contractually due.

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in the Halifax House Price Index, after making allowance for indexation error and dilapidations. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

Lending decisions are based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values for non-mortgage lending are assessed more rigorously at the time of loan origination or when taking enforcement action and may fluctuate, as in the case of floating charges, according to the level of assets held by the customer. Whilst collateral is reviewed on a regular basis in accordance with business unit credit policy, this varies according to the type of lending and collateral involved. It is therefore not practicable to estimate and aggregate current fair values of collateral for non-mortgage lending.

## Notes to the accounts

## 48 Financial risk management (continued)

## Loans and advances – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
Neither past due nor impaired	87,689	22,048	54,639	164,376	1,189	21,872
Past due but not impaired	1,943	723	596	3,262	–	–
Impaired – no provision required	391	81	302	774	–	–
– provision held	194	2,804	523	3,521	–	–
Gross	90,217	25,656	56,060	171,933	1,189	21,872
Allowance for impairment losses (note 18)	(32)	(1,521)	(302)	(1,855)	–	–
Net	90,185	24,135	55,758	170,078	1,189	21,872
Due from fellow Lloyds TSB Group undertakings				42,660	–	6,575
Total				212,738	1,189	28,447

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2006</b>						
Neither past due nor impaired	842	21,833	43,019	65,694	835	25,785
Past due but not impaired	3	734	343	1,080	–	–
Impaired – no provision required	–	77	122	199	–	–
– provision held	1	2,837	260	3,098	–	–
Gross	846	25,481	43,744	70,071	835	25,785
Allowance for impairment losses (note 18)	–	(1,499)	(201)	(1,700)	–	(1)
Net	846	23,982	43,543	68,371	835	25,784
Due from fellow Lloyds TSB Group undertakings				38,205	–	60,804
Total				106,576	835	86,588

No impairment allowances have been raised in respect of amounts due from fellow Lloyds TSB Group undertakings.

## Loans and advances which are neither past due nor impaired – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
Good quality	87,593	12,280	33,998		191	21,680
Satisfactory quality	96	7,515	19,545		670	184
Lower quality	–	641	1,065		327	7
Below standard, but not impaired	–	1,612	31		1	1
Total	87,689	22,048	54,639	164,376	1,189	21,872
<b>31 December 2006</b>						
Good quality	776	11,537	23,956		513	25,566
Satisfactory quality	66	8,050	17,279		314	200
Lower quality	–	640	1,526		3	17
Below standard, but not impaired	–	1,606	258		5	2
Total	842	21,833	43,019	65,694	835	25,785

## Notes to the accounts

## 48 Financial risk management (continued)

## Loans and advances which are past due but not impaired – The Bank

	Loans and advances to customers				Loans and advances designated at fair value through profit or loss £m	Loans and advances to banks £m
	Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m		
<b>31 December 2007</b>						
0-30 days	982	544	241	1,767	–	–
30-60 days	407	150	99	656	–	–
60-90 days	244	28	119	391	–	–
90-180 days	310	1	67	378	–	–
Over 180 days	–	–	70	70	–	–
Total	<b>1,943</b>	<b>723</b>	<b>596</b>	<b>3,262</b>	–	–
Fair value of collateral held	<b>1,926</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>		
<b>31 December 2006</b>						
0-30 days	1	534	138	673	–	–
30-60 days	1	175	54	230	–	–
60-90 days	1	25	33	59	–	–
90-180 days	–	–	69	69	–	–
Over 180 days	–	–	49	49	–	–
Total	<b>3</b>	<b>734</b>	<b>343</b>	<b>1,080</b>	–	–
Fair value of collateral held	<b>5</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>		

## Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2007 totalled £579 million (2006: £342 million) for the Group and £251 million (2006: £45 million) for the Bank.

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
<b>Repossessed collateral</b>				
Residential property	<b>73</b>	55	<b>54</b>	–
Other	<b>9</b>	10	–	–
Total	<b>82</b>	65	<b>54</b>	–

The Group does not take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

## Notes to the accounts

## 48 Financial risk management (continued)

## Debt securities, treasury and other bills – analysis by credit rating

## The Group

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2007</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Debt securities:							
Government securities	62	–	–	–	–	–	62
Mortgage backed securities	–	28	51	8	–	–	87
Other asset backed securities	–	15	61	38	3	5	122
Corporate and other debt securities	268	1,268	1,390	103	59	519	3,607
Total held as trading assets	330	1,311	1,502	149	62	524	3,878
<i>Other assets held at fair value through profit or loss</i>							
Debt securities:							
Government securities	4,808	6	15	1	–	18	4,848
Bank and building society certificates of deposit	42	548	53	–	–	168	811
Mortgage backed securities	61	–	–	–	–	9	70
Other asset backed securities	1,367	214	153	71	–	–	1,805
Corporate and other debt securities	5,118	1,606	2,868	2,528	340	1,104	13,564
Total held at fair value through profit or loss	11,726	3,685	4,591	2,749	402	1,823	24,976
<b>Available-for-sale financial assets</b>							
Debt securities:							
Government securities	310	–	–	–	–	9	319
Other public sector securities	–	–	–	–	–	5	5
Bank and building society certificates of deposit	–	1,683	125	–	15	2	1,825
Mortgage backed securities	5,880	14	10	–	–	146	6,050
Other asset backed securities	3,895	37	27	–	–	112	4,071
Corporate and other debt securities	3,822	1,170	186	–	–	1,092	6,270
Total debt securities	13,907	2,904	348	–	15	1,366	18,540
Treasury bills and other bills	31	1,596	–	–	–	–	1,627
Total held as available-for-sale assets	13,938	4,500	348	–	15	1,366	20,167
<b>As at 31 December 2006</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	148	–	–	–	–	32	180
Mortgage backed securities	235	57	114	35	5	5	451
Other asset backed securities	114	75	172	176	13	45	595
Corporate and other debt securities	345	1,773	1,616	59	6	347	4,146
Total held as trading assets	842	1,905	1,902	270	24	429	5,372
<i>Other assets held at fair value through profit or loss</i>							
Government securities	8,558	30	32	1	–	5	8,626
Other public sector securities	13	–	6	–	–	25	44
Bank and building society certificates of deposit	16	345	47	–	–	165	573
Mortgage backed securities	56	–	–	–	–	31	87
Other asset backed securities	321	5	61	30	–	444	861
Corporate and other debt securities	5,870	1,598	2,915	1,597	153	1,037	13,170
Total held at fair value through profit or loss	15,676	3,883	4,963	1,898	177	2,136	28,733

## Notes to the accounts

**48 Financial risk management** (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>Available-for-sale financial assets</b>							
Debt securities:							
Government securities	379	–	–	–	–	14	393
Other public sector securities	189	–	–	–	–	–	189
Bank and building society certificates of deposit	6	1,229	356	24	–	–	1,615
Mortgage backed securities	5,559	13	–	–	–	90	5,662
Other asset backed securities	4,598	80	27	6	5	5	4,721
Corporate and other debt securities	1,971	976	698	–	–	1,172	4,817
Total debt securities	12,702	2,298	1,081	30	5	1,281	17,397
Treasury bills and other bills	46	1,705	–	–	15	–	1,766
Total held as available-for-sale assets	12,748	4,003	1,081	30	20	1,281	19,163

There are no material amounts for debt securities, treasury and other bills which are past due but not impaired.

**Debt securities, treasury and other bills – analysis by credit rating****The Bank**

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2007</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	62	–	–	–	–	–	62
Mortgage backed securities	–	28	51	8	–	–	87
Other asset backed securities	–	15	61	38	3	5	122
Corporate and other debt securities	268	1,268	1,390	103	59	519	3,607
Total held as trading assets	330	1,311	1,502	149	62	524	3,878
<i>Other assets held at fair value through profit or loss</i>							
Government securities	1	–	–	–	–	–	1
Mortgage backed securities	–	–	–	–	–	8	8
Other asset backed securities	282	–	–	–	–	–	282
Corporate and other debt securities	1,471	12	362	1,357	276	345	3,823
Total held at fair value through profit or loss	2,084	1,323	1,864	1,506	338	877	7,992
<b>Available-for-sale financial assets</b>							
Debt securities:							
Other public sector securities	–	–	–	–	–	5	5
Bank and building society certificates of deposit	–	1,146	125	–	10	2	1,283
Mortgage backed securities	1,424	14	10	–	–	16	1,464
Other asset backed securities	238	37	26	–	–	112	413
Corporate and other debt securities	729	272	1	–	–	25	1,027
Total debt securities	2,391	1,469	162	–	10	160	4,192
Treasury bills and other bills	30	9	–	–	–	–	39
Total held as available-for-sale assets	2,421	1,478	162	–	10	160	4,231



## Notes to the accounts

**48 Financial risk management** (continued)

	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2006</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Debt securities:							
Government securities	148	–	–	–	–	32	180
Mortgage backed securities	235	57	114	35	5	5	451
Other asset backed securities	114	75	172	176	13	45	595
Corporate and other debt securities	345	1,773	1,616	59	6	347	4,146
Total held as trading assets	842	1,905	1,902	270	24	429	5,372
<i>Other assets held at fair value through profit or loss</i>							
Government securities	11	–	–	–	–	–	11
Mortgage backed securities	–	–	–	–	–	7	7
Other asset backed securities	19	–	–	18	–	398	435
Corporate and other debt securities	886	–	225	606	111	322	2,150
Total held at fair value through profit or loss	1,758	1,905	2,127	894	135	1,156	7,975
<b>Available-for-sale financial assets</b>							
Debt securities:							
Government securities	–	–	–	–	–	6	6
Bank and building society certificates of deposit	2	1,229	356	24	–	–	1,611
Mortgage backed securities	1,501	13	–	–	–	90	1,604
Other asset backed securities	310	80	27	6	5	5	433
Corporate and other debt securities	92	5	5	–	–	118	220
Total debt securities	1,905	1,327	388	30	5	219	3,874
Treasury bills and other bills	42	26	–	–	15	–	83
Total held as available-for-sale assets	1,947	1,353	388	30	20	219	3,957

**Liquidity risk**

The tables below analyse financial instrument liabilities of the Group and the Bank, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

**The Group**

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2007</b>						
Deposits from banks	35,466	2,218	1,480	26	–	39,190
Customer accounts	144,406	4,800	7,578	2,002	537	159,323
Derivative financial instruments, trading and other liabilities at fair value through profit or loss	10,454	2,176	3,607	1,589	1,851	19,677
Debt securities in issue	20,299	6,032	7,789	13,152	6,197	53,469
Liabilities arising from non-participating investment contracts	18,197	–	–	–	–	18,197
Subordinated liabilities	16	188	970	5,854	11,098	18,126
Total	228,838	15,414	21,424	22,623	19,683	307,982
<b>As at 31 December 2006</b>						
Deposits from banks	28,376	3,707	1,722	818	1,942	36,565
Customer accounts	129,694	3,492	5,560	2,355	1,590	142,691
Derivative financial instruments, trading and other liabilities at fair value through profit or loss	9,043	2,037	2,600	663	887	15,230
Debt securities in issue	28,887	5,231	6,569	11,030	7,176	58,893
Liabilities arising from non-participating investment contracts	24,370	–	–	–	–	24,370
Subordinated liabilities	4	166	829	4,073	11,812	16,884
Total	220,374	14,633	17,280	18,939	23,407	294,633

Derivatives (other than those used in a hedging relationship) and trading liabilities are included in the up to 1 month column at their fair value. Liquidity risk on these items is not managed on the basis of contractual maturity as they are frequently settled on demand at fair value and therefore this is considered a better presentation of the Group's liquidity risk. Derivatives used in a hedging relationship are included according to their contractual maturity.

Cash flows for undated subordinated liabilities whose terms give the Group the option to redeem at a future date are included within the table on the basis that the Group will exercise its option to redeem.

## Notes to the accounts

**48 Financial risk management** (continued)

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £126 million per annum which is payable in respect of those instruments for as long as they remain in issue (i.e. in perpetuity) is not included beyond 5 years.

**The Bank**

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2007</b>						
Deposits from banks	43,854	2,632	2,067	652	63	49,268
Customer accounts	137,530	5,862	10,545	13,416	1,295	168,648
Derivative financial instruments, trading and other liabilities at fair value through profit or loss	10,641	185	3,509	1,485	1,271	17,091
Debt securities in issue	7,959	5,678	7,605	13,050	5,701	39,993
Subordinated liabilities	–	181	941	5,760	10,451	17,333
<b>Total</b>	<b>199,984</b>	<b>14,538</b>	<b>24,667</b>	<b>34,363</b>	<b>18,781</b>	<b>292,333</b>
<b>As at 31 December 2006</b>						
Deposits from banks	35,852	4,004	2,109	1,407	902	44,274
Customer accounts	104,768	5,397	11,704	5,588	2,553	130,010
Derivative financial instruments, trading and other liabilities at fair value through profit or loss	9,575	27	2,600	660	850	13,712
Debt securities in issue	17,919	4,816	5,217	2,427	5,204	35,583
Subordinated liabilities	–	156	751	3,459	10,819	15,185
<b>Total</b>	<b>168,114</b>	<b>14,400</b>	<b>22,381</b>	<b>13,541</b>	<b>20,328</b>	<b>238,764</b>

Liabilities of the Group arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-2 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2007</b>	<b>238</b>	<b>651</b>	<b>1,570</b>	<b>9,548</b>	<b>26,185</b>	<b>38,192</b>
As at 31 December 2006	247	716	1,852	9,682	29,105	41,602

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

**The Group**

	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>31 December 2007</b>					
Acceptances	39	1	–	–	40
Other contingent liabilities	1,441	1,032	255	796	3,524
<b>Total contingent liabilities</b>	<b>1,480</b>	<b>1,033</b>	<b>255</b>	<b>796</b>	<b>3,564</b>
Lending commitments	60,981	13,759	10,634	4,221	89,595
Other commitments	466	78	108	117	769
<b>Total commitments</b>	<b>61,447</b>	<b>13,837</b>	<b>10,742</b>	<b>4,338</b>	<b>90,364</b>
<b>Total contingents and commitments</b>	<b>62,927</b>	<b>14,870</b>	<b>10,997</b>	<b>5,134</b>	<b>93,928</b>
<b>31 December 2006</b>					
Acceptances	62	1	–	–	63
Other contingent liabilities	953	976	263	522	2,714
<b>Total contingent liabilities</b>	<b>1,015</b>	<b>977</b>	<b>263</b>	<b>522</b>	<b>2,777</b>
Lending commitments	56,019	11,310	11,050	3,900	82,279
Other commitments	5,945	109	23	61	6,138
<b>Total commitments</b>	<b>61,964</b>	<b>11,419</b>	<b>11,073</b>	<b>3,961</b>	<b>88,417</b>
<b>Total contingents and commitments</b>	<b>62,979</b>	<b>12,396</b>	<b>11,336</b>	<b>4,483</b>	<b>91,194</b>

## Notes to the accounts

**48 Financial risk management** (continued)

<b>The Bank</b>	Within 1 year £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
<b>31 December 2007</b>					
Acceptances	41	1	–	–	42
Other contingent liabilities	1,370	1,028	255	796	3,449
Total contingent liabilities	1,411	1,029	255	796	3,491
Lending commitments	71,781	11,780	8,928	3,870	96,359
Other commitments	597	77	108	117	899
Total commitments	72,378	11,857	9,036	3,987	97,258
Total contingents and commitments	73,789	12,886	9,291	4,783	100,749
<b>31 December 2006</b>					
Acceptances	67	1	–	–	68
Other contingent liabilities	1,010	975	263	520	2,768
Total contingent liabilities	1,077	976	263	520	2,836
Lending commitments	60,509	9,531	9,448	3,623	83,111
Other commitments	5,844	109	23	61	6,037
Total commitments	66,353	9,640	9,471	3,684	89,148
Total contingents and commitments	67,430	10,616	9,734	4,204	91,984

**Fair values of financial assets and liabilities**

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been estimated using market prices for instruments held by the Group. Where market prices are not available, fair values have been estimated using quoted values for instruments with characteristics either identical or similar to those of the instruments held by the Group. These estimation techniques are necessarily subjective in nature and involve several assumptions.

The fair values presented in the following table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

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

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

The valuation technique for each major category of financial instrument is discussed below.

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

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practical, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices.

*Derivative financial instruments*

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and options pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative.

*Loans and advances to banks and customers*

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period.

*Available-for-sale financial assets*

Listed securities are valued at current bid prices. Unlisted securities and other financial assets are valued based on discounted cash flows, market prices of similar instruments and other appropriate valuation techniques.

## Notes to the accounts

**48 Financial risk management** (continued)*Deposits from banks and customer accounts*

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits and customer accounts is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

*Debt securities in issue and subordinated liabilities*

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

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

The fair values of financial instruments quoted in active markets are based on quoted prices. The fair values of financial instruments that are not quoted in active markets are determined using valuation techniques including cash flow models which, to the extent practical, use observable market inputs such as interest rate yield curves, equities and commodities prices, option volatilities and currency rates that are either directly observable or are implied from instrument prices.

*Liabilities arising from non-participating investment contracts*

The value of the Group's non-participating investment contracts, all of which are unit-linked, is contractually linked to the fair values of financial assets within the Group's unitised investment funds and is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable.

*Financial commitments and contingent liabilities*

Financial guarantees are valued on the basis of cash premiums receivable. The Group considers that it is not meaningful or practical to provide an estimate of the fair value of other contingent liabilities and financial commitments, given the lack of an established market, the diversity of fee structures and the difficulty of separating the value of the instruments from the value of the overall transaction. Therefore only financial guarantees are included in the following table.

	The Group				The Bank			
	Carrying value		Fair value		Carrying value		Fair value	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
<i>Financial assets</i>								
Trading and other financial assets at fair value through profit or loss	<b>58,096</b>	67,928	<b>58,096</b>	67,928	<b>9,184</b>	8,819	<b>9,184</b>	8,819
Derivative financial instruments	<b>8,688</b>	5,565	<b>8,688</b>	5,565	<b>8,624</b>	5,665	<b>8,624</b>	5,665
Loans and advances to banks	<b>34,845</b>	40,638	<b>34,832</b>	40,641	<b>28,447</b>	86,588	<b>28,434</b>	86,591
Loans and advances to customers	<b>209,814</b>	190,135	<b>209,066</b>	189,827	<b>212,738</b>	106,576	<b>212,015</b>	106,675
Available-for-sale financial assets	<b>20,196</b>	19,178	<b>20,196</b>	19,178	<b>4,260</b>	3,972	<b>4,260</b>	3,972
<i>Financial liabilities</i>								
Deposits from banks	<b>39,091</b>	36,394	<b>39,063</b>	36,383	<b>48,940</b>	44,070	<b>48,912</b>	44,059
Customer accounts	<b>156,713</b>	140,767	<b>156,766</b>	140,688	<b>163,245</b>	127,938	<b>163,293</b>	127,929
Trading and other liabilities at fair value through profit or loss	<b>3,206</b>	1,184	<b>3,206</b>	1,184	<b>3,206</b>	1,184	<b>3,206</b>	1,184
Derivative financial instruments	<b>7,751</b>	5,877	<b>7,751</b>	5,877	<b>8,365</b>	6,405	<b>8,365</b>	6,405
Debt securities in issue	<b>49,828</b>	54,118	<b>49,567</b>	54,070	<b>36,647</b>	32,719	<b>36,387</b>	32,671
Liabilities arising from non-participating investment contracts	<b>18,197</b>	24,370	<b>18,197</b>	24,370	–	–	–	–
Financial guarantees	<b>26</b>	49	<b>26</b>	49	<b>26</b>	49	<b>26</b>	49
Subordinated liabilities	<b>12,437</b>	11,506	<b>12,674</b>	12,250	<b>11,903</b>	10,281	<b>12,162</b>	10,921

**49 Capital**

For the banking businesses the international standard for measuring capital adequacy is the risk asset ratio, which relates regulatory capital to balance sheet assets and off-balance sheet exposures weighted according to broad categories of risk as defined by the Basel I framework. The Group's regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA's General Prudential Sourcebook. Tier 1 comprises mainly shareholders' equity, tier 1 capital instruments and minority interests, after deducting goodwill and other intangible assets. Tier 2 comprises collective impairment provisions, and qualifying subordinated loan capital, with restrictions on the amount of collective impairment provisions and loan capital which may be included. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by deducting investments in subsidiaries and associates which are not consolidated for regulatory purposes and investments in the capital of other credit/financial institutions. In the case of the Group, this means that the net assets of its life assurance and general insurance businesses are deducted from its regulatory capital. Risk-weighted assets are determined according to a broad categorisation of the nature of each asset or exposure and counterparty and, for the FSA defined trading book, by taking into account market-related risks.

## Notes to the accounts

49 Capital (continued)	2007 £m	2006 £m
Tier 1 capital	13,856	12,657
Tier 2 capital	11,669	10,582
	<b>25,525</b>	23,239
Supervisory deductions	<b>(5,135)</b>	(8,004)
Total capital	<b>20,390</b>	15,235

There are limits imposed by the FSA as to the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

The Group and its regulated subsidiary banks have been allocated an Individual Capital Ratio by the FSA, and the board has agreed a formal buffer to be maintained in addition to this ratio. This is subject to ongoing review and monitoring by the Lloyds TSB Group Asset and Liability Committee. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. No such notifications have been made during 2007. With effect from 1 January 2008 the Group moved onto the Basel II framework and maintained satisfactory capital ratios throughout the transition.

The life assurance and general insurance businesses are subject to separate regulatory rules. Further disclosure relating to the life assurance business, as required by FRS 27, is set out below.

#### Life assurance businesses

The principal subsidiary involved in the Group's life assurance operations is Scottish Widows plc ('Scottish Widows'), which holds the only large With Profit Fund managed by the Lloyds TSB Group. Throughout 2006 and up until the third quarter of 2007, the Group also owned Abbey Life Assurance Company Limited (which had been closed to new business since March 2000) but this business was sold at the end of September 2007.

#### Basis of determining regulatory capital of the life assurance businesses

##### Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the FSA. Different rules apply depending on the nature of the fund, as detailed below.

**Statutory basis.** Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. Liabilities are calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

**'Realistic' basis.** The FSA requires each life assurance company which contains a with-profits fund in excess of £500 million, including Scottish Widows, to carry out a 'realistic' valuation of that fund. The word 'realistic' in this context reflects the terminology used for reporting to the FSA and is an assessment of the financial position of a with-profits fund calculated under a prescribed methodology.

The valuation of with-profits assets in a with-profits fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profits business written in a with-profits fund (a relatively small amount of business in the case of Scottish Widows), it includes the present value of the anticipated future release of the prudent margins for adverse deviation. The realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above.

The realistic valuation of liabilities is carried out using a stochastic simulation model which values liabilities on a basis consistent with tradable market option contracts (a 'market-consistent' basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given below in the section entitled 'Options and guarantees'.

##### Regulatory capital requirements

Each life assurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows, the regulatory capital requirement is a combination of amounts held in respect of actuarial reserves, sums at risk and maintenance expenses (the Long-Term Insurance Capital Requirement) and amounts required to cover various stress tests. The regulatory capital requirement is deducted from the available capital resources to give 'statutory excess capital'.

For Scottish Widows, no amount is required to cover the impact of stress tests on the actuarial reserves. However, a further test is required in respect of the With Profit Fund, which compares the level of 'realistic excess capital' to the 'statutory excess capital' of the With Profit Fund. In circumstances where the 'realistic excess capital' position is less than 'statutory excess capital', the Company is required to hold additional capital to cover the shortfall, but only to the extent it exceeds the value, calculated in a prescribed way, of internal transfers from the With Profit Fund. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component. The 'realistic excess capital' is calculated as the difference between realistic assets and realistic liabilities of the With Profit Fund with a further deduction to cover various stress tests.

## Notes to the accounts

**49 Capital** (continued)

The determination of realistic liabilities of the With Profit Fund in respect of Scottish Widows includes the value of internal transfers expected to be made from the With Profit Fund to the Non-Participating Fund of Scottish Widows. These internal transfers include charges on policies where the associated costs are borne by the Non-Participating Fund. The With-Profits Insurance Capital Component is reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the Non-Participating Fund.

**Capital statement**

The following table provides more detail regarding the sources of capital in the life assurance business. The figures quoted are based on management's current expectations pending completion of the annual financial return to the FSA. The figures allow for an anticipated transfer of £300 million from the Long Term Fund to the Shareholder Fund as at 31 December 2007.

	With Profit Fund £m	Non- Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
<b>As at 31 December 2007</b>					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	946	946
Assets attributable to the shareholder held within the long-term funds	–	2,346	2,346	–	2,346
Total shareholders' funds	–	2,346	2,346	946	3,292
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	569	–	569	–	569
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(431)	(431)	(600)	(1,031)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(634)	–	(634)	–	(634)
Adjustment to replace 'realistic' liabilities with statutory liabilities	3,696	–	3,696	–	3,696
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(23)	–	(23)	–	(23)
Qualifying loan capital	–	–	–	541	541
Available capital resources	3,608	1,915	5,523	887	6,410

The figures shown above for available capital resources within the insurance business relate to Scottish Widows plc only. The estimated total additional resources relating to the other life assurance subsidiaries within the Group are £330 million.

The comparative position as at 31 December 2006 was as follows (again, relating to Scottish Widows plc only):

	With Profit Fund £m	Non- Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
<b>As at 31 December 2006</b>					
Assets attributable to the shareholder held outside the long-term funds	–	–	–	1,947	1,947
Assets attributable to the shareholder held within the long-term funds	–	2,225	2,225	–	2,225
Total shareholders' funds	–	2,225	2,225	1,947	4,172
Adjustments onto a regulatory basis:					
Life assurance business					
Unallocated surplus within insurance business	615	–	615	–	615
Adjustments to remove differences between IFRS and regulatory valuation of assets and liabilities	–	(263)	(263)	(810)	(1,073)
Adjustment to include estimated 'realistic' liabilities payable to the shareholder	(680)	–	(680)	–	(680)
Adjustment to replace 'realistic' liabilities with statutory liabilities	3,783	–	3,783	–	3,783
Adjustment to remove the value of future profits recognised in respect of non-participating contracts written in the With Profit Fund	(32)	–	(32)	–	(32)
Qualifying loan capital	–	–	–	533	533
Available capital resources	3,686	1,962	5,648	1,670	7,318

*Formal intra-group capital arrangements*

Scottish Widows has a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its subsidiary Scottish Widows Annuities Limited and its fellow group undertaking Scottish Widows Bank plc.

*Constraints over available capital resources*

Scottish Widows was created following the demutualisation of Scottish Widows Fund and Life Assurance Society in 2000. The terms of the demutualisation are governed by a Court-approved Scheme of Transfer (the 'Scheme') which, *inter alia*, created a With Profit Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below.

## Notes to the accounts

**49 Capital** (continued)

*Requirement to maintain a Support Account:* The Scheme requires the maintenance of a 'Support Account' within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation and must be maintained until the value of these assets reaches a minimum level. Assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2007, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,915 million (31 December 2006: £1,962 million) and the estimated value of the Support Account was £827 million (31 December 2006: £974 million).

*Further Support Account:* The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2007, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £4,028 million (31 December 2006: £3,962 million) and the estimated combined value of the Support Account and Further Support Account was £2,834 million (31 December 2006: £2,873 million).

*Other restrictions in the Non-Participating Fund:* In addition to the policies which existed at the date of demutualisation, the With Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2007 is £193 million (31 December 2006: £216 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

*Movements in regulatory capital*

The movements in Scottish Widows plc's available capital resources can be analysed as follows:

	With Profit Fund £m	Non- Participating Fund £m	Total Long Term Fund £m	Shareholder Fund £m	Total £m
As at 31 December 2006	3,686	1,962	5,648	1,670	7,318
Changes in estimations and in assumptions used to measure life assurance liabilities	(104)	(40)	(144)	–	(144)
Dividends and capital transfers	–	(300)	(300)	(1,560)	(1,860)
Changes in regulatory requirements	–	69	69	–	69
New business and other factors	26	224	250	777	1,027
<b>As at 31 December 2007</b>	<b>3,608</b>	<b>1,915</b>	<b>5,523</b>	<b>887</b>	<b>6,410</b>

The primary reasons for the movement in total available capital resources during the year are as follows:

*With Profit Fund:*

Available capital in the With Profit Fund has decreased from £3,686 million at 31 December 2006 to an estimated £3,608 million at 31 December 2007. The key driver is investment market performance, which was broadly neutral over 2007.

*Non-Participating Fund:*

Available capital in the Non-Participating Fund has decreased from £1,962 million at 31 December 2006 to an estimated £1,915 million at 31 December 2007. This is primarily a result of the anticipated transfer from the Non-Participating Fund to the Shareholder Fund at the year end of £300 million, offset by the return generated from the business.

*Shareholder Fund:*

During 2007, dividends of £1,860 million were paid. These were partly financed by the sale of Abbey Life Assurance Company Limited.

**Financial information calculated on a 'realistic' basis**

The estimated financial position of the With Profit Fund of Scottish Widows at 31 December 2007, calculated on a 'realistic' basis, is given in the following table, in the form reported to the FSA. As a result of the capital support arrangements, it is considered appropriate to also disclose the estimated 'realistic' financial position of the Long Term Fund of Scottish Widows as a whole, which consists of both the With Profit Fund and the Non-Participating Fund.

## Notes to the accounts

**49 Capital** (continued)

	31 December 2007		31 December 2006	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Realistic value of assets of fund	16,781	20,929	18,183	22,278
Support arrangement assets	1,020	–	1,190	–
Realistic value of assets available to the fund	17,801	20,929	19,373	22,278
Realistic value of liabilities of fund	(16,846)	(16,901)	(18,248)	(18,316)
<b>Working capital for fund</b>	<b>955</b>	<b>4,028</b>	1,125	3,962
<b>Working capital ratio for fund</b>	<b>5.4%</b>	<b>19.2%</b>	5.8%	17.9%

The financial information calculated on a 'realistic' basis reconciles to the Capital statement as follows:

	31 December 2007		31 December 2006	
	With Profit Fund £m	Long Term Fund £m	With Profit Fund £m	Long Term Fund £m
Available regulatory capital	3,608	5,523	3,686	5,648
Support arrangement assets	1,020	–	1,190	–
Adjustments to replace statutory liabilities with 'realistic' liabilities	(3,696)	(3,582)	(3,783)	(3,614)
Adjustments to include the value of future profits recognised in respect of Non-Participating business written in the With Profit Fund	23	23	32	32
Recognition of future profits allowable for 'realistic' capital purposes	–	2,064	–	1,896
	<b>955</b>	<b>4,028</b>	1,125	3,962

Analysis of policyholder liabilities in respect of the Group's life assurance business:

	Scottish Widows plc With Profit Fund (in accordance with FRS 27) £m	Other long-term funds £m	Total life business £m
<b>As at 31 December 2007</b>			
With Profit Fund liabilities	16,533	–	16,533
Unit-linked business (excluding that accounted for as investment contracts)	–	14,282	14,282
Other life assurance business	–	6,714	6,714
Insurance and participating investment contract liabilities	16,533	20,996	37,529
Non-participating investment contract liabilities	–	18,197	18,197
Total policyholder liabilities	<b>16,533</b>	<b>39,193</b>	<b>55,726</b>
<b>As at 31 December 2006</b>			
With Profit Fund liabilities	17,984	116	18,100
Unit-linked business (excluding that accounted for as investment contracts)	–	12,734	12,734
Other life assurance business	–	10,181	10,181
Insurance and participating investment contract liabilities	17,984	23,031	41,015
Non-participating investment contract liabilities	–	24,370	24,370
Total policyholder liabilities	17,984	47,401	65,385

The sale of Abbey Life Assurance Company Limited during 2007 reduced total policyholder liabilities by £11,632 million.



## Notes to the accounts

**49 Capital** (continued)**Capital sensitivities***Shareholders' funds*

Shareholders' funds outside the long-term business fund, other than those used to match regulatory requirements, are mainly invested in assets that are less sensitive to market conditions.

*With Profit Fund*

The with-profits realistic liabilities and the available capital for the With Profit Fund are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put options also increases the market consistent value of the options given to policyholders and worsens the capital position.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the With Profit Fund is partly mitigated by the actions that can be taken by management.

*Other long-term funds*

Outside the With Profit Fund, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life assurance contracts. In addition, poor cost control would gradually depreciate the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

Assets held in excess of those backing actuarial reserves are invested across a range of investment categories including fixed interest securities, equities, properties and cash. The mix of investments is determined in line with the policy of Lloyds TSB Group to minimise the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

**Options and guarantees**

The Group has sold insurance products that contain options and guarantees, both within the With Profit Fund and in other funds.

*Options and guarantees within the With Profit Fund*

The most significant options and guarantees provided from within the With Profit Fund are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies. For those policies written pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With Profit Fund of Scottish Widows called the Additional Account which is available, *inter alia*, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2007 of £1.7 billion (2006: £1.8 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of the With Profit Fund are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

- *Risk-free yield.* The risk-free yield is defined as 0.1 per cent higher than spot yields derived from the UK gilt yield curve.
- *Investment volatility.* The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2007, the 10 year equity-implied at-the-money assumption was set at 25.5 per cent (31 December 2006: 20 per cent). The assumption for property volatility was 15 per cent (31 December 2006: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 11 per cent (31 December 2006: 13 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

*Options and guarantees outside the With Profit Fund of Scottish Widows*

Certain personal pension policyholders, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £65 million (31 December 2006: £98 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £3 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £12 million.

## Notes to the accounts

**50 Acquisitions**

During 2006, the Group, through its Asset Finance subsidiaries, acquired two businesses engaged in consumer finance for a total consideration of £16 million, settled in cash in that year. Goodwill of £4 million arose on those acquisitions; no significant fair value adjustments were made.

**51 Cash flow statements****a Change in operating assets**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Change in loans and advances to banks	8,673	(11,063)	8,831	(3,465)
Change in loans and advances to customers	(18,946)	(14,069)	(18,989)	(15,431)
Change in trading assets	(4,329)	(7,112)	(3,352)	(2,574)
Change in other operating assets	(511)	50	(38)	(131)
Change in operating assets	(15,113)	(32,194)	(13,548)	(21,601)

**b Change in operating liabilities**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Change in deposits from banks	2,136	5,222	4,321	6,750
Change in customer accounts	15,905	9,668	20,359	12,728
Change in debt securities in issue	(4,194)	15,068	(9,241)	1,699
Change in trading liabilities	3,895	482	3,978	382
Change in investment contract liabilities	(58)	3,795	–	–
Change in other operating liabilities	923	(71)	26	380
Change in operating liabilities	18,607	34,164	19,443	21,939

**c Non-cash and other items**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Depreciation and amortisation	630	619	299	295
Revaluation of investment property	321	(631)	–	–
Allowance for loan losses	1,721	1,560	1,405	1,268
Write-off of allowance for loan losses	(1,405)	(1,299)	(1,171)	(1,146)
Impairment of available-for-sale securities	70	–	70	–
Insurance claims	7,522	8,569	–	–
Insurance claims paid	(6,697)	(7,486)	–	–
Customer remediation provision	–	–	–	(8)
Customer remediation paid	(54)	(93)	(48)	(76)
Other provision movements	2	(19)	5	(16)
Net charge in respect of defined benefit schemes	175	109	126	73
Contributions to defined benefit schemes	(452)	(556)	(348)	(432)
Other non-cash items	789	175	140	(695)
Total non-cash items	2,622	948	478	(737)
Interest expense on subordinated liabilities	770	727	704	614
Profit on disposal of businesses	(657)	–	(407)	–
Other	(46)	(43)	(18)	(32)
Total other items	67	684	279	582
Non-cash and other items	2,689	1,632	757	(155)

## Notes to the accounts

**51 Cash flow statements** (continued)**d Analysis of cash and cash equivalents as shown in the balance sheet**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash and balances with central banks	4,330	1,898	4,211	1,678
Less: mandatory reserve deposits <sup>1</sup>	(338)	(300)	(319)	(169)
	<b>3,992</b>	1,598	<b>3,892</b>	1,509
Loans and advances to banks	34,845	40,638	28,447	86,588
Less: amounts with a maturity of three months or more and balances due from subsidiary undertakings	(6,946)	(16,798)	(8,312)	(72,662)
	<b>27,899</b>	23,840	<b>20,135</b>	13,926
	<b>31,891</b>	25,438	<b>24,027</b>	15,435

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

Included within cash and cash equivalents of the Group at 31 December 2007 is £7,426 million (2006: £9,054 million) held within the Group's life funds, which is not immediately available for use in the business.

**e Analysis of changes in financing during the year**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Share capital (including share premium account): At 1 January and 31 December	4,502	4,502	4,502	4,502

	The Group	
	2007 £m	2006 £m
Minority interests: At 1 January	352	435
Exchange and other adjustments	(1)	(4)
Repayment of capital to minority shareholders	(80)	(151)
Minority share of profit after tax	32	104
Dividends to minority shareholders	(19)	(32)
At 31 December	<b>284</b>	352

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Subordinated liabilities At 1 January	11,506	12,635	10,281	11,382
Exchange and other adjustments	133	(620)	124	(592)
Issue of subordinated liabilities	1,098	-	1,098	-
Repayments of subordinated liabilities	(300)	(509)	(300)	(509)
Transfer of C&G business (note 26)	-	-	700	-
At 31 December	<b>12,437</b>	11,506	<b>11,903</b>	10,281

**f Acquisition of group undertakings and businesses**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Investment in subsidiary	-	-	18	8
Net assets acquired:				
Loans and advances to customers	-	11	-	-
Other assets	-	1	-	-
Goodwill arising on consolidation	-	4	-	-
Net cash outflow from acquisitions in the year	-	16	18	8
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	8	4	-	-
Net cash outflow from acquisitions	<b>8</b>	20	<b>18</b>	8

## Notes to the accounts

**51 Cash flow statements** (continued)**g Disposal and closure of group undertakings and businesses**

	The Group		The Bank	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash and balances at central banks	37	-	-	-
Trading and other financial assets at fair value through profit or loss	10,999	-	-	-
Loans and advances to banks	1,150	-	-	-
Value of in-force business	412	-	-	-
Liabilities arising from insurance contracts and participating investment contracts	(4,349)	-	-	-
Liabilities arising from non-participating investment contracts	(7,283)	-	-	-
Unallocated surplus within insurance businesses	(15)	-	-	-
Other net assets and liabilities	(95)	-	111	-
	856	-	111	-
Profit on sale of businesses	657	-	407	-
Cash and cash equivalents disposed of	(37)	-	-	-
Consideration for 2005 disposal settled in cash	-	936	-	936
Net cash inflow from disposals	1,476	936	518	936

## Notes to the accounts

**52 Future developments**

The following pronouncements will be relevant to the Group but were not effective at 31 December 2007 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group, however, the initial view is that none of these pronouncements are expected to cause any material adjustments to reported numbers in the financial statements.

Pronouncement	Nature of change	Effective date
IFRIC 11 IFRS 2 – Group and Treasury Share Transactions	Clarifies the application of IFRS 2 Share-based Payment to certain share-based payment arrangements involving own equity instruments and arrangements involving equity instruments of a parent entity.	Annual periods beginning on or after 1 March 2007.
IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirement and their Interaction <sup>1</sup>	Provides guidance on the availability of refunds or reductions in future contributions for retirement plans and specifies how a minimum funding requirement might either affect the availability of reductions in future contributions or give rise to a liability	Annual periods beginning on or after 1 January 2008.
IFRIC 13 Customer Loyalty Programmes <sup>1,2</sup>	Addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services.	Annual periods beginning on or after 1 July 2008.
IAS 1 Presentation of Financial Statements <sup>1,2</sup>	Revises the overall requirements for the presentation of financial statements, guidance for their structure and minimum content requirements. The revised standard requires the presentation of all non-owner changes in equity within a statement of comprehensive income.	Annual periods beginning on or after 1 January 2009.
IAS 23 Borrowing Costs <sup>1,2</sup>	Requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense excepting that those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale must be capitalised as part of the cost of those assets.	Annual periods beginning on or after 1 January 2009.
IFRS 8 Operating Segments <sup>2</sup>	Replaces IAS 14 Segment Reporting and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated internally.	Annual periods beginning on or after 1 January 2009.
IFRS 2 Share-based Payment – Vesting Conditions and Cancellations <sup>1,2</sup>	The amendment restricts the definition of vesting conditions to include only service conditions and performance conditions and deals with the accounting consequences of a failure to meet a condition other than a vesting condition including how to deal with cancellations by the counterparty and circumstances where neither the entity nor the counterparty is in a position to choose whether or not to meet a vesting condition.	Annual periods beginning on or after 1 January 2009.
Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation <sup>1,2</sup>	The amendment requires some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.	Annual periods beginning on or after 1 January 2009.
IFRS 3 Business Combinations <sup>1,2</sup>	The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the minority interest, and all transaction costs are expensed.	Annual periods beginning on or after 1 July 2009.
IAS 27 Consolidated and Separate Financial Statements <sup>1,2</sup>	Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is remeasured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.	Annual periods beginning on or after 1 July 2009.

<sup>1</sup> At the date of this report, these pronouncements are awaiting EU endorsement.

<sup>2</sup> Subject to any EU endorsement, the Group has not yet made a final decision as to whether it will apply these pronouncements in the 2008 financial statements.

## Notes to the accounts

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### **53 Approval of the financial statements and other information**

The financial statements were approved by the directors of Lloyds TSB Bank plc on 21 February 2008.

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



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