Bank of Scotland plc

Half-Year Management Report

For the half-year to 30 June 2015

Member of the Lloyds Banking Group

FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements with respect to the business, strategy and plans of the Bank of Scotland Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about the Bank of Scotland Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future. Factors that could cause actual business, strategy, plans and/or results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Bank of Scotland Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to Bank of Scotland plc's, HBOS plc's, Lloyds Bank plc's or Lloyds Banking Group plc's credit ratings; the ability to derive cost savings; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, the potential for one or more countries to exit the Eurozone or European Union (EU) (including the UK as a result of a referendum on its EU membership) and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; pandemic, natural and other disasters, adverse weather and similar contingencies outside the Lloyds Banking Group's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of further Scottish devolution; changes to regulatory capital or liquidity requirements and similar contingencies outside the Lloyds Banking Group's control; the policies, decisions and actions of governmental or regulatory authorities in the UK, the EU, the US or elsewhere including the implementation of key legislation and regulation; the ability to attract and retain senior management and other employees; requirements or limitations imposed on Lloyds Banking Group plc, Lloyds Bank plc, HBOS plc and the Bank of Scotland Group as a result of HM Treasury's investment in Lloyds Banking Group plc; actions or omissions by the Bank of Scotland Group's directors, management or employees including industrial action; the provision of banking operations services to TSB Banking Group plc; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Bank of Scotland Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services and lending companies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to Lloyds Banking Group plc's latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements. Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of today's date, and the Bank of Scotland Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements.

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FINANCIAL REVIEW

Principal activities

Bank of Scotland plc (the Bank) and its subsidiaries (together, the Group) provide a wide range of banking and financial services in the UK and overseas.

During the half-year to 30 June 2015, the Group earned revenue through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; and private banking.

Review of results

The Group recorded a profit before tax of £1,513 million for the half-year to 30 June 2015, an increase of £383 million, or 34 per cent, compared to the profit before tax of £1,130 million for the half-year to 30 June 2014.

Total income increased by £186 million to £3,735 million for the half-year to 30 June 2015 from £3,549 million in the half-year to 30 June 2014.

Net interest income increased by £157 million, or 5 per cent, to £3,271 million. The net interest margin increased, reflecting the disposal of lower margin assets which were outside of the Group's risk appetite at the end of 2014 as well as the continued benefits of reduced funding and liability costs, partly offset by lower asset prices.

Other income increased by £29 million, or 7 per cent, to £464 million, largely due to an increase in net trading income of £130 million which more than offset a £112 million decrease in other operating income. Net trading income was a profit of £219 million compared to a profit of £89 million in the half-year to 30 June 2014. Net fee and commission income was £11 million, or 5 per cent, higher at £236 million, Other operating income was £112 million lower at £9 million partly as a result of gains on asset sales in 2014 which were not repeated.

Total operating expenses increased by £286 million, or 16 per cent, to £2,131 million; although there was a charge in respect of regulatory provisions of £547 million compared to a charge of £214 million in the same period in 2014. Excluding these items, costs were £47 million, or 3 per cent, lower at £1,584 million. This decrease reflects the impact of business disposals and the ongoing benefits of the Lloyds Banking Group's efficiency programmes.

The Group increased the provision for expected PPI costs by a further £341 million in first half of 2015. This brings the amount provided to £3,760 million, of which £772 million remains unutilised. The unutilised provision comprises elements to cover the Past Business Review (PBR), remediation activity and future reactive complaints including associated administration costs. The volume of reactive PPI complaints in the first half of 2015 fell by 8 per cent compared with the first half of 2014 but were marginally higher than the fourth quarter 2014 run-rate and above expectations. Reactive complaints continue to be driven by Claims Management Company (CMC) activity.

The Group also made a further charge of £206 million in respect of other conduct issues. This comprises £164 million of provisions related to potential claims and remediation in respect of legacy product sales and a fine of £42 million following the agreement reached with the Financial Conduct Authority with regard to aspects of the Group's PPI complaint handling process during the period March 2012 to May 2013.

Impairment losses decreased by £483 million, or 84 per cent, to £91 million; the improvement reflects lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment.

The tax charge for the half-year to 30 June 2015 was £292 million (half-year to 30 June 2014: £218 million), representing an effective tax rate of 19.3 per cent; this compares to an effective tax rate of 19.3 per cent in the first half of 2014.

FINANCIAL REVIEW (continued)

On the balance sheet, total assets were £13,416 million, or 4 per cent, lower at £367,809 million at 30 June 2015, compared to £381,225 million at 31 December 2014. Loans and advances to customers decreased by £3,451 million, or 1 per cent, to £268,223 million and customer deposits decreased by £10,122 million, to £193,376 million. Shareholders' equity decreased by £3,854 million, or 18 per cent, from £20,845 million at 31 December 2014 to £16,991 million at 30 June 2015 as the retained profit for the period of £1,221 million was more than offset by the impact of a dividend of £5,000 million paid in March 2015.

The Group's common equity tier 1 capital ratio fell to 12.7 per cent at the end of June 2015, from 13.3 per cent at the end of December 2014, reflecting the adjustment to retained earnings for foreseeable dividends, offset by a reduction in risk-weighted assets.

FINANCIAL REVIEW (continued)

Capital ratios

Capital resources	**At 30 June 2015 £m**	At 31 Dec 2014 £m
Common equity tier 1		
Shareholders' equity per balance sheet	**16,991**	20,845
Adjustment to retained earnings for foreseeable dividends	**(3,250)**	(5,000)
Unrealised reserve on available-for-sale securities	**–**	(134)
Cash flow hedging reserve	**(351)**	(484)
Other adjustments	**(215)**	(123)
	13,175	15,104
Less: deductions from common equity tier 1		
Goodwill and other intangible assets	**(420)**	(423)
Excess of expected losses over impairment provisions and value adjustments	**(200)**	(314)
Securitisation deductions	**(174)**	(181)
Deferred tax assets	**(2,021)**	(2,144)
Common equity tier 1 capital	**10,360**	12,042
Additional tier 1		
Additional tier 1 instruments	**464**	569
Total tier 1 capital	**10,824**	12,611
Tier 2		
Tier 2 instruments	**6,600**	6,860
Eligible provisions	**337**	354
Total tier 2 capital	**6,937**	7,214
Total capital resources	**17,761**	19,825
Risk-weighted assets	**81,681**	90,550
Common equity tier 1 capital ratio	**12.7%**	13.3%
Tier 1 capital ratio	**13.3%**	13.9%
Total capital ratio	**21.7%**	21.9%

PRINCIPAL RISKS AND UNCERTAINTIES

The most significant risks faced by the Group which could impact the success of delivering against the Group's long-term strategic objectives and through which global macro-economic and regulatory developments and market liquidity dynamics could manifest, are detailed below. Except where noted, there has been no significant change to the description of these risks or key mitigating actions disclosed in the Group's 2014 Annual Report and Accounts, with any quantitative disclosures updated herein.

Credit risk – Adverse changes in the economic and market environment or the credit quality of our counterparties and customers could reduce asset values; potentially increase write-downs and allowances for impairment losses thereby adversely impacting profitability. Refer to 2014 Annual Report and Accounts for mitigating actions and further details.

Conduct risk – We face significant potential conduct risk, including selling products which do not meet customer needs; failing to deal with complaints effectively and exhibiting behaviours which do not meet market or regulatory standards. Refer to 2014 Annual Report and Accounts for mitigating actions and further details.

Market risk – Key market risks include interest rate and credit spread in the Banking business, credit spread and equity in the Insurance business where asset and liability movements impact on our capital position. Refer to 2014 Annual Report and Accounts for mitigating actions and further details. In addition, a hedge has been implemented to provide protection from Insurance equity volatility.

Operational risk – Significant operational risks which may result in financial loss, disruption or damage to the reputation of Lloyds Banking Group, including the availability, resilience and security of our core IT systems and the potential for failings in our customer processes. Refer to 2014 Annual Report and Accounts for mitigating actions and further details.

Capital risk – Future capital position is potentially at risk from a worsening macroeconomic environment, which could lead to adverse financial performance and deplete capital resources and/or increase capital requirements. Refer to 2014 Annual Report and Accounts for mitigating actions and further details.

Funding and liquidity risk – Our funding and liquidity position is supported by a significant and stable customer deposit base. A deterioration in either our or the UK's credit rating, or a sudden and significant withdrawal of customer deposits could adversely impact Lloyds Banking Group's funding and liquidity position. Refer to 2014 Annual Report and Accounts for mitigating actions and further details. In addition, Lloyds Banking Group has a contingency funding plan providing management actions and strategies available in stressed conditions.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Legal and regulatory risk – The Group and its businesses are subject to ongoing regulation, associated legal and regulatory risks, and legal and regulatory actions. They are also subject to the effects of changes in the laws, regulations, policies, voluntary codes of practice (as well as in their respective interpretations) and court rulings in the UK, the European Union and the other markets in which the Group operates. These laws and regulations include (i) increased regulatory oversight, particularly in respect of conduct issues; (ii) prudential regulatory developments; and (iii) industry-wide initiatives. Depending on the specific nature of the requirements and how they are enforced, such changes could have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements.

Mitigating actions

- The Legal, Regulatory and Mandatory Change Committee ensure we drive forward activity to develop plans for ensuring delivery of all legal and regulatory changes and track their progress against those plans.
- Continued investment in our people, processes, training and IT systems is assisting us in meeting our legal and regulatory commitments.
- Engagement with the regulatory authorities on forthcoming regulatory changes, market reviews and CMA investigations.
- Defined and embedded conduct risk strategy.

Governance risk – Against a background of increased regulatory focus on governance and risk management the most significant challenges arise from the Senior Managers and Certification Regime (SMR) which comes into operation in March 2016 and the requirement to Ring Fence core UK financial services and activities from January 2019.

Mitigating actions

- The Group's response to SMR is managed through a programme with workstreams addressing the implementation of each of the major components.
- A programme is in place to address the requirements of ring fencing and the Group is in close and regular contact with regulators to develop the plans for our anticipated operating and legal structures.
- Our aim is to ensure that evolving risk and governance arrangements continue to reflect the balance of business in the Group while adhering to regulatory objectives.

People risk – Key people risks include the risk that the Group may fail to attract and retain talent in an increasingly competitive marketplace, particularly in the light of the introduction of the Senior Managers and Certification Regime in 2016 which introduces a reverse burden of proof and increased accountability.

Mitigating actions

- Focused actions on delivery of strategies to attract, retain and develop high calibre people.
- Maintain compliance with legal and regulatory requirements relating to Senior Managers and Certification Regime, embedding compliant and appropriate colleague behaviours.
- Continue focus on the Group's culture, delivering initiatives which reinforce behaviours to generate the best long-term outcomes for customers and colleagues.

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED INCOME STATEMENT

	Note	**Half-year to 30 June 2015 £ million**	Half-year to 30 June 2014 £ million
Interest and similar income		**5,339**	5,859
Interest and similar expense		**(2,068)**	(2,745)
Net interest income		**3,271**	3,114
Fee and commission income		**377**	382
Fee and commission expense		**(141)**	(157)
Net fee and commission income		**236**	225
Net trading income		**219**	89
Other operating income		**9**	121
Other income		**464**	435
Total income		**3,735**	3,549
Regulatory provisions	8	**(547)**	(214)
Other operating expenses		**(1,584)**	(1,631)
Total operating expenses	2	**(2,131)**	(1,845)
Trading surplus		**1,604**	1,704
Impairment	3	**(91)**	(574)
Profit before tax		**1,513**	1,130
Taxation	4	**(292)**	(218)
Profit for the period		**1,221**	912
Profit attributable to non-controlling interests		**–**	–
Profit attributable to equity shareholders		**1,221**	912
Profit for the period		**1,221**	912

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Half-year to 30 June 2015 £ million	Half-year to 30 June 2014 £ million
Profit for the period	**1,221**	912
Other comprehensive income:		
Items that may subsequently be reclassified to profit or loss:		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	**(14)**	99
Income statement transfers in respect of disposals	**(34)**	(90)
Income statement transfers in respect of impairment	**9**	4
Taxation	**2**	5
	(37)	18
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value	**155**	(114)
Net income statement transfers	**(320)**	(218)
Taxation	**33**	67
	(132)	(265)
Currency translation differences (tax: nil)	**12**	5
Other comprehensive income for the period, net of tax	**(157)**	(242)
Total comprehensive income for the period	**1,064**	670
Total comprehensive income attributable to non-controlling interests	**–**	–
Total comprehensive income attributable to equity shareholders	**1,064**	670
Total comprehensive income for the period	**1,064**	670

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED BALANCE SHEET

	Note	**At 30 June 2015 £ million**	At 31 Dec 2014 £ million
Assets			
Cash and balances at central banks		**5,186**	5,110
Items in course of collection from banks		**345**	375
Trading and other financial assets at fair value through profit or loss	5	**16,191**	13,922
Derivative financial instruments		**19,208**	23,487
Loans and receivables:			
Loans and advances to banks		**864**	734
Loans and advances to customers	6	**268,223**	271,674
Debt securities		**185**	219
Due from fellow Lloyds Banking Group undertakings		**48,884**	54,373
		318,156	327,000
Available-for-sale financial assets		**4,276**	5,465
Investment properties		**171**	178
Goodwill		**325**	325
Other intangible assets		**95**	100
Tangible fixed assets		**1,102**	1,139
Current tax recoverable		**2**	4
Deferred tax assets		**2,226**	2,432
Other assets		**526**	1,688
Total assets		**367,809**	381,225

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED BALANCE SHEET (continued)

	Note	**At 30 June 2015 £ million**	At 31 Dec 2014 £ million
Equity and liabilities			
Liabilities			
Deposits from banks		**1,257**	2,291
Customer deposits		**193,376**	203,498
Due to fellow Lloyds Banking Group undertakings		**90,586**	86,838
Items in course of transmission to banks		**354**	275
Trading and other financial liabilities at fair value through profit or loss		**16,004**	13,769
Derivative financial instruments		**18,250**	21,410
Notes in circulation		**1,090**	1,129
Debt securities in issue	7	**19,453**	20,408
Other liabilities		**1,083**	1,154
Current tax liabilities		**619**	427
Deferred tax liabilities		**–**	–
Other provisions		**1,467**	1,546
Subordinated liabilities		**7,271**	7,627
Total liabilities		**350,810**	360,372
Equity			
Share capital		**5,847**	5,847
Share premium account		**–**	–
Other reserves		**2,348**	2,505
Retained profits		**8,796**	12,493
Shareholders' equity		**16,991**	20,845
Non-controlling interests		**8**	8
Total equity		**16,999**	20,853
Total equity and liabilities		**367,809**	381,225

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Attributable to equity shareholders					
	Share capital £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2015	**5,847**	**2,505**	**12,493**	**20,845**	**8**	**20,853**
Comprehensive income						
Profit for the period	**–**	**–**	**1,221**	**1,221**	**–**	**1,221**
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	**–**	**(37)**	**–**	**(37)**	**–**	**(37)**
Movements in cash flow hedging reserve, net of tax	**–**	**(132)**	**–**	**(132)**	**–**	**(132)**
Currency translation differences (tax: nil)	**–**	**12**	**–**	**12**	**–**	**12**
Total other comprehensive income	**–**	**(157)**	**–**	**(157)**	**–**	**(157)**
Total comprehensive income	**–**	**(157)**	**1,221**	**1,064**	**–**	**1,064**
Transactions with owners						
Capital contribution received	**–**	**–**	**82**	**82**	**–**	**82**
Dividends paid	**–**	**–**	**(5,000)**	**(5,000)**		**(5,000)**
Total transactions with owners	**–**	**–**	**(4,918)**	**(4,918)**	**–**	**(4,918)**
Balance at 30 June 2015	**5,847**	**2,348**	**8,796**	**16,991**	**8**	**16,999**

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (continued)

	Attributable to equity shareholders					
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2014	33,326	2,816	(17,788)	18,354	20	18,374
Comprehensive income						
Profit for the period	–	–	912	912	–	912
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	18	–	18	–	18
Movements in cash flow hedging reserve, net of tax	–	(265)	–	(265)	–	(265)
Currency translation differences (tax: nil)	–	5	–	5	–	5
Total other comprehensive income	–	(242)	–	(242)	–	(242)
Total comprehensive income	–	(242)	912	670	–	670
Transactions with owners						
Change in non-controlling interests	–	–	54	54	–	54
Balance at 30 June 2014	33,326	2,574	(16,822)	19,078	20	19,098
Comprehensive income						
Profit for the period	–	–	1,754	1,754	–	1,754
Other comprehensive income						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	88	–	88	–	88
Movements in cash flow hedging reserve, net of tax	–	(159)	–	(159)	–	(159)
Currency translation differences (tax: nil)	–	2	–	2	–	2
Total other comprehensive income	–	(69)	–	(69)	–	(69)
Total comprehensive income	–	(69)	1,754	1,685	–	1,685
Transactions with owners						
Capital contribution received	–	–	82	82	–	82
Capital restructuring	(27,479)	–	27,479	–	–	–
Change in non-controlling interests	–	–	–	–	(12)	(12)
Total transactions with owners	(27,479)	–	27,561	82	(12)	70
Balance at 31 December 2014	5,847	2,505	12,493	20,845	8	20,853

CONDENSED CONSOLIDATED HALF-YEAR FINANCIAL STATEMENTS (UNAUDITED) (continued)

CONSOLIDATED CASH FLOW STATEMENT

	Half-year to 30 June 2015 £ million	Half-year to 30 June 2014 £ million
Profit before tax	**1,513**	1,130
Adjustments for:		
Change in operating assets	**12,075**	164,155
Change in operating liabilities	**(9,299)**	(164,806)
Non-cash and other items	**461**	(1,243)
Tax received	**169**	178
Net cash (used in) provided by operating activities	**4,919**	(586)
Cash flows from investing activities		
Purchase of available-for-sale financial assets	**(6,673)**	(2,606)
Proceeds from sale and maturity of available-for-sale financial assets	**7,411**	1,067
Purchase of fixed assets	**(56)**	(80)
Proceeds from sale of fixed assets	**23**	227
Acquisition of businesses, net of cash acquired	**–**	(1)
Disposal of businesses, net of cash disposed	**11**	17
Net cash (used in) provided by investing activities	**716**	(1,376)
Cash flows from financing activities		
Dividends paid to equity shareholders	**(5,000)**	–
Interest paid on subordinated liabilities	**(141)**	(210)
Repayment of subordinated liabilities	**(250)**	(250)
Net cash used in financing activities	**(5,391)**	(460)
Effects of exchange rate changes on cash and cash equivalents	**(1)**	–
Change in cash and cash equivalents	**243**	(2,422)
Cash and cash equivalents at beginning of period	**4,829**	7,874
Cash and cash equivalents at end of period	**5,072**	5,452

Cash and cash equivalents comprise cash and balances at central banks (excluding mandatory deposits) and amounts due from banks with a maturity of less than three months.

NOTES

1. Accounting policies, presentation and estimates

These condensed consolidated half-year financial statements as at and for the period to 30 June 2015 have been prepared in accordance with the Disclosure Rules and Transparency Rules of the Financial Conduct Authority (FCA) and with International Accounting Standard 34 (IAS 34), *Interim Financial Reporting* as adopted by the European Union and comprise the results of Bank of Scotland plc (the Bank) together with its subsidiaries (the Group). They do not include all of the information required for full annual financial statements and should be read in conjunction with the Group's consolidated financial statements as at and for the year ended 31 December 2014 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Copies of the 2014 Annual Report and Accounts are available on the Lloyds Banking Group's website and are available upon request from Investor Relations, Lloyds Banking Group plc, 25 Gresham Street, London EC2V 7HN.

The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the condensed consolidated half-year financial statements. In reaching this assessment, the directors have considered projections for the Group's capital and funding position and have had regard to the factors set out in Principal risks and uncertainties: Funding and liquidity on page 4.

The accounting policies are consistent with those applied by the Group in its 2014 Annual Report and Accounts.

Future accounting developments

Details of those IFRS pronouncements which will be relevant to the Group but which will not be effective at 31 December 2015 and which have not been applied in preparing these condensed consolidated half-year financial statements are set out in note 14.

Critical accounting estimates and judgements

The preparation of the Group's financial statements requires management to make judgements, estimates and assumptions that impact the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may include 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. There have been no significant changes in the basis upon which estimates have been determined, compared to that applied at 31 December 2014.

2. Operating expenses

	Half-year to 30 June 2015 £m	Half-year to 30 June 2014 £m
Administrative expenses:		
Staff	**781**	810
Premises and equipment	**126**	171
Other expenses	**591**	560
	1,498	1,541
Depreciation and amortisation	**86**	90
Total operating expenses, excluding regulatory provisions	**1,584**	1,631
Regulatory provisions:		
Payment protection insurance provision (note 8)	**341**	100
Other regulatory provisions (note 8)	**206**	114
	547	214
Total operating expenses	**2,131**	1,845

3. Impairment

	Half-year to 30 June 2015 £m	Half-year to 30 June 2014 £m
Impairment losses on loans and receivables:		
Loans and advances to customers	**100**	572
Debt securities classified as loans and receivables	**(2)**	–
Impairment losses on loans and receivables	**98**	572
Impairment of available-for-sale financial assets	**–**	2
Other credit risk provisions	**(7)**	–
Total impairment charged to the income statement	**91**	574

4. Taxation

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

	Half-year to 30 June 2015 £m	Half-year to 30 June 2014 £m
Profit before tax	**1,513**	1,130
Tax charge thereon at UK corporation tax rate of 20.25 per cent (2014: 21.5 per cent)	**(306)**	(243)
Factors affecting tax credit:		
UK corporation tax rate change	**9**	–
Disallowed items	**(18)**	(6)
Non-taxable items	**–**	3
Overseas tax rate differences	**1**	(3)
Gains exempted or covered by capital losses	**24**	33
Adjustments in respect of previous years	**(2)**	(2)
Tax charge	**(292)**	(218)

In accordance with IAS 34, the Group's income tax expense for the half-year to 30 June 2015 is based on the best estimate of the weighted-average annual income tax rate expected for the full financial year. The tax effects of one-off items are not included in the weighted-average annual income tax rate, but are recognised in the relevant period.

On 8 July 2015, the Government announced that the corporation tax rate applicable from 1 April 2017 would be 19 per cent and from 1 April 2020 would be 18 per cent. In addition, the Government announced that from 1 January 2016 banking profits will be subject to an additional tax surcharge of 8 per cent. The proposed reductions in the rate of corporation tax and the introduction of the banking surcharge are expected to be enacted, and the impact accounted for, in the second half of 2015.

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

	At 30 June 2015 £m	At 31 Dec 2014 £m
Trading assets	**15,989**	13,750
Other financial assets at fair value through profit or loss (equity shares)	**202**	172
Total trading and other financial assets at fair value through profit or loss	**16,191**	13,922

6. Loans and advances to customers

	At 30 June 2015 £m	At 31 Dec 2014 £m
Agriculture, forestry and fishing	**650**	609
Energy and water supply	**296**	345
Manufacturing	**739**	606
Construction	**1,737**	2,132
Transport, distribution and hotels	**4,056**	4,543
Postal and communications	**235**	394
Property companies	**9,817**	10,807
Financial, business and other services	**3,951**	5,922
Personal:		
Mortgages	**241,020**	241,191
Other	**10,051**	9,949
Lease financing	**673**	843
Hire purchase	**12**	16
	273,237	277,357
Allowance for impairment losses on loans and advances	**(5,014)**	(5,683)
Total loans and advances to customers	**268,223**	271,674

Loans and advances to customers include advances securitised under the Group's securitisation and covered bond programmes.

7. Debt securities in issue

	At 30 June 2015 £m	At 31 Dec 2014 £m
Medium-term notes issued	**1,919**	2,074
Covered bonds	**9,888**	11,208
Securitisation notes	**7,534**	7,014
	19,341	20,296
Amounts due to fellow Lloyds Banking Group undertakings	**112**	112
Total debt securities in issue	**19,453**	20,408

The notes issued by the Group’s securitisation and covered bond programmes are held by external parties and by subsidiaries of the Group.

Securitisation programmes

At 30 June 2015, external parties held £7,534 million (31 December 2014: £7,014 million) and the Group’s subsidiaries held £17,528 million (31 December 2014: £20,609 million) of total securitisation notes in issue of £25,062 million (31 December 2014: £27,623 million). The notes are secured on loans and advances to customers and debt securities classified as loans and receivables amounting to £38,137 million (31 December 2014: £43,090 million), the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. The structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet.

7. Debt securities in issue (continued)

Covered bond programmes

At 30 June 2015, external parties held £9,888 million (31 December 2014: £11,208 million) and the Group's subsidiaries held £4,970 million (31 December 2014: £6,339 million) of total covered bonds in issue of £14,858 million (31 December 2014: £17,547 million). The bonds are secured on certain loans and advances to customers that have been assigned to bankruptcy remote limited liability partnerships. These loans are retained on the Group's balance sheet.

Cash deposits of £5,489 million (31 December 2014: £5,035 million) held by the Group are restricted in use to repayment of the debt securities issued by the structured entities, the term advances relating to covered bonds and other legal obligations.

8. Provisions for liabilities and charges

Payment protection insurance

The Group made provisions totalling £3,419 million to 31 December 2014 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administration expenses.

The Group has increased the provision by a further £341 million, which brings the total amount provided to £3,760 million, of which, at 30 June 2015, £772 million of the provision remained unutilised (21 per cent of total provision). The remaining provision covers the Past Business Review (PBR), remediation activity and future customer initiated complaints including associated administration costs.

PBR is nearing completion with remaining customers expected to be mailed by the end of 2015 and significant progress has been made on the re-review of previously handled cases. During the year 2015 customer initiated complaints have continued to fall and are lower than the same six months last year but are marginally higher than the Q4 2014 run-rate and expectations. Reactive complaints continue to be driven by Claims Management Company (CMC) activity.

Sensitivities

The total amount provided for PPI represents the Group's best estimate of the likely future costs. The cash payments in the first half of 2015 were approximately £500 million covering PBR, remediation and reactive complaints including associated administration costs. The PBR and remediation programmes are expected to be substantially complete by the end of this year.

A number of risks and uncertainties remain in particular with respect to future complaint volumes, which are primarily driven by the level of CMC initiated complaints. These costs could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key sensitivities are as follows:

- the number of customer initiated complaints received: an increase of 50,000 from the level assumed would increase the provision for redress costs by £100 million;
- average uphold rate per policy: an increase of one percentage point in this assumption would increase the provision by £5 million;
- average redress paid per upheld policy: an increase of £100 in this assumption would increase the provision by £35 million.

8. Provisions for liabilities and charges (continued)

Other regulatory provisions

Interest rate hedging products

In June 2012, a number of banks, including the Lloyds Banking Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. As at 30 June 2015 the Lloyds Banking Group had identified 1,723 sales of IRHPs to customers within scope of the agreement with the FCA which have opted in and are being reviewed and, where appropriate, redressed. The Lloyds Banking Group agreed that it would provide redress to any in-scope customers where appropriate. The Lloyds Banking Group continues to review the remaining cases within the scope of the agreement with the FCA and has met all of the regulator's requirements to date.

At 30 June 2015, the total amount provided for redress and related administration costs for in-scope customers was £204 million (31 December 2014: £204 million). As at 30 June 2015, the Group has utilised £187 million (31 December 2014: £98 million), with £17 million (31 December 2014: £106 million) of the provision remaining.

FCA review of complaint handling

On 5 June 2015 the FCA announced a settlement with the Lloyds Banking Group totalling £117 million, of which £42 million has been borne by the Group, following its investigation into aspects of the Lloyds Banking Group's PPI complaint handling process during the period March 2012 to May 2013. The FCA did not find that the Lloyds Banking Group acted deliberately. The Lloyds Banking Group has reviewed all customer complaints fully defended during the Relevant Period. The remediation costs of reviewing these affected cases are not materially in excess of existing provisions.

Other legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. During the half-year to 30 June 2015, the Group charged an additional £164 million (half-year to 30 June 2014: £89 million) in respect of a number of matters affecting the Retail, Commercial Banking and Consumer Finance divisions. This includes a provision of £47 million for customer redress and associated administration costs in response to complaints concerning Packaged Bank Accounts. At 30 June 2015, provisions for other legal actions and regulatory matters of £364 million remained unutilised.

9. Contingent liabilities and commitments

Interchange fees

With respect to interchange fees, the Group is following closely the course of investigations, litigation and recent regulation (as described below) which involve card schemes such as Visa and MasterCard. The Group is not directly involved in these matters but is a member of certain card schemes, in particular, Visa and MasterCard. The matters referred to above include the following:

- A new European Regulation to regulate cross-border and domestic fallback multilateral interchange fees (MIFs) in the EU. This regulation came into force on 8 June 2015 and it will introduce interchange fee caps for credit card MIFs (to 30 bps) and debit card MIFs (to 20bps). The interchange fee caps come in to force on 9 December 2015;
- The European Commission also continues to pursue other competition investigations into MasterCard and Visa probing, amongst other things, interchange paid in respect of cards issued outside the EEA;
- Litigation continues in the English High Court against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly ‘overpaid’ MIFs;
- The new UK payments regulator may exercise its powers to regulate domestic interchange fees. In addition, the FCA has undertaken a market study in relation to the UK credit cards market.

The ultimate impact on the Group of the above investigations, regulatory or legislative developments and the litigation against VISA and MasterCard can only be known at the conclusion of these matters.

LIBOR and other trading rates

In July 2014, the Lloyds Banking Group announced that it had reached settlements totalling £217 million (at 30 June 2014 exchange rates) to resolve with UK and US federal authorities legacy issues regarding the manipulation several years ago of Lloyds Banking Group companies’ submissions to the British Bankers’ Association (BBA) London Interbank Offered Rate (LIBOR) and Sterling Repo Rate. The Lloyds Banking Group continues to cooperate with various other government and regulatory authorities, including the Serious Fraud Office, the Swiss Competition Commission, and a number of US State Attorneys General, in conjunction with their investigations into submissions made by panel members to the bodies that set LIBOR and various other interbank offered rates.

Certain Lloyds Banking Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Commodity Exchange Act (CEA), as well as various state statutes and common law doctrines. Certain of the plaintiffs’ claims, including those asserted under US anti-trust laws, have been dismissed by the US Federal Court for Southern District of New York (the District Court). That court’s dismissal of plaintiffs’ anti-trust claims has been appealed to the New York Federal Court of Appeal.

Certain Lloyds Banking Group Companies are also named as defendants in UK based claims raising LIBOR manipulation allegations in connection with interest rate hedging products.

The Lloyds Banking Group also reviewed its activities in relation to the setting of certain foreign exchange daily benchmark rates and related matters. The Lloyds Banking Group has been co-operating with the FCA and other regulators and has been providing information about the Group’s review to those regulators. In addition, the Lloyds Banking Group, together with a number of other banks, was named as a defendant in several actions filed in the District Court between late 2013 and February 2014, in which the plaintiffs alleged that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. On 31 March 2014, plaintiffs effectively withdrew their claims against the Lloyds Banking Group (but not against all defendants) by filing a superseding consolidated and amended pleading against a number of other defendants without naming any Lloyds Banking Group entity as a defendant.

9. Contingent liabilities and commitments (continued)

It is currently not possible to predict the scope and ultimate outcome on the Lloyds Banking Group of the various outstanding regulatory investigations not encompassed by the settlements, any private lawsuits or any related challenges to the interpretation or validity of any of the Lloyds Banking Group's contractual arrangements, including their timing and scale.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. At 31 March 2015, the principal balance outstanding on these loans was £15,797 million (31 March 2014: £16,591 million). Although the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

PRA/FCA report on HBOS

On 12 September 2012 the FSA announced that it was starting work on a public interest report on HBOS. That report is now being produced as a joint PRA/FCA report but has not yet been published.

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities. This includes open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law which might lead to additional tax. The Lloyds Banking Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In the second half of 2013 HMRC informed the Lloyds Banking Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Lloyds Banking Group's deferred tax asset of approximately £400 million (overall impact on the Group of approximately £200 million). The Lloyds Banking Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due.

Residential mortgage repossessions

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases, concerning certain aspects of the Lloyds Banking Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The Lloyds Banking Group is reviewing the issues raised by the judgment and will respond as appropriate to any investigations or proceedings that may in due course be instigated as a result of these issues.

9. Contingent liabilities and commitments (continued)

Plevin v Paragon Personal Finance Limited

On 27 May 2015 the FCA gave an update on its announcement from January 2015 that it would be collecting evidence on current trends in PPI complaints to assess whether the current approach to PPI complaint handling is continuing to meet its objectives. The FCA stated that it expects to give its view in the summer. In that announcement the FCA also noted that in November 2014 the Supreme Court had ruled in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 6 (*Plevin*) that the lender's failure to disclose a large commission payment on a single premium PPI policy made the relationship between that lender and the borrower unfair under section 140A of the Consumer Credit Act 1974. The FCA is considering whether additional rules and/or guidance are required to deal with the potential impact of the *Plevin* decision on complaints about PPI and indicated that it expects to announce its views on this aspect, including next steps, in its announcement in the summer. The Financial Ombudsman Service are also considering the implications for PPI complaints. Given the current uncertainty, it is not presently possible to estimate the financial impact of the *Plevin* decision and accordingly no additional provision has been established at this stage, but it is possible that the impact could be material.

Other legal actions and regulatory matters

In addition, during the ordinary course of business the Group is subject to other complaints and threatened or actual legal proceedings (including class or group action claims) brought by or on behalf of employees, customers, investors or other third parties, as well as regulatory reviews, challenges, investigations and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the 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 at the relevant balance sheet date. In some cases it will not be possible to form a view, for example because the facts are unclear or because further time is needed properly to assess the merits of the case, and no provisions are held in relation to such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

Contingent liabilities and commitments arising from the banking business

	At 30 June 2015 £m	At 31 Dec 2014 £m
Contingent liabilities		
Acceptances and endorsements	**1**	1
Other:		
Other items serving as direct credit substitutes	**3**	8
Performance bonds and other transaction-related contingencies	**165**	220
	168	228
Total contingent liabilities	**169**	229
Commitments		
Documentary credits and other short-term trade-related transactions	**–**	1
Forward asset purchases and forward deposits placed	**32**	–
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	**9,423**	7,515
Other commitments	**20,834**	21,047
	30,257	28,562
1 year or over original maturity	**3,949**	3,853
Total commitments	**34,238**	32,416

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £12,051 million (31 December 2014: £12,466 million) was irrevocable.

10. Fair values of financial assets and liabilities

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine those fair values. Note 42 to the Group's 2014 financial statements describes the definitions of the three levels in the fair value hierarchy.

Valuation control framework

Key elements of the valuation control framework, which covers processes for all levels in the fair value hierarchy including level 3 portfolios, include model validation (incorporating pre-trade and post-trade testing), product implementation review and independent price verification. Formal committees meet quarterly to discuss and approve valuations in more judgemental areas.

Transfers into and out of level 3 portfolios

Transfers out of level 3 portfolios arise when inputs that could have a significant impact on the instrument's valuation become market observable; conversely, transfers into the portfolios arise when consistent sources of data cease to be available.

Valuation methodology

For level 2 and level 3 portfolios, there is no significant change to what was disclosed in the Group's 2014 Annual Report and Accounts in respect of the valuation methodology (techniques and inputs) applied to such portfolios.

The table below summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date.

	30 June 2015		31 December 2014	
	Carrying value £m	**Fair value £m**	Carrying value £m	Fair value £m
Financial assets				
Trading and other financial assets at fair value through profit or loss	**16,191**	**16,191**	13,922	13,922
Derivative financial instruments	**19,208**	**19,208**	23,487	23,487
Loans and receivables:				
Loans and advances to banks	**864**	**864**	734	734
Loans and advances to customers	**268,223**	**269,686**	271,674	271,240
Debt securities	**185**	**173**	219	209
Due from fellow Lloyds Banking Group undertakings	**48,884**	**48,884**	54,373	54,373
	318,156	**319,607**	327,000	326,556
Available-for-sale financial instruments	**4,276**	**4,276**	5,465	5,465
Financial liabilities				
Deposits from banks	**1,257**	**1,257**	2,291	2,297
Customer deposits	**193,376**	**193,828**	203,498	203,637
Due to fellow Lloyds Banking Group undertakings	**90,586**	**90,586**	86,838	86,838
Trading and other financial liabilities at fair value through profit or loss	**16,004**	**16,004**	13,769	13,769
Derivative financial instruments	**18,250**	**18,250**	21,410	21,410
Debt securities in issue	**19,453**	**18,651**	20,408	20,011
Financial guarantees	**17**	**17**	21	21
Subordinated liabilities	**7,271**	**7,338**	7,627	7,689

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks and notes in circulation.

10. Fair values of financial assets and liabilities (continued)

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

The following tables provide an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Financial assets

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 30 June 2015				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	**–**	**15,916**	**–**	**15,916**
Debt securities	**44**	**29**	**–**	**73**
Equity shares	**–**	**–**	**202**	**202**
Total trading and other financial assets at fair value through profit or loss	**44**	**15,945**	**202**	**16,191**
Available-for-sale financial assets:				
Debt securities	**33**	**3,904**	**–**	**3,937**
Equity shares	**1**	**35**	**303**	**339**
Total available-for-sale financial assets	**34**	**3,939**	**303**	**4,276**
Derivative financial instruments	**–**	**18,782**	**426**	**19,208**
Total financial assets carried at fair value	**78**	**38,666**	**931**	**39,675**
At 31 December 2014				
Trading and other financial assets at fair value through profit or loss:				
Loans and advances to customers	–	13,476	–	13,476
Loans and advances to banks	–	201	–	201
Debt securities	45	28	–	73
Equity shares	–	–	172	172
Total trading and other financial assets at fair value through profit or loss	45	13,705	172	13,922
Available-for-sale financial assets:				
Debt securities	31	5,125	–	5,156
Equity shares	1	38	270	309
Total available-for-sale financial assets	32	5,163	270	5,465
Derivative financial instruments	–	22,965	522	23,487
Total financial assets carried at fair value	77	41,833	964	42,874

10. Fair values of financial assets and liabilities (continued)

Financial liabilities

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 30 June 2015				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	**–**	**–**	**1**	**1**
Trading liabilities	**46**	**15,957**	**–**	**16,003**
Total trading and other financial liabilities at fair value through profit or loss	**46**	**15,957**	**1**	**16,004**
Derivative financial instruments	**–**	**18,198**	**52**	**18,250**
Financial guarantees	**–**	**–**	**17**	**17**
Total financial liabilities carried at fair value	**46**	**34,155**	**70**	**34,271**
At 31 December 2014				
Trading and other financial liabilities at fair value through profit or loss:				
Liabilities held at fair value through profit or loss	–	–	5	5
Trading liabilities	47	13,717	–	13,764
Total trading and other financial liabilities at fair value through profit or loss	47	13,717	5	13,769
Derivative financial instruments	–	21,309	101	21,410
Financial guarantees	–	–	21	21
Total financial liabilities carried at fair value	47	35,026	127	35,200

10. Fair values of financial assets and liabilities (continued)

Movements in level 3 portfolio

The tables below analyse movements in the level 3 financial assets portfolio.

	Trading and other financial assets at fair value through profit or loss £m	**Available-for-sale financial assets £m**	**Derivative assets £m**	**Total financial assets carried at fair value £m**
At 1 January 2015	**172**	**270**	**522**	**964**
Exchange and other adjustments	**1**	**–**	**(30)**	**(29)**
Gains recognised in the income statement within other income	**62**	**–**	**19**	**81**
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	**–**	**1**	**–**	**1**
Purchases	**–**	**38**	**–**	**38**
Sales	**(33)**	**(6)**	**(49)**	**(88)**
Transfers out of the level 3 portfolio	**–**	**–**	**(36)**	**(36)**
At 30 June 2015	**202**	**303**	**426**	**931**
Gains recognised in the income statement within other income relating to those assets held at 30 June 2015	**26**	**–**	**19**	**45**

	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale financial assets £m	Derivative assets £m	Total financial assets carried at fair value £m
At 1 January 2014	130	375	440	945
Exchange and other adjustments	2	(8)	(6)	(12)
Gains recognised in the income statement within other income	18	(78)	24	(36)
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	15	–	15
Purchases	55	199	–	254
Sales	(19)	(173)	(1)	(193)
Transfers into the level 3 portfolio	–	–	–	–
Transfers out of the level 3 portfolio	–	(1)	(53)	(54)
At 30 June 2014	186	329	404	919
Gains recognised in the income statement within other income relating to those assets held at 30 June 2014	(11)	–	24	13

10. Fair values of financial assets and liabilities (continued)

Movements in level 3 portfolio

The tables below analyse movements in the level 3 financial liabilities portfolio.

	Trading and other financial liabilities at fair value through profit or loss £m	**Derivative liabilities £m**	**Financial guarantees £m**	**Total financial liabilities carried at fair value £m**
At 1 January 2015	**5**	**101**	**21**	**127**
Exchange and other adjustments	**–**	**(3)**	**–**	**(3)**
(Gains) losses recognised in the income statement within other income	**–**	**(3)**	**(4)**	**(7)**
Redemptions	**(4)**	**(43)**	**–**	**(47)**
At 30 June 2015	**1**	**52**	**17**	**70**
Gains (losses) recognised in the income statement within other income relating to those liabilities held at 30 June 2015	**–**	**(3)**	**(4)**	**(7)**

	Trading and other financial liabilities at fair value through profit or loss £m	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities carried at fair value £m
At 1 January 2014	39	46	17	102
Exchange and other adjustments	–	(2)	–	(2)
(Gains) losses recognised in the income statement within other income	(2)	9	(1)	6
Redemptions	(25)	(1)	–	(26)
At 30 June 2014	12	52	16	80
Gains (losses) recognised in the income statement within other income relating to those liabilities held at 30 June 2014	–	(9)	–	(9)

10. Fair values of financial assets and liabilities (continued)

The tables below set out the effects of reasonably possible alternative assumptions for categories of level 3 financial assets and financial liabilities.

				At 30 June 2015		
					Effect of reasonably possible alternative assumptions[1]	
	Valuation technique(s)	**Significant unobservable inputs**	**Range[2]**	**Carrying value £m**	**Favourable changes £m**	**Unfavourable changes £m**
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	**n/a**	**202**	**20**	**(18)**
				202		
Available for sale financial assets				**303**	**9**	**(27)**
Derivative financial assets:						
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (bps)	**6/177**	**120**	**1**	**(2)**
	Option pricing model	Interest rate volatility	**0%/76%**	**306**	**–**	**(3)**
				426		
Financial assets carried at fair value				**931**		
Trading and other financial liabilities at fair value through profit or loss				**1**		
Derivative financial liabilities:						
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (bps)	**6/177**	**19**	**–**	**–**
	Option pricing model	Interest rate volatility	**0%/76%**	**33**	**–**	**–**
				52		
Financial guarantees				**17**		
Financial liabilities carried at fair value				**70**		

[1] Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

[2] The range represents the highest and lowest inputs used in the level 3 valuations.

[3] Underlying asset/net asset values represent fair value.

10. Fair values of financial assets and liabilities (continued)

	Valuation technique(s)	Significant unobservable inputs	Range[2]	At 31 December 2014 Carrying value £m	Effect of reasonably possible alternative assumptions[1] Favourable changes £m	Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss:						
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	n/a	172	26	(23)
				172		
Available for sale financial assets				270		
Derivative financial assets:						
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (bps)	3/167	139	2	(2)
	Option pricing model	Interest rate volatility	4%/120%	383	–	–
				522		
Financial assets carried at fair value				964		
Trading and other financial liabilities at fair value through profit or loss				5	–	–
Derivative financial liabilities:						
Interest rate derivatives	Discounted cash flow	Inflation swap rate – funding component (bps)	3/167	40	–	–
	Option pricing model	Interest rate volatility	4%/120%	61	–	–
				101		
Financial guarantees				21		
Financial liabilities carried at fair value				127		

1 Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

2 The range represents the highest and lowest inputs used in the level 3 valuations.

3 Underlying asset/net asset values represent fair value.

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are unchanged from those described in the Group's 2014 financial statements.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships and are unchanged from those described in the Group's 2014 financial statements.

11. Related party transactions

Balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings

The Bank and its subsidiaries have balances due to and from the Bank's ultimate parent company, Lloyds Banking Group plc, and fellow Lloyds Banking Group undertakings. These are included on the balance sheet as follows:

	At 30 June 2015 £m	At 31 Dec 2014 £m
Assets		
Derivative financial instruments	**13,192**	14,867
Loans and receivables: Due from fellow Lloyds Banking Group undertakings	**48,884**	54,373
Trading and other financial assets at fair value through profit or loss	**15,665**	12,537
Liabilities		
Due to fellow Lloyds Banking Group undertakings	**90,586**	86,838
Trading liabilities	**15,332**	11,598
Derivative financial instruments	**14,408**	15,978
Debt securities in issue	**641**	665
Subordinated liabilities	**5,610**	5,653

During the half-year ended 30 June 2015 the Group earned £236 million (half-year ended 30 June 2014: £400 million) of interest income and incurred £1,214 million (half-year ended 30 June 2014: £1,341 million) of interest expense on balances and transactions with Lloyds Banking Group plc and fellow Lloyds Banking Group undertakings.

UK government

In January 2009, the UK government through HM Treasury became a related party of the Lloyds Banking Group plc, the Bank's ultimate parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 30 June 2015, HM Treasury held an interest of 16.87 per cent in Lloyds Banking Group plc's ordinary share capital, with its interest having fallen below 20 per cent on 11 May 2015. As a consequence of HM Treasury no longer being considered to have a significant influence, it ceased to be a related party of Lloyds Banking Group plc, and therefore of the Group, for IAS 24 purposes at that date.

In accordance with IAS 24, UK government-controlled entities were related parties of the Group; the Group regarded the Bank of England and entities controlled by the UK government, including The Royal Bank of Scotland Group plc (RBS), NRAM plc and Bradford & Bingley plc, as related parties.

The Lloyds Banking Group has participated in a number of schemes operated by the UK government and central banks and made available to eligible banks and building societies.

National Loan Guarantee Scheme

The Lloyds Banking Group has participated in the UK government's National Loan Guarantee Scheme, which was launched on 20 March 2012. Through the scheme, the Lloyds Banking Group is providing eligible UK businesses with discounted funding, subject to continuation of the scheme and its financial benefits, and based on the Lloyds Banking Group's existing lending criteria. Eligible businesses who have taken up the funding benefit from a 1 per cent discount on their funding rate for a pre-agreed period of time.

11. Related party transactions (continued)

Funding for Lending

In August 2012, the Lloyds Banking Group announced its support for the UK Government's Funding for Lending Scheme and confirmed its intention to participate in the scheme. The Funding for Lending Scheme represents a further source of cost effective secured term funding available to the Lloyds Banking Group. The original initiative supported a broad range of UK based customers, providing householders with more affordable housing finance and businesses with cheaper finance to invest and grow. In November 2013, the Lloyds Banking Group entered into extension letters with the Bank of England to take part in an extension of the Funding for Lending Scheme until the end of January 2015. This extension of the Funding for Lending Scheme focused on providing businesses with cheaper finance to invest and grow. In December 2014, the Bank of England announced a further extension to the Funding for Lending Scheme running to the end of January 2016 with an increased focus on supporting small businesses. At 30 June 2015, the Lloyds Banking Group had drawn down £24 billion (31 December 2014: £20 billion) under the Funding for Lending Scheme, of which £14 billion had been drawn down under the extension to the scheme announced in 2013.

Enterprise Finance Guarantee

The Lloyds Banking Group participates in the Enterprise Finance Guarantee Scheme which was launched in January 2009 as a replacement for the Small Firms Loan Guarantee Scheme. The scheme is a UK government-backed loan guarantee, which supports viable businesses with access to lending where they would otherwise be refused a loan due to a lack of lending security. The Department for Business, Innovation and Skills (formerly the Department for Business, Enterprise and Regulatory Reform) provides the lender with a guarantee of up to 75 per cent of the capital of each loan subject to the eligibility of the customer within the rules of the scheme. As at 30 June 2015, the Lloyds Banking Group had offered 6,378 loans to customers, worth over £539 million. Under the most recent renewal of the terms of the scheme, Lloyds Bank plc and Bank of Scotland plc, on behalf of the Lloyds Banking Group, contracted with The Secretary of State for Business, Innovation and Skills.

Help to Buy

On 7 October 2013, Bank of Scotland plc entered into an agreement with The Commissioners of Her Majesty's Treasury by which it agreed that the Halifax Division of Bank of Scotland plc would participate in the Help to Buy Scheme with effect from 11 October 2013 and that Lloyds Bank plc would participate from 3 January 2014. The Help to Buy Scheme is a scheme promoted by the UK government and is aimed to encourage participating lenders to make mortgage loans available to customers who require higher loan-to-value mortgages. Halifax and Lloyds are currently participating in the Scheme whereby customers borrow between 90 per cent and 95 per cent of the purchase price. In return for the payment of a commercial fee, HM Treasury has agreed to provide a guarantee to the lender to cover a proportion of any loss made by the lender arising from a higher loan-to-value loan being made. £2,484 million of outstanding loans at 30 June 2015 (31 December 2014: £1,950 million) had been advanced by the Lloyds Banking Group under this scheme.

Business Growth Fund

The Lloyds Banking Group has invested £151 million (31 December 2014: £118 million) in the Business Growth Fund (under which an agreement was entered into with RBS amongst others) and, as at 30 June 2015, carries the investment at a fair value of £142 million (31 December 2014: £105 million).

Big Society Capital

The Lloyds Banking Group has invested £33 million in the Big Society Capital Fund under which an agreement was entered into with RBS amongst others.

Housing Growth Partnership

The Lloyds Banking Group has committed to invest up to £50 million into the Housing Growth Partnership under which an agreement was entered into with the Homes and Communities Agency.

Central bank facilities

In the ordinary course of business, the Lloyds Banking Group may from time to time access market-wide facilities provided by central banks.

11. Related party transactions (continued)

Other government-related entities
There were no significant transactions with other UK government-controlled entities (including UK government-controlled banks) during the year that were not made in the ordinary course of business or that were unusual in their nature or conditions.

Other related party transactions
Other related party transactions for the half-year to 30 June 2015 are similar in nature to those for the year ended 31 December 2014.

12. Ordinary dividends

A dividend of £5,000 million in respect of the year ended 31 December 2014 was paid in March 2015.

13. Events since the balance sheet date

On 30 July 2015, the Group announced that it had agreed the sale of a portfolio of Irish commercial loans, with a book value of £724 million, for a cash consideration of approximately £827 million; after transaction and other costs the gain on disposal is not expected to be significant. The transaction is expected to complete in the fourth quarter of 2015.

14. Future accounting developments

The following pronouncements are not applicable for the year ending 31 December 2015 and have not been applied in preparing these financial statements. Save as disclosed below, the full impact of these accounting changes is being assessed by the Group.

IFRS 9 *Financial Instruments*
IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income and amortised cost, on the basis of the objectives of the entity's business model for managing its financial assets and the contractual cash flow characteristics of the instruments. These changes are not expected to have a significant impact on the Group.

IFRS 9 also replaces the existing 'incurred loss' impairment approach with an expected credit loss approach. This change is likely to result in an increase in the Group's balance sheet provisions for credit losses although the extent of any increase will depend upon, amongst other things, the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. In February 2015, the Basel Committee on Banking Supervision published a consultative document outlining supervisory expectations regarding sound credit risk practices associated with implementing and applying an expected credit loss accounting framework. A final version is expected to be issued at the end of 2015.

The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The revised requirements are not expected to have a significant impact on the Group.

IFRS 9 is effective for annual periods beginning on or after 1 January 2018. As at 30 July 2015, this pronouncement is awaiting EU endorsement.

14. Future accounting developments (continued)

IFRS 15 *Revenue from Contracts with Customers*
IFRS 15 replaces IAS 18 Revenue and IAS 11 Construction Contracts. IFRS 15 establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised at an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods and services. Financial instruments, leases and insurance contracts are out of scope and so this standard is not expected to have a significant impact on the Group.

IFRS 15 is effective for annual periods beginning on or after 1 January 2017, although in May 2015, the IASB issued an exposure draft proposing to defer the effective date to 1 January 2018. In addition, on 30 July 2015 another exposure draft was issued proposing targeted amendments to the standard. As at 30 July 2015, this standard is awaiting EU endorsement.

15. Ultimate parent undertaking

Bank of Scotland plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Lloyds Banking Group plc has published consolidated accounts for the year to 31 December 2014 and copies may be obtained from Investor Relations, Lloyds Banking Group, 25 Gresham Street, London EC2V 7HN and available for download from www.lloydsbankinggroup.com

16. Other information

The financial information in these condensed consolidated half-year financial statements does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. Statutory accounts for the year ended 31 December 2014 have been delivered to the Registrar of Companies. The auditors' report on those accounts was unqualified, did not include an emphasis of matter paragraph and did not include a statement under section 498 of the Companies Act 2006.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The directors listed below (being all the directors of Bank of Scotland plc) confirm that to the best of their knowledge these condensed consolidated half-year financial statements have been prepared in accordance with International Accounting Standard 34, *Interim Financial Reporting*, as adopted by the European Union, and that the half-year management report herein includes a fair review of the information required by DTR 4.2.7R and DTR 4.2.8R, namely:

- an indication of important events that have occurred during the six months ended 30 June 2015 and their impact on the condensed consolidated half-year financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year; and
- material related party transactions in the six months ended 30 June 2015 and any material changes in the related party transactions described in the last annual report.

Signed on behalf of the board by

António Horta-Osório
Group Chief Executive
30 July 2015

Bank of Scotland plc board of directors:
Lord Blackwell (Chairman)
António Horta-Osório (Group Chief Executive)
George Culmer (Chief Financial Officer)
Juan Colombás (Chief Risk Officer)
Anita Frew (Deputy Chairman)
Alan Dickinson
Carolyn Fairbairn
Simon Henry
Dyfrig John CBE
Nicholas Luff
Nicholas Prettejohn
Anthony Watson CBE
Sara Weller CBE

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC

Report on the condensed consolidated half-year financial statements

Our conclusion

We have reviewed the condensed consolidated half-year financial statements, defined below, in the half-year management report of Bank of Scotland plc for the six months ended 30 June 2015. Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated half-year financial statements are not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

This conclusion is to be read in the context of what we say in the remainder of this report.

What we have reviewed

The condensed consolidated half-year financial statements, which are prepared by Bank of Scotland plc, comprise:

- the consolidated income statement for the six months ended 30 June 2015;
- the consolidated statement of comprehensive income for the six months ended 30 June 2015;
- the consolidated balance sheet as at 30 June 2015;
- the consolidated statement of changes in equity for the six months ended 30 June 2015;
- the consolidated cash flow statement for the six months ended 30 June 2015; and
- the explanatory notes to the condensed consolidated half-year financial statements.

As disclosed in note 1, the financial reporting framework that has been applied in the preparation of the full annual financial statements of the group is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

The condensed consolidated half-year financial statements included in the half-year management report have been prepared in accordance with International Accounting Standard 34, 'Interim Financial Reporting', as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

What a review of condensed consolidated financial statements involves

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity' issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and, consequently, does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

We have read the other information contained in the half-year management report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed consolidated half-year financial statements.

INDEPENDENT REVIEW REPORT TO BANK OF SCOTLAND PLC (continued)

Responsibilities for the condensed consolidated half-year financial statements and the review

Our responsibilities and those of the directors

The half-year management report, including the condensed consolidated half-year financial statements, is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-year management report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

Our responsibility is to express to the company a conclusion on the condensed consolidated half-year financial statements in the half-year management report based on our review. This report, including the conclusion, has been prepared for and only for the company for the purpose of complying with the Disclosure and Transparency Rules of the Financial Conduct Authority and for no other purpose. We do not, in giving this conclusion, 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.

PricewaterhouseCoopers LLP
Chartered Accountants
30 July 2015
London

Notes:

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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