Lloyds Banking Group plc
Form 20-F
March 05, 2014

As filed with the Securities and Exchange Commission on 5 March 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

£ REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

S ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended 31 December 2013

OR

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

£ SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-15246

LLOYDS BANKING GROUP plc

(previously Lloyds TSB Group plc)

(Exact name of Registrant as Specified in Its Charter)

Scotland

(Jurisdiction of Incorporation or Organization)

25 Gresham Street

London EC2V 7HN

United Kingdom

(Address of Principal Executive Offices)

Marc Boston, Company Secretary

Tel +44 (0) 20 7356 1274, Fax +44 (0) 20 7356 3506

25 Gresham Street

London EC2V 7HN

United Kingdom

(Name, telephone, e-mail and/or facsimile number and address of Company contact person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares	The New York Stock Exchange
7.75% Public Income Notes due 2050	The New York Stock Exchange
6.375% Senior Notes due 2021	The New York Stock Exchange
2.3% Senior Notes due 2018	The New York Stock Exchange
4.875% Senior Notes due 2016	The New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2013 was:

Ordinary shares, nominal value 10 pence each	71,368,453,941
Limited voting shares, nominal value 10 pence each	80,921,051
Preference shares, nominal value 25 pence each	412,215,065
Preference shares, nominal value 25 cents each	1,420,175
Preference shares, nominal value 25 euro cents each	Nil

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes S No £

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Yes £ No S

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes S No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes £ No £

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer S   Accelerated filer £   Non-Accelerated filer £

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements including in this filing: U.S. GAAP £ International Financial Reporting Standards as issued by the International Accounting Standards Board S Other £

If 'Other' has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 £   Item 18 £

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes £   No S

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PRESENTATION OF INFORMATION

In this annual report, references to the ‘Company’ are to Lloyds Banking Group plc; references to ‘Lloyds Banking Group’, ‘Lloyds’ or the ‘Group’ are to Lloyds Banking Group plc and its subsidiary and associated undertakings; references to ‘Lloyds Bank’ are to Lloyds Bank plc (previously Lloyds TSB Bank plc); and references to the ‘consolidated financial statements’ or ‘financial statements’ are to Lloyds Banking Group’s consolidated financial statements included in this annual report. References to the ‘Financial Conduct Authority’ or ‘FCA’ and to the ‘Prudential Regulation Authority’ or ‘PRA’ are to the United Kingdom (the UK) Financial Conduct Authority and the UK Prudential Regulation Authority. References to the ‘Financial Services Authority’ or ‘FSA’ are to their predecessor organisation, the UK Financial Services Authority.

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

In this annual report, amounts described as 'statutory' refer to amounts included within the Group's consolidated financial statements.

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds ('pounds sterling', 'sterling' or '£'), the lawful currency of the UK. In this annual report, references to 'pence' and 'p' are to one-hundredth of one pound sterling; references to 'US dollars', 'US$' or '$' are to the lawful currency of the United States (the US); references to 'cent' or 'c' are to one-hundredth of one US dollar; references to 'euro' or '€' are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to 'euro cent' are to one-hundredth of one euro; and references to 'Japanese yen', 'Japanese ¥' or '¥' are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2013, which was $1.6574 = £1.00. The Noon Buying Rate on 31 December 2013 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

BUSINESS OVERVIEW

Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to individual and business customers. At 31 December 2013, total Lloyds Banking Group assets were £847,030 million and Lloyds Banking Group had some 88,977 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was £56,295 million. The Group reported a profit before tax for the 12 months to 31 December 2013 of £415 million, and its capital ratios at that date were 20.8 per cent for total capital, 14.5 per cent for tier 1 capital and 14.0 per cent for core tier 1 capital.

Set out below is the Group's summarised income statement for the last three years:

	2013	2012[1]	2011[1]
	£m	£m	£m
Net interest income	**7,338**	7,718	12,698
Other income	**30,647**	31,195	14,145
Total income	**37,985**	38,913	26,843
Insurance claims	**(19,507)**	(18,396)	(6,041)
Total income, net of insurance claims	**18,478**	20,517	20,802
Operating expenses	**(15,322)**	(15,974)	(13,259)
Trading surplus	**3,156**	4,543	7,543
Impairment	**(2,741)**	(5,149)	(8,094)
Profit (loss) before tax	**415**	(606)	(551)

[1] Restated – see note 1 on page F-11.

Lloyds Banking Group's main business activities are retail and commercial banking, general insurance, and life, pensions and investment provision. Services are offered through a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland, TSB and Scottish Widows, and a range of distribution channels including the largest banking branch network in the UK and a comprehensive digital, telephony and mobile proposition.

At 31 December 2013, the Group's four primary operating divisions, which constituted the Group's reporting segments, were: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. Retail provides banking, mortgages and other financial services to personal customers in the UK. Commercial Banking provides banking and related services to business clients, from small businesses to large corporates. Wealth, Asset Finance and International provides private banking and asset management and asset finance primarily in the UK and overseas and operates the Group's international retail businesses. Insurance provides long-term savings, protection and investment products as well as general insurance products in the UK.

Profit before tax is analysed on pages 16 to 26 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 27 to 39 on an underlying basis. The key principles adopted in the preparation of this basis of reporting are described on page 27. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources; this reporting is on an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. The table below shows the results of Lloyds Banking Group's Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance segments and Group Operations and Central items in the last three fiscal years, and their aggregation. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission's Regulation G are set out on pages F-27 to F-31.

	2013	2012[1]	2011[1]
	£m	£m	£m
Retail	3,749	3,188	2,749
Commercial Banking	1,575	(324)	(812)
Wealth, Asset Finance and International	(42)	(929)	(2,785)
Insurance	1,090	1,107	1,465
Group Operations and Central items:			
Group Operations	(57)	(51)	(56)
Central items	(149)	(426)	(132)
	(206)	(477)	(188)
Profit before tax – underlying basis	6,166	2,565	429

[1] Restated – see note 1 on page F-11.

Lloyds Banking Group plc was incorporated as a public limited company and registered in Scotland under the UK Companies Act 1985 on 21 October 1985 with the registered number 95000. Lloyds Banking Group plc's registered office is The Mound, Edinburgh EH1 1YZ, Scotland, and its principal executive offices in the UK are located at 25 Gresham Street, London EC2V 7HN, United Kingdom, telephone number + 44 (0) 20 7626 1500.

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SELECTED CONSOLIDATED FINANCIAL DATA

The financial information set out in the tables below has been derived from the annual reports and accounts of Lloyds Banking Group plc for each of the past five years adjusted for subsequent changes in accounting policy and presentation. The financial statements for each of the years shown have been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm.

	2013	2012[1]	2011[1]	2010[1]	2009[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	18,478	20,517	20,802	24,868	22,526
Operating expenses	(15,322)	(15,974)	(13,259)	(16,455)	(16,065)
Trading surplus	3,156	4,543	7,543	8,413	6,461
Impairment losses	(2,741)	(5,149)	(8,094)	(10,952)	(16,673)
Gain on acquisition	–	–	–	–	11,173
Profit (loss) before tax	415	(606)	(551)	(2,904)	961
(Loss) profit for the year	(802)	(1,387)	(554)	(2,613)	2,895
(Loss) profit for the year attributable to equity shareholders	(838)	(1,471)	(627)	(2,675)	2,769
Total dividend for the year[2]	–	–	–	–	–
Balance sheet data at 31 December (£m)					
Share capital	7,145	7,042	6,881	6,815	10,472
Shareholders' equity	38,989	41,896	45,506	43,018	41,158
Customer deposits	441,311	426,912	413,906	393,633	406,741
Subordinated liabilities	32,312	34,092	35,089	36,232	34,727
Loans and advances to customers	495,281	517,225	565,638	592,597	626,969
Total assets	847,030	934,221	970,609	992,269	1,028,080
Share information					
Basic (loss) earnings per ordinary share	(1.2)p	(2.1)p	(0.9)p	(4.0)p	7.3p
Diluted (loss) earnings per ordinary share	(1.2)p	(2.1)p	(0.9)p	(4.0)p	7.3p
Net asset value per ordinary share	55p	60p	66p	63p	64p
Total dividend per ordinary share[2]	–	–	–	–	–
Equivalent cents per share[2,3]	–	–	–	–	–
Market price per ordinary share (year end)	78.9p	47.9p	25.9p	65.7p	50.7p
Number of shareholders (thousands)	2,681	2,733	2,770	2,798	2,834
Number of ordinary shares in issue (millions)[4]	71,368	70,343	68,727	68,074	63,775
Financial ratios (%)[5]					
Dividend payout ratio	–	–	–	–	–
Post-tax return on average shareholders' equity	(2.0)	(3.3)	(1.4)	(6.0)	9.0
Post-tax return on average assets	(0.09)	(0.14)	(0.06)	(0.26)	0.28
Average shareholders' equity to average assets	4.7	4.6	4.5	4.4	2.9
Cost:income ratio[6]	82.9	77.9	63.7	66.2	71.3
Capital ratios (%)[7,8,9]					
Total capital	20.8	17.3	15.6	14.5	12.4
Tier 1 capital	14.5	13.8	12.5	11.0	9.6
Core tier 1 capital	14.0	12.0	10.8	9.6	8.1

[1] Restated, where appropriate, in 2013 for IAS 19 (Revised) and IFRS 10; see note 1 on page F-11.

[2] Annual dividends comprise both interim and final dividend payments. The total dividend for the year represents the interim dividend paid during the year and the final dividend, which is paid and accounted for in the following year.

[3] Translated into US dollars at the Noon Buying Rate on the date each payment was made.

[4] This figure excludes the limited voting ordinary shares owned by the Lloyds Bank Foundations.

[5] Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.

[6] The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims).

[7] Capital ratios for 2012 and earlier years have not been restated to reflect the adoption of IAS 19 (Revised).

[8] Capital ratios for 2009 were restated in 2010 to reflect a prior year adjustment to available-for-sale revaluation reserves.

[9] Capital ratios are in accordance with modified Basel II framework as implemented by the PRA.

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EXCHANGE RATES

In this annual report, unless otherwise indicated, all amounts are expressed in pounds sterling. For the months shown the US dollar high and low Noon Buying Rates per pound sterling were:

	2014 February	2014 January	2013 December	2013 November	2013 October	2013 September
US dollars per pound sterling:						
High	**1.68**	1.66	1.66	1.64	1.62	1.62
Low	**1.63**	1.63	1.63	1.59	1.59	1.55

For each of the years shown, the average of the US dollar Noon Buying Rates per pound sterling based on the last day of each month was:

	2013	2012	2011	2010	2009
US dollars per pound sterling:					
Average	1.57	1.59	1.61	1.54	1.57

On 28 February 2014, the latest practicable date, the US dollar Noon Buying Rate was $1.68 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

The history of the Group can be traced back to the 18th century when the banking partnership of Taylors and Lloyds was established in Birmingham, England. Lloyds Bank Plc was incorporated in 1865 and during the late 19th and early 20th centuries entered into a number of acquisitions and mergers, significantly increasing the number of banking offices in the UK. In 1995, it continued to expand with the acquisition of the Cheltenham and Gloucester Building Society (C&G).

TSB Group plc became operational in 1986 when, following UK Government legislation, the operations of four Trustee Savings Banks and other related companies were transferred to TSB Group plc and its new banking subsidiaries. By 1995, the TSB Group had, either through organic growth or acquisition, developed life and general insurance operations, investment management activities, and a motor vehicle hire purchase and leasing operation to supplement its retail banking activities.

In 1995, TSB Group plc merged with Lloyds Bank Plc. Under the terms of the merger, the TSB and Lloyds Bank groups were combined under TSB Group plc, which was re-named Lloyds TSB Group plc, with Lloyds Bank Plc, which was subsequently re-named Lloyds TSB Bank plc, the principal subsidiary. In 1999, the businesses, assets and liabilities of TSB Bank plc, the principal banking subsidiary of the TSB Group prior to the merger, and its subsidiary Hill Samuel Bank Limited were vested in Lloyds TSB Bank plc, and in 2000, Lloyds TSB Group acquired Scottish Widows. In addition to already being one of the leading providers of banking services in the UK, the acquisition of Scottish Widows also positioned Lloyds TSB Group as one of the leading suppliers of long-term savings and protection products in the UK.

The HBOS Group had been formed in September 2001 by the merger of Halifax plc and Bank of Scotland. The Halifax business began with the establishment of the Halifax Permanent Benefit Building Society in 1852; the society grew through a number of mergers and acquisitions including the merger with Leeds Permanent Building Society in 1995 and the acquisition of Clerical Medical in 1996. In 1997 the Halifax converted to plc status and floated on the London stock market. Bank of Scotland was founded in July 1695, making it Scotland’s first and oldest bank.

On 18 September 2008, with the support of the UK Government, the boards of Lloyds TSB Group plc and HBOS plc announced that they had reached agreement on the terms of a recommended acquisition by Lloyds TSB Group plc of HBOS plc. The shareholders of Lloyds TSB Group plc approved the acquisition at the Company’s general meeting on 19 November 2008. On 16 January 2009, the acquisition was completed and Lloyds TSB Group plc changed its name to Lloyds Banking Group plc.

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company’s issued ordinary share capital. Following the UK Government’s sale of 4,282 million shares on 20 September 2013 and the effect of issues of ordinary shares, the UK Government’s holding has been reduced to approximately 32.7 per cent at 28 February 2014. On 3 February 2014, the Group confirmed that preparatory work, including the preparation of certain documents required for a possible future sale of further shares held by the UK Government in Lloyds Banking Group plc to the public, had commenced.

The Group has completed a number of asset disposals during 2013, including the sales of its shareholding in St. James’s Place and its Australian and Spanish banking businesses. In addition, in August 2013 the Group announced the sale of its German life insurance business, Heidelberger Lebensversicherung AG, for a consideration valued at around €300 million (or approximately £250 million); and in November 2013, the Group announced that it had agreed to sell its asset management business Scottish Widows Investment Partnership to Aberdeen Asset Management for a consideration valued at the time at up to £660 million. Both of these sales are expected to complete the first half of 2014.

STRATEGY OF LLOYDS BANKING GROUP

The Group is a leading UK financial services group providing a wide range of banking and financial services, primarily in the UK, to individual and business customers. The Group's main business activities are retail and commercial banking, general insurance and life, pensions and investments. Services are provided through a number of well recognised brands such as Lloyds Bank, Halifax, Bank of Scotland, TSB and Scottish Widows and through a range of distribution channels, including the largest branch network in the UK.

The Group operates a simple, low-risk, customer-focused retail and commercial banking business primarily in the UK. The Group's corporate strategy is built around being the best bank for personal and commercial customers across the UK and creating value by investing in areas that make a real difference to these customers. The Group is creating a simpler, more agile, efficient and responsive customer-focused organisation which operates sustainably and responsibly and Helps Britain Prosper. The Group is delivering its strategy through a clear action plan focused on reshaping its business portfolio to fit its assets, capabilities and risk appetite, strengthening its balance sheet and liquidity position, simplifying the Group to improve agility and efficiency and investing to be the best bank for customers.

The four key elements of the action plan to deliver the strategy are:

RESHAPE THE BUSINESS PORTFOLIO TO FIT THE GROUP'S ASSETS, CAPABILITIES AND RISK APPETITE

In reshaping its business the Group is focusing on the continued reduction of assets outside of its risk appetite, the continued application of a conservative approach to, and a prudent appetite for, risk and the streamlining of its international presence.

STRENGTHEN THE GROUP'S BALANCE SHEET AND LIQUIDITY POSITION

The Group continues to strengthen its balance sheet with the aim of ensuring the financial strength and security of the Group. The Group is enhancing its capital ratios and ensuring that it exceeds regulatory liquidity requirements, whilst maintaining a stable funding base and ensuring loan to deposit ratios remain close to its long-term targets.

SIMPLIFY THE GROUP TO IMPROVE AGILITY AND EFFICIENCY

The Simplification programme aims to reduce the Group's costs and increase efficiency through a fundamental review of operations and processes, the creation of a more efficient distribution platform and increased use of digital channels, optimising sourcing and creating a more agile organisation through delayering the management structure, centralising control functions and simplifying legal structures.

The programme delivered run-rate cost savings of over £1,450 million by the end of 2013. The Simplification programme is central to the successful delivery of the Group's strategy and the Group continues to make progress in driving further cost savings and efficiencies through the business whilst improving the customer experience.

INVEST TO BE THE BEST BANK FOR CUSTOMERS

The Group intends to increase the investment in its business with a focus on becoming the best bank for individual customers, becoming the best partner for business clients and enhancing the insurance proposition.

The Group will invest in core areas which offer strong returns and attractive growth: these are businesses which are capital and liquidity efficient, with sustainable competitive advantages, and which are central to the Group's core customer strategy.

SUMMARY

The Group is looking to create a simpler, more agile, efficient and responsive organisation with a focus on operating sustainably and responsibly and helping Britain prosper. The Group will focus on core markets, which offer strong returns and active growth, and maintain a prudent approach to risk and further strengthen its balance sheet.

The Group believes that the successful execution of its strategy to be the best bank for customers will enable delivery of strong and sustainable returns for shareholders.

Following the significant progress made against its original strategic plan, the Group expects to announce an update to its strategic plan in the second half of 2014.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

At 31 December 2013 the Group's activities were organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance.

Further information on the Group's segments is set out on pages 32 to 38 and in note 4 to the financial statements.

Following a reorganisation, the Group will be revising its reporting segments for 2014 reporting as follows:

– Subsequent to the sale of the Group's international wealth business based in Geneva and the simplification of its offshore business, the primary focus will now be on developing the Wealth business in the UK and accordingly the Wealth business will be integrated into the Retail division;

- The Wealth, Asset Finance and International division will become Consumer Finance and will include credit cards, asset finance and the European online deposits businesses. As a result, the Retail and Commercial Banking credit cards businesses will transfer into Consumer Finance; and

- A new Group Digital, Marketing and Customer Development function will be created to focus on customers and how the Group services them. The Group aims to create a 'centre of excellence' responsible for the development of all digital business across Lloyds Banking Group and as such, the new function will support the whole Group and all Divisions serving individual and business and corporate customers. This function will be reported along with Group Operations and Central items.

MATERIAL CONTRACTS

The Company and its subsidiaries are party to various contracts in the ordinary course of business.

For information relating to the Company's relationship with the UK Government see *Major Shareholders and Related Party Transactions –Information about the Lloyds Banking Group's relationship with the UK Government*.

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BUSINESS

ENVIRONMENTAL MATTERS

EMISSIONS REPORTING

The Group has voluntarily reported on its carbon dioxide (CO_2) emissions in its annual Responsible Business report and Annual Report and Accounts since 2009, but new regulations introduced through an amendment to the Companies Act 2006 require changes to the scope of disclosure compared to previous years. Previously, reported scope 1 emissions covered only the emissions generated from the gas and oil in UK buildings where the Group holds the supply contract direct with the utilities supplier along with emissions generated from company-owned vehicles used for business travel, and reported scope 2 emissions covered only the emissions generated from the use of electricity in UK buildings where the Group holds the supply contract direct with the electricity supplier. This year, additional emissions included in the scope of 2013 reporting relate to: UK sites where the Group does not hold the supply contract direct with the energy supplier (shadow sites), energy consumed in international locations (non-UK sites) and gas emissions arising from the use of air-conditioning and chiller/refrigerant plant (fugitive emissions). In addition the Group are now reporting emissions in terms of CO_2 equivalent tonnes (CO_2e).

Scope of disclosure

The Group reports emissions based on an operational boundary. Reported scope 1 emissions cover: emissions generated from the gas and oil used in all the buildings the Group operates business from (UK and International); emissions generated from UK company-owned vehicles used for business travel; and fugitive emissions arising from the use of air-conditioning and chiller/refrigerant plant to service the Group's UK property portfolio. Reported scope 2 emissions cover emissions generated from the use of electricity in all the buildings the Group operates business from. Reported scope 3 emissions relate to business travel undertaken by colleagues based in the UK using rail, privately owned vehicles, hired vehicles and air travel. Emissions associated with joint ventures and investments are not included in the emissions disclosure as they fall outside the scope of the Group's operational boundary.

The Group follows the principles of the Greenhouse Gas (GHG) Protocol Corporate Standard and Department for Environment, Food and Rural Affairs (Defra) Voluntary Reporting 2012 Guidelines to calculate its emissions in scope 1, 2 and 3.

Omissions

The Group does not have available data or estimates for business travel undertaken by colleagues based outside the UK when using company vehicles, or for fugitive emissions arising from the use of air-conditioning and chiller/refrigerant plant to service the Group's non-UK property portfolio.

Under the new regulation this activity would be part of the Group's scope 1 emissions.

Compliance with the regulations

The Group understands the principles of the regulations to report all emissions or explain where data has been unavailable for the first year of reporting. Rather than omit material elements the Group has included estimated emissions, where actual data is not available. These are listed below; each of these sources of emissions is being reported for the first time.

Energy consumed on non-UK sites, shadow sites and fugitive emissions

Non-UK sites – Lloyds Banking Group is a UK based retail bank with 97 per cent of employees based in the UK (2012 headcount data). The Group is continuing the strategic reshaping of its international footprint and intends to further reduce its presence outside of the UK. As lessees the Group does not usually have access to consumption data for Non-UK sites. Estimates have been based on a GHG emission value per full time equivalent employee (FTE) for UK based operations.

Shadow sites – As the Group is not billed directly for energy consumed in these sites it does not have full visibility of consumption data. To allow emissions relating to these sites to be included within emissions reporting for 2013, an estimation using an average gas/electricity consumption level per occupied square metre (obtained from sites where the Group holds the energy supply contract direct with the supplier) has been calculated. For electricity, consumption estimated in this way relates to 397 sites, for gas, consumption estimated in this way relates to 185 sites.

The CO_2e emissions relating to this subset of the emissions report are calculated using the same methodology and emissions factors that have been applied to actual billed consumption data.

Fugitive emissions – Fugitive emissions for Lloyds Banking Group arise from the use of air-conditioning and chiller/refrigerant plant to service the UK property portfolio. Actual data relating to fugitive emissions is not currently collated centrally by the Group. Therefore, for the 2013 reporting period these emissions have been estimated based on a register of assets used by the Group's Facilities Management partner to maintain and service the Group's estate. Leakage rates and emissions factors from the 2012 Guidelines to Defra/Department of Energy and Climate Change (DECC's) GHG Conversion Factors have been applied to each asset on the register according to the gas type used within the asset.

GHG emissions – CO_2e tones

	October 2012 –

Scope	September 2013 (including additional mandatory emissions)*		October 2012 – September 2013 (like for like basis)	October 2011 – September 2012
Scope 1	73,196	1	53,279	49,943
Scope 2	333,212	2	291,547	293,521
Scope 3	37,827		37,827	34,740
Total	444,235		382,653	378,204

* **Additional mandatory carbon reporting includes:**

1 Scope 1 emissions generated from the energy billed for gas and oil where the Group does not hold the supply contract directly with the energy supplier (shadow sites), fugitive emissions generated from the Group's non-UK sites.

2 Scope 2 emissions generated from the energy billed for electricity for sites where the Group does not hold the supply contract directly with the energy supplier (shadow sites) and emissions generated from the Group's non-UK sites.

The Group has applied the principles of the new regulations to its previous reporting period. The totals include all GHG gases and the totals are CO_2e. In previous years the Group has only reported on CO_2.

The Group has restated the emissions data for the October 2011 – September 2012 reporting period, replacing estimates with actual billed data. The Group has applied the emissions factors from the 2012 Defra guidelines to both reporting periods.

Intensity ratio

As the Group uses an operational boundary for emission reporting, an intensity ratio of GHG gases per FTE has been selected.

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BUSINESS

	October 2012 – September 2013 (including additional mandatory emissions)*	October 2012 – September 2013	October 2011 – September 2012
GHG emissions per average FTE (based on 2012 FTE)	3.91	3.37	3.33

Verification

Although not required by mandatory regulations the Group has retained the services of PricewaterhouseCoopers LLP to provide an independent and robust assessment of the Group's Scope 1, 2 and 3 emissions and their independent limited assurance report is included as part of the Group's 2013 Responsible Business Report.

WORKING CONTINUALLY TO REDUCE ENVIRONMENTAL IMPACT

The Group's ability to help Britain prosper in a sustainable way is inextricably linked to wider environmental issues. Man-made climate change and global trends such as resource scarcity, extreme weather and rising energy and commodity prices have an impact on the Group's stakeholders and its own operations. The Group aims to manage its environmental impacts and support the drive towards a low carbon, more resource-efficient economy.

ACHIEVEMENTS IN 2013

- Achieved a reduction in energy use of 12.7 per cent against the Group's 2009 baseline, resulting in cost avoidance of £9 million in 2013 and cost avoidance of £22 million since 2010.
- Achieved a reduction in water consumption of 18 per cent against the Group's 2009 baseline.
- Diverted 95 per cent of the Group's operational waste from landfill – beating the Group's 2020 target of 92 per cent.
- Engaged colleagues in the Group's Environmental Action Plan through the Group's Sustainability Network.
- Worked for positive environmental change through many different external bodies, including the Corporate Leaders Group for Climate Change, Climatewise, AIM4C and the Banking Environment Initiative (BEI).

PRIORITIES FOR 2014

- Investing £7 million in specific energy efficiency projects.
- Continue to engage Small and Medium-Sized Enterprises (SMEs) to help them understand how to become more sustainable and realise the benefits to their businesses.
- Complete the environmental accreditation of even more of the Group's property estate.

MANAGING THE GROUP'S CARBON EMISSIONS

Despite the Group's continuing efforts throughout 2013 to move closer to its Environmental Action Plan (EAP) targets, the Group's overall carbon emissions have increased slightly compared to 2012 by 1.2 per cent (on a like-for-like basis). This has mainly been down to increased business travel, increased gas use during cold winter conditions and increased electricity use as a result of the hot conditions in summer 2013. The underlying trend is that the Group continues to improve its efficiency and remains committed to delivering its EAP.

USING SCARCE RESOURCES MORE EFFICIENTLY

During 2013, the Group has made progress against its EAP targets.

	2020 target	Progress to 2020 target	2012	**2013**
Energy	30% reduction in energy consumption*	42%	657Gwh	**678Gwh**
Paper	20% reduction in paper consumption	75%	26,565 tonnes	**27,220 tonnes**
Business travel	20% reduction in the Group's business travel	95%	315m kms	**334m kms**
Waste	92% of waste diverted from landfill	>100%	94%	**95%**
Water	20% reduction in water consumption	90%	1,075,016 m^3	**1,059,999 m^3**
Buildings	20% of m^2 floor area environmentally accredited	23%	1.5%	4.7%

* Target excludes IT data centres and the use of oil as a fuel.

SUPPORTING THE GREEN ECONOMY

The Group works together with government and other stakeholders to understand how it can help businesses that provide low carbon products and services or green technologies along with mainstream businesses who wish to do more in this emerging sector.

The Group works with SMEs to help them to understand and maximise the commercial benefits of sustainable business practices. Early in 2013, Lloyds Bank and Bank of Scotland both launched versions of the Group's new online tool, REDUCE – a free resource that enables SMEs to create and implement their own sustainable business plan.

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PROPERTIES

At 31 December 2013, Lloyds Banking Group occupied 3,110 properties in the UK. Of these, 892 were held as freeholds and 2,218 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations – London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 260 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis, principally in North America, with a reducing presence in Europe and Asia.

LEGAL ACTIONS AND REGULATORY MATTERS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory challenge both in the UK and overseas. Set out below is a summary of the more significant matters. Further details are included in notes 43 and 52 to the financial statements.

INTERCHANGE FEES

On 24 May 2012, the General Court of the European Union (the General Court) upheld the European Commission's 2007 decision that an infringement of EU competition law had arisen from arrangements whereby MasterCard issuers charged a uniform fallback multilateral interchange fee (MIF) in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card.

MasterCard has appealed the General Court's judgment to the Court of Justice of the European Union. MasterCard is supported by several card issuers, including the Group. Judgment is not expected until the summer of 2014 or later.

In parallel:

- the European Commission is also considering further action, and has proposed legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;

- the European Commission has consulted on commitments proposed by VISA to settle an investigation into whether arrangements adopted by VISA for the levying of the MIF in respect of cross-border credit card payment transactions also infringe European Union competition laws. VISA has proposed *inter alia* to reduce the level of interchange fees on cross-border credit card transactions to the interim level (30 basis points) also agreed by MasterCard. VISA has previously reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange fees for cross-border debit card transactions to the interim levels agreed by MasterCard;

- the Office of Fair Trading (OFT) has placed on hold its examination of whether the levels of interchange fees paid by retailers in respect of MasterCard and VISA credit cards, debit cards and charge cards in the UK infringe competition law. The OFT has placed the investigation on hold pending the outcome of the MasterCard appeal to the Court of Justice of the European Union; and

- the UK Government held a consultation in 2013, Opening Up UK Payments. The consultation included a proposal to legislate to introduce a new economic regulator with responsibility for payment systems, including three and four party card schemes, and a role in setting or approving interchange fees.

The ultimate impact of the investigations and any regulatory or legislative developments on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings and once regulatory or legislative proposals are more certain.

PAYMENT PROTECTION INSURANCE

Following the unsuccessful legal challenge by the BBA against the Financial Services Authority (FSA) and the Financial Ombudsman Service (FOS), the Group made provisions totalling £6,775 million in 2010 and 2012 against the costs of paying redress to customers in respect of past sales of PPI policies, including the related administrative expenses.

During 2013 average monthly customer initiated complaints have continued to fall. Good progress has also been made in the planned proactive mailings. There have been some adverse trends (as detailed below), and a further £3,050 million has been added to the provision, of which £500 million was at the half year; £750 million in the third quarter and £1,800 million at the year end. This brings the total amount provided to £9,825 million, of which approximately £2,090 million relates to anticipated administrative expenses. As at 31 December 2013, £2,807 million of the provision remained unutilised (29 per cent of total provision) relative to an average monthly spend including administration costs in the last six months of £230 million. The increase of £3,050 million in 2013, and the overall provision, is underpinned by the following drivers:

- **Volumes of customer initiated complaints (after excluding complaints from customers where no PPI policy was held)** – at 31 December 2012, the provision assumed a total of 2.3 million complaints would be received. Average monthly volumes in 2013 decreased by 54 per cent compared to 2012, and fourth quarter volumes fell in line with the Group's revised end third quarter expectations. However, following further statistical modelling and the results of a customer survey, the Group is now forecasting a slower decline in future volumes than previously expected. A further provision of £870 million was therefore made during the year to reflect this. Approximately 2.5 million complaints have been received to date, with the provision assuming approximately 550,000 in the future compared to an average run-rate of approximately 37,000 per month in the last three months. The table below details the historical complaint trends.

Average monthly complaint volumes – reactive

Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013
109,893	130,752	110,807	84,751	61,259	54,086	49,555	37,457

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- **Proactive Mailing resulting from Past Business Reviews (PBR)** – the Group is proactively mailing customers where it has been identified that there was a risk of potential mis-sale. During the year, further groups of customers have been added to the proactive mailing exercise increasing the scope to 2.8 million policies, including approximately 300,000 additional policies in the second half. This, combined with higher than expected response rates from customers covered by the proactive mailing, resulted in a further provision of £470 million for the full year to reflect the additional cost incurred to date and in relation to future mailings.

- **Uphold rates** – average uphold rates per policy have increased from 61 per cent during the first half to 80 per cent for the last six months, with an average of 81 per cent in the fourth quarter. This reflects the impact of changes to the complaint handling policy, in part following consultation with the Financial Conduct Authority (FCA) and feedback from the FOS. In addition to this, there was a greater proportion of proactive mailing complaints received during the period for which uphold rates are higher. The provision assumes a slightly higher uphold rate going forward to allow for further embedding of complaint handling policy changes. The impact of higher uphold rates has resulted in a £335 million increase to the provision.

- **Average redress** – the average redress paid per policy has been relatively stable, but remains higher than expected by approximately £160 per policy due to the product and age mix of the complaints. This has resulted in an additional provision of £135 million.

- **Re-review of previously handled cases** – previously reviewed complaints are being assessed to ensure consistency with the current complaint handling policy. At 31 December 2012 the expected level of re-review was minimal. During 2013, and most notably in the fourth quarter, this has increased to approximately 590,000 cases at an estimated cost of £460 million.

- **Expenses** – given the update to volume related assumptions, the Group has also increased its estimate for administrative expenses which comprise complaint handling costs and costs arising from cases subsequently referred to the FOS, by £780 million.

An Enforcement Team of the FCA is investigating the Group's governance of third party suppliers and potential failings in the PPI complaint handling process. A provision of £50 million has been made in respect of the likely administration costs of responding to the FCA's inquiries. It is not possible at this stage to make any assessment of what, if any, additional liability may result from the investigation.

Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 40 per cent of the policies sold since 2000, covering both customer-initiated complaints and actual and expected proactive mailings undertaken by the Group. The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, in particular complaint volumes, uphold rates, average redress paid, the scope and cost of proactive mailings and remediation, and the outcome of the FCA Enforcement Team investigation. The cost of these factors could differ materially from the Group's estimates and the assumptions underpinning them and could result in a further provision being required.

Key metrics and sensitivities are highlighted in the table below:

Sensitivities[1]	To date unless noted	Future	Sensitivity
Customer initiated complaints since origination (m)	2.5	0.5	0.1 = £200m
Proactive Mailing: – number of policies (m)[2]	1.66	1.19	0.1 = £45m
– response rate[3]	37%	31%	1% = £20m
Average uphold rate per policy[4]	80%	83%	1% = £15m
Average redress paid per upheld policy[5]	£1,600	£1,600	£100 = £110m
Remediation cases (k)	21	569	1 Case = £770
Administrative expenses (£m)	1,410	680	1 Case = £500
FOS Referral Rate[6]	35%	36%	1%= £4m
FOS Overturn Rate[7]	49%	33%	1%= £2m

1 All sensitivities exclude claims where no PPI policy was held.

2 To date volume includes customer initiated complaints.

3 Metric has been adjusted to include mature mailings only, and exclude expected customer initiated complaints. Future response rates are expected to be lower than experienced to date as mailings to higher risk customers have been prioritised.

4 The percentage of complaints where the Group finds in favour of the customer. This is a blend of proactive and customer initiated complaints. The 80 per cent uphold rate is based on the latest six months to December 2013.

5 The amount that is paid in redress in relation to a policy found to have been mis-sold, comprising, where applicable, the refund of premium, compound interest charged and interest at 8 per cent per annum. Actuals are based on six months to December 2013.

The accumulation of interest on future redress is expected to be offset by the mix shifting away from more expensive cases.

6 The percentage of cases reviewed by the Group that are subsequently referred to the FOS by the customer. A complaint is considered mature when six months have elapsed since initial decision. Actuals are based on decision made by the Group during January to June 2013 and subsequently referred to the FOS.

7 The percentage of complaints referred where the FOS arrive at a different decision to the Group. Actuals are based on six months to December 2013. The future overturn rate is expected to be lower due to changes in the case review process implemented during 2013 which has resulted in a higher uphold rate as noted above. In turn this reduces the number / percentage of cases likely to be overturned by the FOS.

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INVESTIGATIONS AND LITIGATION RELATING TO INTERBANK OFFERED RATES, AND OTHER REFERENCE RATES

A number of government agencies in the UK, US and elsewhere, including the UK Financial Conduct Authority, the Serious Fraud Office, the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the US Department of Justice and a number of State Attorneys General, as well as the European and Swiss Competition Commissions, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates including the BBA London Interbank Offered Rates (LIBOR) and the European Banking Federation's Euribor, along with other reference rates. Certain Group companies were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA LIBOR panels. No Group company is or was a member of the Euribor panel. Certain Group companies have received subpoenas and requests for information from certain government agencies and the Group is co-operating with their investigations.

Certain 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 LIBOR. The claims have been asserted by plaintiffs claiming to have had an interest in various types of financial instruments linked to US Dollar LIBOR. The allegations in these cases, the majority of which have been coordinated for pre-trial purposes in multi-district litigation proceedings (MDL) in the US District Court for the Southern District of New York (the 'District Court'), are substantially similar to each other. The lawsuits 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 have been dismissed by the District Court, various motions directed to the sufficiency of their pleading of certain claims are still pending, and many of these cases have been stayed by order of the District Court.

The Group is also reviewing its activities in relation to the setting of certain foreign exchange daily benchmark rates, following the FCA's publicised initiation of an investigation into other financial institutions in relation to this activity. In addition, the Group, together with a number of other banks, has been named as a defendant in several actions in the District Court, in which the plaintiffs allege that the defendants manipulated WM/Reuters foreign exchange rates in violation of US antitrust laws. The time-frame for the Group and the other defendants to move to dismiss these claims has not yet been set.

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

LITIGATION IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY

Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group recognised a further provision of £150 million in its accounts for the year ended 31 December 2012 bringing the total amount provided to £325 million. During the half-year to 30 June 2013 the Group has charged a further £75 million with respect to this litigation increasing the total provision to £400 million. The remaining unutilised provision as at 31 December 2013 is £246 million.

However, there are still a number of uncertainties as to the full impact of the FCJ's decisions, and the validity of any of the claims facing CMIG will turn upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will only be known once there is further clarity with respect to a range of legal issues and factual determinations involved in these claims and/or all relevant claims have been resolved.

INTEREST RATE HEDGING PRODUCTS

In June 2012, a number of banks, including the 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 31 December 2013 the Group had identified 1,771 sales of IRHPs to customers within scope of the agreement with the FCA which are being reviewed and, where appropriate, redressed. The Group agreed that on conclusion of this review it would provide redress to any in-scope customers where appropriate.

The Group provided £400 million in its accounts for the year ended 31 December 2012 for the estimated cost of redress and related administration costs, based on a pilot review that had been conducted at the time. In the final quarter of 2013, a significant number of additional cases were reviewed, providing a larger and more representative sample from which to estimate the total cost of the review. As a result, an additional provision of £130 million has been recognised. During the same period, the Group confirmed it would pay any redress due to in-scope customers before any consequential loss claims had been outlined and agreed with them. At 31 December 2013, the total amount provided for the cost of redress and related administration costs is £530 million of which £162 million had been utilised. No provision has been recognised in relation to claims from customers which are not covered by the agreement with the FCA, or incremental claims from customers within the scope of the review. These will be monitored and future provisions will be recognised to the extent an obligation resulting in a probable outflow is identified.

OTHER 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 governmental authorities in relation to a range of matters; a provision is held against the costs expected to be incurred as a result of the conclusions reached. In 2013 the provision was increased by a further £200 million, in respect of matters affecting the Retail, Commercial, and Wealth and Asset Finance businesses, bringing the total amount charged to £300 million of which £75 million had been utilised at 31 December 2013. This increase reflects the Group’s assessment of a limited number of matters under discussion, none of which currently is individually considered financially material in the context of the Group.

US SHAREHOLDER LITIGATION

In November 2011 the Group and two former members of the Group’s Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. In October 2012 the court dismissed the complaint. The plaintiffs’ appeal against this decision was dismissed on 19 September 2013 and the time limit for further appeals expired in December 2013.

INVESTIGATION INTO BANK OF SCOTLAND AND REPORT ON HBOS

The FSA's enforcement investigation into Bank of Scotland plc's Corporate division between 2006 and 2008 concluded with the publication of a Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. On 12 September 2012 the FSA confirmed it was starting work on a public interest report on HBOS. That report is currently expected to be published in 2014.

US-SWISS TAX PROGRAMME

The US Department of Justice (the DOJ) and the Swiss Federal Department of Finance announced on 29 August 2013 a programme (the Programme) for Swiss banks to obtain resolution concerning their status in connection with on-going investigations by the DOJ into individuals and entities that use foreign (i.e. non-U.S.) bank accounts to evade U.S. taxes and reporting requirements, and individuals and entities that facilitate or have facilitated the evasion of such taxes and reporting requirements. Swiss banks that choose to participate have to notify the DOJ of their election to categorise their relevant banking operations according to one of a number of defined categories under the Programme. The Group, which carried out private banking operations in Switzerland prior to disposing of these operations in November 2013, has notified the DOJ of its elected categorisation on the basis that while it believes it has operated in full compliance with all US federal tax laws, there remains the possibility that certain of its clients may not have declared their assets in compliance with such laws. The Group will continue to co-operate with the DOJ under the terms of the Programme. However, at this time, it is not possible to predict the ultimate outcome of the Group's participation in the Programme, including the timing and scale of any fine finally payable to the DOJ.

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 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 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 Group's deferred tax asset of approximately £400 million. The 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.

OTHER LEGAL ACTIONS AND REGULATORY MATTERS

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (including class or group action claims brought on behalf of customers, shareholders or other third parties), and regulatory 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 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 and no provisions are held against 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.

COMPETITIVE ENVIRONMENT

The Group provides financial services to individual and business customers, predominantly in the UK but also overseas. The main business activities of the Group are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision.

In the retail banking market, the Group competes with banks and building societies, major retailers and internet-only providers. In the mortgage market, competitors include the traditional banks and building societies and specialist mortgage providers. The Group competes with both UK and foreign financial institutions in the commercial banking markets and with bancassurance, life assurance and general insurance companies in the UK insurance market.

The markets for the UK financial services, and the other markets within which the Group operates, are competitive, and management expects such competition to continue or intensify in response to competitor behaviour, including TSB as a new challenger on the high street, consumer demand, technological changes such as the growth of digital banking, and the impact of regulatory actions and other factors.

See *Risk Factors – Business and Economic Risks – The Group's businesses are conducted in competitive environments, with increased competition scrutiny, and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures*.

See *Regulation – Competition Regulation.*

RECENT DEVELOPMENTS

SALE OF INVESTMENT IN SAINSBURY'S BANK PLC

On 31 January 2014 the Group completed the sale of its 50 per cent shareholding in Sainsbury's Bank plc to J Sainsbury plc.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The results discussed below are not necessarily indicative of Lloyds Banking Group's results in future periods. The following information contains certain forward looking statements. For a discussion of certain cautionary statements relating to forward looking statements, see *Forward looking statements*.

The following discussion is based on and should be read in conjunction with the consolidated financial statements and the related notes thereto included elsewhere in this annual report. For a discussion of the accounting policies used in the preparation of the consolidated financial statements, see *Accounting policies* in note 2 to the financial statements.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW AND TREND INFORMATION

MARKET OVERVIEW

Given the Group's UK focus, its financial performance is inextricably linked to the performance of the UK economy, its regulatory environment and its effect on the Group's markets.

UK ECONOMIC TRENDS

THE UK ECONOMY STARTED TO GROW AGAIN IN 2013

As with many developed economies, the shift from rising debt in the pre-crisis decade to a period of debt repayment in recent years has proved a difficult transition for the UK economy. Many countries cutting back on private spending and government spending at the same time resulted in self-perpetuating cycles of weak growth and confidence, with exports unable to compensate for weak domestic demand.

However, progress on consumer and bank debt reduction has been greater in the UK than across much of Europe, and consequently UK economic growth picked up significantly in 2013, much more so than in the Eurozone. Business and consumer confidence increased as the Eurozone economy stabilised, following the European Central Bank's commitment to purchase government bonds of countries experiencing financing difficulties and from a slowdown in their mandated pace of government deficit reduction. UK consumers appear to have reduced their precautionary saving, and the appetite for unsecured credit, particularly for car purchase, increased, helping consumer spending growth to accelerate to 2.4 per cent in 2013, up from 1.5 per cent in 2012.

GOVERNMENT INITIATIVES HAVE SUPPORTED THE RECOVERY

A number of government initiatives have helped support recovery. The Bank of England initially introduced 'forward guidance' for Bank Rate, ruling out any increase until the unemployment rate had fallen significantly, hoping to limit concerns that interest rates might rise before the economy was much stronger, and although the guidance has since been updated, this helped provide reassurance. The government launched a two-pronged Help to Buy scheme to help first-time house buyers struggling to raise deposits as well as existing home-owners constrained by low levels of equity in their current properties. Alongside the improving economy, this contributed to a rise in house prices of 6 per cent in 2013 compared to 2 per cent in 2012. The Funding for Lending scheme, introduced in 2012, continued to support the economy with its beneficial impact on banks' funding costs and consequent lowering in interest rates on lending products, although its support for mortgage lending has now been withdrawn. The Group's participation in both of these schemes has not only been beneficial to the Group but also illustrates its commitment to and focus on supporting the UK economy and helping Britain prosper.

RECOVERY SO FAR HAS BEEN WEAK

Early estimates suggest that the UK economy grew by 1.8 per cent in 2013 compared to 0.3 per cent in 2012. However, given how much the economy shrank during the 2008-9 recession, recovery so far has been weak in a historical UK context and is only now outperforming the Eurozone. The weak Eurozone economy continues to drag on the UK – the UK's overseas trade balance remained close to 1.5 per cent of GDP in 2013, as in 2012, with export growth below 1 per cent in 2013. Further improvement in external trade is necessary if the economy is to make up some of the gap between current output and the pre-crisis trend, without increasing debt again.

Unemployment, although still well above its pre-crisis level, fell relatively quickly through 2013 from 7.8 per cent at the end of 2012 to 7.2 per cent in the final quarter of 2013. Low interest rates have helped to keep company failures subdued, falling to just 0.6 per cent of active companies in 2013, close to its pre-crisis low.

GROWTH EXPECTED TO IMPROVE FURTHER

The most likely outlook is for continued recovery in 2014, with faster growth than in 2013. But the recovery will still be held back by consumers' subdued appetite to borrow and government deficit reduction in the UK and across much of the Eurozone. The current consensus for 2014 GDP growth is 2.7 per cent, close to the long-term average, and unemployment should continue to fall. However, with growth in wages and companies' unit labour costs remaining subdued Bank Rate is expected to remain unchanged at 0.5 per cent through 2014.

RISKS TO SUSTAINED RECOVERY REMAIN

Risks to this outlook are more evenly balanced than in recent years. In the short-term, the rise in confidence and the renewed buoyancy in house prices could lead growth to accelerate by more than expected. However, downside risks also remain, mainly from outside the UK. The Eurozone still doesn't have in place the full cross-country risk sharing necessary to ensure the long term stability of the Euro, so financial market turbulence remains a possibility if some countries' governments or banks are revealed to be less robust than they currently appear. In the US, the unsustainable long-term trajectory of government debt could still result in sharp spending cuts despite the recent bi-partisan agreement. Such scenarios would significantly impact the UK economy, which would, in turn, have a negative impact on the Group's income, funding costs and impairment charges.

THE EFFECT ON THE GROUP'S MARKETS

The weak economic recovery has kept many of the Group's markets subdued. Growth in UK households' deposits slowed to 3.7 per cent in 2013 from 5.7 per cent in 2012. Net new mortgage lending amounted to just 0.9 per cent of outstanding balances during 2013, the fifth consecutive year around 1 per cent or less. Unsecured consumer borrowing, net of repayments, increased by 4.7 per cent in 2013, the second consecutive year of positive net borrowing, but at less than 1 per cent of income this remains only one third of the level of the early 2000s. Non-financial company deposits with UK banks and building societies rose by 8.8 per cent in 2013, up from 4.9 per cent in 2012 while they reduced their borrowing from banks for the fifth consecutive year. Overall levels of corporate debt have however remained fairly flat relative to GDP in recent years, as large corporates have been refinancing bank debt in bond markets.

As the economic recovery continues, the Group expects demand for credit from households and small and medium-sized businesses to increase, but growth is likely to stay well below pre-crisis rates as the appetite to borrow remains constrained by recent experience. With Bank Rate not expected to rise until 2015, arrears are expected to continue to decline.

REGULATION

The regulatory landscape is now clearer but significant change is still expected. In particular, within the UK over the next few years the Group will need to implement the recommendations relating to ring-fencing and culture established within the Banking Reform Act (2013). Key regulatory developments in 2013 are outlined below.

FINANCIAL SERVICES (BANKING REFORM) ACT 2013

The Financial Services (Banking Reform) Act gained Royal Assent on 18 December 2013. The Act implements the recommendations of the Independent Commission on Banking and the Parliamentary Commission on Banking Standards. It includes provisions for criminal sanctions and the new Senior Persons Regime. It also requires banks to ring-fence some retail and SME activities from investment banking activities and conform to additional capital requirements beyond those required by Basel III. Importantly for the Group, given it is primarily a UK focused retail and commercial bank, the majority of its operations are likely to be within the ring-fence.

CAPITAL REQUIREMENTS DIRECTIVE IV (CRD IV)

Final rules following the outcome of the Prudential Regulatory Authority’s consultation on future capital requirements were issued in December 2013, and have implemented the European Union’s new capital requirements legislation, known as CRD IV, in the UK from 1 January 2014.

RECOVERY AND RESOLUTION MECHANISMS

The European Commission published the Recovery and Resolution Directive on 6 June 2012. This should come in to force on 1 January 2015. The Directive requires all firms to develop a recovery plan and contribute to a resolution fund. It also proposes new early intervention powers for supervisors and introduces new powers for regulators at resolution stage. This was in line with the recommendations of the Financial Stability Board. The UK has pre-empted the European legislative process, with firms already required to prepare recovery plans.

UK SUPERVISORY STRUCTURE

The Financial Services Act 2012 confirmed the responsibilities of the Financial Policy Committee for ‘macro-prudential regulation’ and formalised the replacement of the FSA with two new bodies for prudential and conduct regulation: the Prudential Regulation Authority and the Financial Conduct Authority. The new institutions came into being on 1 April 2013.

OTHER REGULATORY REFORMS

The Group is also implementing a broader range of regulatory changes, which includes accounting standards, the Dodd-Frank Act, Benchmarks, Foreign Account Tax Compliance Act (FATCA), the updated Markets in Financial Instruments Directive Review, and updates to the Deposit Guarantee Scheme, amongst others.

MARKET TRENDS

KEY OPPORTUNITIES

– Economic environment: significant progress in reducing the Group's risk profile and strengthening the balance sheet along with strategic actions taken in the last couple of years means that the Group is better positioned to benefit as the economy recovers.

– Customer requirements: the Group's differentiated customer focused strategy along with its comprehensive multi-channel distribution network, well recognised brands and high quality people mean that it is well positioned to address changing customer needs.

– Regulatory environment: greater clarity emerging on regulatory requirements.

KEY CHALLENGES

– Economic environment: continuing economic uncertainty in the Eurozone.

– Regulatory environment: uncertainty remains over key elements of the proposals on ring fencing.

– Competition: increasingly competitive market for lending and deposits will require the Group to innovate and offer attractive new products.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CUSTOMER DRIVERS

In the competitive open markets in which the Group operates, customers are benefiting from an increasing range of products and services from a growing choice of providers. The expectations and demands of customers continue to rise.

Access to convenient branches remains important for many customers, but demand for a quality multi-channel banking proposition is now more prevalent. More customers expect to be able to manage their finances whenever and wherever is most convenient for them, whether by telephone, online, or using smartphones. Service remains one of the key drivers of customer satisfaction and customers are less accepting of poor service given the competitive nature of the market.

In the current low interest rate environment, many customers are motivated by their desire to achieve better value for money, but security and reputation remain important factors. Customers want clear and transparent products delivered with good service and access to helpful, relevant, expert advice when they need it. Product innovation is also important for some, whereas long-standing relationships remain important for others.

There are some clear customer trends emerging, but the Group recognises that every customer, whether an individual or an organisation, has particular needs and the Group must engage with them accordingly. Fundamentally, every customer has a choice and will select the provider that can most effectively fulfil their personal needs.

The Group is seeing a number of new or expanding players make an increasing impact into an already highly competitive sector and the TSB business, which the Group intends to float on the London Stock Exchange through an Initial Public Offering (IPO) in 2014, will have the capability of being another strong and effective challenger. An enhanced industry-wide switching service was launched in September 2013, giving customers increased confidence to change provider when dissatisfied or offered a better deal elsewhere.

Technological developments are already reshaping the banking industry and the Group expects this change to accelerate in the coming years. The Group anticipates an influx of new entrants, with business models that do not rely on expensive branch networks, offering innovative digital banking services. These new entrants are likely to have expertise and experience in digital product offerings, with strong funding positions, credible challenger brands, and in some cases pre-existing customer bases.

From a regulatory perspective, the new conduct regulator, the Financial Conduct Authority, has a competition duty giving it an explicit mandate to tackle competition issues, such as hurdles to switching or barriers to entry, swiftly and effectively.

The Group's strategy reflects these market conditions and the changing needs of customers. Above all it recognises that the Group operates in a competitive market where additional challengers continue to emerge and the only way of ensuring success is by focusing on the ever-changing needs of its customers.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements requires management to make estimates and assumptions that affect amounts reported therein. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates.

The accounting policies that are deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, are discussed in note 3 to the financial statements.

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group's IFRS reporting are discussed in note 57 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS – 2013, 2012 AND 2011

SUMMARY

	2013	2012[1]	2011[1]
	£m	£m	£m
Net interest income	**7,338**	7,718	12,698
Other income	**30,647**	31,195	14,145
Total income	**37,985**	38,913	26,843
Insurance claims	**(19,507)**	(18,396)	(6,041)
Total income, net of insurance claims	**18,478**	20,517	20,802
Operating expenses	**(15,322)**	(15,974)	(13,259)
Trading surplus	**3,156**	4,543	7,543
Impairment	**(2,741)**	(5,149)	(8,094)
Profit (loss) before tax	**415**	(606)	(551)
Taxation	**(1,217)**	(781)	(3)
Loss for the year	**(802)**	(1,387)	(554)
Profit attributable to non-controlling interests	**36**	84	73
Loss attributable to equity shareholders	**(838)**	(1,471)	(627)
Loss for the year	**(802)**	(1,387)	(554)

[1] Restated – see note 1 on page F-11.

2013 compared with 2012

For the year ended 31 December 2013, the Group recorded a profit before tax of £415 million compared with a loss before tax in 2012 of £606 million; the result in 2013 included a provision in respect of redress to customers relating to past sales of Payment Protection Insurance of £3,050 million and there was a charge of £3,575 million in the year ended 31 December 2012. Excluding these charges from both years, profit before tax was £496 million, or 17 per cent, higher at £3,465 million in the year ended 31 December 2013 compared to £2,969 million in the previous year.

Total income decreased by £928 million, or 2 per cent, to £37,985 million in 2013 compared with £38,913 million in 2012, comprising a £548 million decrease in other income and a decrease of £380 million in net interest income.

Net interest income was £7,338 million in 2013; a decrease of £380 million, or 5 per cent compared to £7,718 million in 2012. There was a credit of £109 million in 2012 arising from liability management gains but no similar item in 2013 and there was an adverse impact of £293 million in 2013 from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group. After adjusting for these items, net interest income was little changed at £10,429 million in 2013 compared to £10,407 million in 2012 reflecting a decrease in average interest-earning assets across all Divisions, mainly due to the disposal of assets outside of the Group’s risk appetite more than offsetting targeted lending growth, offset by an increase in net interest margin, which resulted from improvements in deposit pricing.

Other income was £548 million, or 2 per cent, lower at £30,647 million in 2013 compared to £31,195 million in 2012. Fee and commission income was £531 million, or 11 per cent, lower at £4,119 million compared to £4,650 million in 2012. Fee and commission expense decreased by £59 million, or 4 per cent, to £1,385 million compared with £1,444 million in 2012. The decrease in net fee and commission income largely reflects the deconsolidation of St James’s Place from March 2013. Net trading income increased by £1,462 million, or 10 per cent, to £16,467 million in 2013 compared to £15,005 million in 2012; this increase included an improvement of £1,347 million in gains on policyholder investments held within the insurance business as a result of movements in financial markets, offset by a similar increase in the related claims expense. Insurance premium income was £87 million, or 9 per cent, lower at £8,197 million in 2013 compared with £8,284 million in 2012; an increase of £31 million in life insurance premiums was more than offset by a £118 million decrease in general insurance premiums reflecting the continued run-down of the closed creditor book and the focus on more profitable home insurance products. Other operating income was £1,451 million, or 31 per cent, lower at £3,249 million in 2013 compared to £4,700 million in 2012. Other operating income includes gains and losses on disposal of available-for-sale financial assets which were £2,918 million, or 82 per cent, lower at £629 million in 2013 compared to £3,547 million in 2012 following the completion of the repositioning of the Group’s government bond portfolio in early 2013. Other operating income also includes gains and losses on liability management. During 2012 the Group had exchanged certain existing subordinated debt securities for new securities and also took advantage of opportunities to buy back some of its other issued securities; these exchanges resulted in a loss on extinguishment of the existing securities of £338 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued and other consideration paid. The Group did not undertake any similar transactions in respect of its subordinated liabilities in 2013, however it did take advantage of opportunities to exchange some of its debt securities in issue for new instruments, generating losses in 2013 of £142 million. Excluding gains and losses on sale of available-for-sale financial assets and the impact of liability management activities, other operating income was £1,271 million higher at £2,762 million in 2013 compared to £1,491 million in 2012 including the gain of £540 million from the sales of shares in St James’s Place and £538 million following the sale of the Group’s portfolio of US Residential Mortgage-Backed Securities.

Insurance claims expense was £1,111 million, or 6 per cent, higher at £19,507 million in 2013 compared to £18,396 million in 2012. The insurance claims expense in respect of life and pensions business was £1,120 million, or 6 per cent, higher at £19,151 million in 2013 compared to £18,031 million in 2012; this increase in claims was matched by a similar improvement in net trading income, reflecting the improved performance of policyholder investments. Insurance claims in respect of general insurance business were £9 million, or 2 per cent, lower at £356 million in 2013 compared to £365 million in 2012.

Operating expenses decreased by £652 million, or 4 per cent to £15,322 million in 2013 compared with £15,974 million in 2012; the main reason for the decrease being the £720 million reduction in charges for regulatory provisions from £4,175 million in 2012 to £3,455 million in 2013. In addition, 2013 included a past service pension charge of £104 million compared to a credit of £250 million in 2012. Staff costs were £350 million, or 6 per cent higher at £5,841 million in 2013 compared with £5,491 million in 2012. Excluding the past service pension charge from 2013 and credit from 2012, staff costs were flat at £5,737 million in 2013 compared with £5,741 million in 2012; annual pay rises and an increase in pension costs offset the impact of headcount reductions resulting from business disposals and the Group's rationalisation programmes. Premises and equipment costs were £21 million, or 2 per cent, higher at £970 million in 2013 compared with £949 million in 2012. Other expenses (excluding the charges in respect of payment protection insurance and other regulatory provisions of £3,455 million from 2013 and £4,175 million from 2012) were £117 million, or 4 per cent, lower at £3,116 million in 2013 compared with £3,233 million in 2012 as increased technology-related spend and a higher charge in respect of the UK bank levy were more than offset by reductions in professional fees and in other costs. Depreciation and amortisation costs were £186 million, or 9 per cent, lower at £1,940 million in 2013 compared to £2,126 million in 2012.

Impairment losses decreased by £2,408 million, or 47 per cent, to £2,741 million in 2013 compared with £5,149 million in 2012. Impairment losses in respect of loans and advances to customers were £2,400 million, or 47 per cent, lower at £2,725 million compared with £5,125 million in 2012. The overall performance of the portfolio reflects improving credit quality and, particularly for Commercial Banking, improvements in the economic environment. The impairment charge in respect of debt securities classified as loans and receivables was a charge of £1 million in 2013 compared to a credit of £4 million in 2012 and the impairment charge in respect of available-for-sale financial assets was £22 million, or 59 per cent, lower at £15 million in 2013 compared to £37 million in 2012. There was no charge in respect of other credit provisions; there had been a release of £9 million in 2012 following the draw-down of a number of commitments.

In 2013, the Group recorded a tax charge of £1,217 million compared to a tax charge of £781 million in 2012. The tax charge in 2013 was £1,121 million higher than the charge that would arise at the standard UK corporation tax rate of 23.25 per cent; principally as a result of a £594 million charge arising from the reduction in the corporation tax rate, a £348 million write-off of deferred tax assets following the sale of the Group's Australian operations and a £251 million policyholder tax charge. The tax charge of £781 million in 2012 arose on a loss before tax of £606 million; this tax charge reflected a policyholder tax charge arising from the revaluation of policyholder tax credits in light of economic forecasts and changes to the taxation of life insurance companies and the impact of the UK corporation tax rate reduction to 23 per cent on the net deferred tax asset.

Over the course of 2013 the Group made further progress in strengthening the balance sheet and reducing risk, while continuing to manage down wholesale funding. Total assets were £87,191 million, or 9 per cent, lower at £847,030 million at 31 December 2013 compared to £934,221 million at 31 December 2012, reflecting the run-down of assets which are outside of the Group's risk-appetite, the sale of St James's Place plc and reduced placings with central banks. Customer deposits were £14,399 million, or 3 per cent, higher at £441,311 million compared to £426,912 million at 31 December 2013, reflecting growth in the Group's relationship brands in Retail and Commercial Banking, but deposits by banks were £24,423 million, or 64 per cent, lower at £13,982 million at 31 December 2013 compared to £38,405 million at 31 December 2012 and debt securities in issue were £30,151 million, or 26 per cent, lower at £87,102 million at 31 December 2013 compared to £117,253 million at the end of 2012. Liabilities arising from non-participating investment contracts were £26,782 million, or 49 per cent, lower at £27,590 million at 31 December 2013 compared to £54,372 million at 31 December 2012 primarily as a result of the sale of St James' Place plc.

The Group's funding structure and liquidity position remain robust. The Group further reduced wholesale funding by £32.0 billion, a 19 per cent decrease in the year, with the proportion of funding with a maturity of less than a year at 32 per cent. The Group continues to maintain a strong liquidity position including £89.3 billion of cash and highly rated, low-risk securities. The 3 per cent increase in customer deposits, together with the reduction in assets which are outside of the Group's risk appetite, drove a further improvement in the Group's loan to deposit ratio to 113 per cent at the end of 2013 from 121 per cent at the end of 2012.

In acknowledgement of the progress made in improving the Group's capitalisation and transforming its financial profile, the rating agencies Fitch and Standard & Poor's upgraded Lloyds Bank plc's standalone rating to 'bbb+' in September and December 2013 respectively, and affirmed their long-term credit ratings of Lloyds Bank plc as 'A'.

As at 31 December 2013, the Group's capital ratios had increased with a total capital ratio on a Basel II basis of 20.8 per cent (compared to 17.3 per cent at 31 December 2012, before restatement for the impact of IAS 19 Revised); a tier 1 capital ratio of 14.5 per cent compared to 13.8 per cent and a core tier 1 ratio of 14.0 per cent compared to 12.0 per cent. During 2013 risk-weighted assets decreased by £46,449 million to £263,850 million at 31 December 2013 compared with £310,299 million at 31 December 2012; this decrease reflected risk-weighted asset reductions across all divisions driven by reductions in assets outside of the Group's risk appetite, lower lending balances and beneficial movements in external economic factors. Risk-weighted assets in the Retail division were £9,793 million lower, risk-weighted assets in Commercial Banking were £26,668 million lower and those in Wealth, Asset Finance and International were £10,281 million lower.

2012 Compared With 2011

For the year ended 31 December 2012, the Group recorded a loss before tax of £606 million compared with a loss before tax in 2011 of £551 million; the result in 2012 included a provision in respect of redress to customers relating to past sales of Payment Protection Insurance of £3,575 million (2011: £nil).

Total income increased by £12,070 million, or 45 per cent, to £38,913 million in 2012 compared with £26,843 million in 2011, comprising a £17,050 million increase in other income only partly offset by a decrease of £4,980 million in net interest income.

Net interest income was £7,718 million in 2012; a decrease of £4,980 million, or 39 per cent compared to £12,698 million in 2011. There was a credit of £109 million in 2012 arising from liability management gains compared to a credit of £696 million in 2011 and an adverse impact of £3,017 million from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group. After adjusting for these items, there was a reduction in net interest income of £1,376 million, or 12 per cent, reflecting a decrease in average interest-earning assets across all Divisions, mainly due to subdued lending demand and the disposal of assets outside of the Group's risk appetite. It was also driven by a decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds.

Other income was £17,050 million, or 121 per cent, higher at £31,195 million in 2012 compared to £14,145 million in 2011. Fee and commission income was £285 million, or 6 per cent, lower at £4,650 million compared to £4,935 million in 2011. Fee and commission expense increased by £53 million or 4 per cent to £1,444 million compared with £1,391 million in 2011. Net trading income increased by £15,373 million to £15,005 million in 2012 compared to a deficit of £368 million in 2011; this increase included an improvement of £15,475 million in gains on policyholder investments held within the insurance business, offset by a similar increase in the related claims expense. Insurance premium income was largely unchanged at £8,284 million in 2012 compared with £8,170 million in 2011; an increase of £114 million or 1 per cent. During 2012 the Group exchanged certain existing subordinated debt securities for new securities and also took advantage of opportunities to buy back some of its other issued securities; these exchanges resulted in a loss on extinguishment of the existing securities of £338 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued and other consideration paid. Together with related fees and costs, liability management activities resulted in gains of £599 million recognised in 2011. Excluding the impact of liability management activities, other operating income was £2,838 million higher at £5,038 million in 2012 compared to £2,200 million in 2011; this largely reflected profits on the sale of government bonds as the Group repositions its portfolio and a positive variance of £891 million in the income arising from the movement in value of in-force insurance business.

Insurance claims expense was £12,355 million higher at £18,396 million in 2012 compared to £6,041 million in 2011. The insurance claims expense in respect of life and pensions business was £12,333 million higher at £18,031 million in 2012 compared to £5,698 million in 2011; this increase in claims was matched by a similar improvement in net trading income, reflecting the improved performance of policyholder investments. Insurance claims in respect of general insurance business were £22 million, or 6 per cent, higher at £365 million compared to £343 million in 2011.

Operating expenses increased by £2,715 million, or 20 per cent to £15,974 million in 2012 compared with £13,259 million in 2011; the main reasons for the increase being the £3,575 million payment protection insurance provision raised in 2012, only partly offset by a past service pension credit of £250 million in the same year. Staff costs were £884 million, or 14 per cent lower at £5,491 million in 2012 compared with £6,375 million in 2011. Excluding the past service pension credit in 2012, staff costs were £634 million, or 10 per cent lower at £5,741 million compared with £6,375 million in 2011 due to the ongoing impact of headcount reductions, more than offsetting the effect of annual pay rises. Premises and equipment costs were £102 million, or 10 per cent, lower at £949 million compared with £1,051 million in 2011. Other expenses (excluding the charges in respect of payment protection insurance and other regulatory provisions of £4,175 million from 2012 and £175 million from 2011) were £185 million, or 5 per cent, lower at £3,233 million in 2012 compared with £3,418 million in 2011 as increased technology-related spend was more than offset by reductions in advertising spend and in other costs. Depreciation and amortisation costs were £49 million, or 2 per cent lower at £2,126 million in 2012 compared to £2,175 million in 2011. In 2011 there had been a charge of £65 million in relation to the impairment of tangible fixed assets; there was no such charge in 2012.

Impairment losses decreased by £2,945 million, or 36 per cent, to £5,149 million in 2012 compared with £8,094 million in 2011. Impairment losses in respect of loans and advances to customers were £2,895 million, or 36 per cent, lower at £5,125 million compared with £8,020 million in 2011. The overall performance of the portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although improving, unemployment.

The impairment charge in respect of debt securities classified as loans and receivables was £53 million better at a credit of £4 million in 2012 compared to a charge of £49 million in 2011 and the impairment charge in respect of available-for-sale financial assets was £43 million, or 54 per cent, lower at £37 million in 2012 compared to £80 million in 2011. There was a release of £9 million in respect of other credit provisions compared to a release of £55 million in 2011, as a number of commitments have now been drawn down.

In 2012, the Group recorded a tax charge of £781 million compared to a tax charge of £3 million in 2011. The tax charge of £781 million in 2012 arose on a loss before tax of £606 million. This tax charge reflects a policyholder tax charge arising from the revaluation of policyholder tax credits in light of current economic forecasts and recent changes to the taxation of life insurance companies and the impact of the UK corporation tax rate reduction to 23 per cent on the net deferred tax asset.

The Group continues to focus on improving its risk profile and further strengthening its balance sheet, through improving the capital and funding position and making continued progress on reducing holdings of assets outside of its risk appetite, despite challenging market conditions, resulting in a reduction in such assets of £42 billion to £98 billion. There was a further strengthening of the funding position, with an improvement in the maturity profile of wholesale funding, with less than 30 per cent of wholesale funding having a maturity of less than one year at 31 December 2012, compared to 45 per cent at 31 December 2011.

As at 31 December 2012, the Group’s capital ratios had increased with a total capital ratio on a Basel II basis of 17.3 per cent (compared to 15.6 per cent at 31 December 2011); a tier 1 capital ratio of 13.8 per cent (compared to 12.5 per cent at 31 December 2011) and a core tier 1 ratio of 12.0 per cent (compared to 10.8 per cent at 31 December 2011). During 2012 risk-weighted assets decreased by £42,042 million to £310,299 million at 31 December 2012 compared with £352,341 million at 31 December 2011; this decrease reflected risk-weighted asset reductions across all divisions driven by reductions in assets outside of the Group’s risk appetite, lower lending balances and strong management of risk. Risk-weighted assets in the Retail division were £7,767 million lower, risk-weighted assets in Commercial Banking were £27,676 million lower and those in Wealth, Asset Finance and International were £7,426 million lower.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2013	2012[1]	2011
Net interest income £m	7,338	7,718	12,698
Average interest-earning assets £m	663,364	710,669	736,032
Average rates:			
Gross yield on interest-earning assets %[2]	3.19	3.31	3.58
Interest spread %[3]	0.87	0.90	1.63
Net interest margin %[4]	1.11	1.09	1.73

[1] Restated – see note 1 on page F-11.

[2] Gross yield is the rate of interest earned on average interest-earning assets.

[3] Interest spread is the difference between the rate of interest earned on average interest-earning assets and the rate of interest paid on average interest-bearing liabilities.

[4] The net interest margin represents the interest spread together with the contribution of interest-free liabilities. It is calculated by expressing net interest income as a percentage of average interest-earning assets.

2013 COMPARED WITH 2012

Net interest income was £7,338 million in 2013; a decrease of £380 million, or 5 per cent, compared to £7,718 million in 2012. Net interest income in 2013 includes a charge of £3,091 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2012 of £2,798 million. In 2012 net interest income included a credit of £109 million arising from liability management gains, with no such item in 2013. After adjusting for these items, net interest income was £22 million higher at £10,429 million in 2013 compared to £10,407 million in 2012. The impact of a decrease in average interest earning assets, mainly due to the disposal of assets outside of the Group’s risk appetite, was partly offset by an increase in net interest margin mainly reflecting improved deposit margins and lower wholesale funding costs.

Average interest-earning assets were £47,305 million, or 7 per cent, lower at £663,364 million in 2013 compared to £710,669 million in 2012. The reduction reflected the continuing run-off of assets which were outside of the Group’s risk appetite, including business disposals, more than offsetting the impact of focused new lending.

Average interest-earning assets in Retail were £6,375 million, or 2 per cent, lower at £344,298 million in 2013 compared to £350,673 million in 2012. Average mortgage balances were £4,725 million, or 1 per cent, lower at £321,965 million in 2013 compared with £326,690 million in 2012. Other personal lending balances were £1,650 million, or 7 per cent, lower at £22,333 million in 2013 compared with £23,983 million in 2012, as a result of the full year impact of reductions in customer personal indebtedness, particularly unsecured lending, in 2012.

Average interest-earning assets across the rest of the Group were £40,930 million, or 11 per cent, lower at £319,066 million in 2013, compared to £359,996 million in 2012. Relationship lending and similar average interest-earning assets in Commercial Banking were £18,913 million, or 13 per cent, lower at £125,466 million in 2013 compared to £144,379 million in 2012. Balances in Wealth, Asset Finance and International were £7,055 million, or 15 per cent, lower at £41,153 million in 2013 compared to £48,208 million in 2012. The remainder of the Group's average interest-earning assets, which include certain non-relationship and treasury-related balances in the Commercial Banking division and bank deposits held in the insurance business, were £14,962 million, or 9 per cent, lower at £152,447 million in 2013 compared to £167,409 million in 2012.

Adjusting net interest income for the amounts paid to unitholders in Open-Ended Investment Companies and for the effects of the liability management exercises, the net interest margin was 11 basis points higher at 1.57 per cent in 2013 compared to 1.46 per cent in 2012. Margins in Retail increased, driven by improved deposit mix and a favourable funding environment, more than offsetting reduced lending rates; margins in Commercial Banking increased through disciplined pricing of new business, and reduced funding costs and margins in Wealth, Asset Finance and International also increased, due to improvements in the Wealth business and in online deposits.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2012 COMPARED WITH 2011

Net interest income was £7,718 million in 2012; a decrease of £4,980 million, or 39 per cent compared to £12,698 million in 2011. There was a small credit of £109 million in 2012 arising from liability management gains compared to a credit of £696 million in 2011 and a negative impact of £3,017 million from an increase in the amounts payable to unitholders in those Open-Ended Investment Companies included in the consolidated results of the Group. After adjusting for these items, the underlying reduction in net interest income reflected a decrease in average interest-earning assets, mainly due to the disposal of assets outside of the Group's risk appetite and subdued lending demand. It was also driven by decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds. These effects were partly mitigated by the benefits of re-pricing certain lending portfolios, an improving funding mix, and the reduction in certain lower margin asset portfolios.

Average interest-earning assets were £25,363 million, or 3 per cent, lower at £710,669 million in 2012 compared to £736,032 million in 2011. This reduction reflected the continuing run-off of assets which were outside of the Group's risk appetite from the Group's balance sheet and subdued lending demand.

Average interest-earning assets in Retail were £11,472 million, or 3 per cent, lower at £350,673 million in 2012 compared to £362,145 million in 2011. Average personal mortgage balances were £8,806 million, or 3 per cent, lower at £326,690 million in 2012 compared with £335,496 million in 2011. Average other personal lending balances were £2,666 million, or 10 per cent, lower at £23,983 million in 2012 compared with £26,649 million in 2011 as a result of customers continuing to reduce their personal indebtedness, particularly in unsecured lending.

Average interest-earning assets across the rest of the Group were £13,891 million, or 4 per cent, lower at £359,996 million in 2012 compared to £373,887 million in 2011. Relationship lending and similar average interest-earning assets in Commercial Banking were £22,327 million, or 13 per cent, lower at £144,379 million in 2012 compared to £166,706 million in 2011. Balances in Wealth, Asset Finance and International were £8,327 million, or 15 per cent, lower at £48,208 million in 2012 compared to £56,535 million in 2011. The remainder of the Group's average interest-earning assets, which include certain non-relationship and treasury-related balances in the Commercial Banking division and the bank deposits held in the insurance business, were £16,763 million, or 11 per cent, higher at £167,409 million in 2012 compared to £150,646 million in 2011.

The Group's net interest margin decreased by 64 basis points to 1.09 per cent in 2012 compared to 1.73 per cent in 2011. However, net interest income in 2012 included only £109 million in relation to the revision in the carrying values of certain debt securities compared to £696 million in 2011; and there was also a charge of £2,798 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a credit of £219 million in 2011. Excluding these amounts net interest income was £1,376 million, or 12 per cent, lower at

£10,407 million in 2012 compared to £11,783 million in 2011 and the net interest margin was 14 basis points lower at 1.46 per cent in 2012 compared to 1.60 per cent in 2011. Margins in Commercial banking reduced, as a result of increased wholesale funding costs and competition for customer deposits; margins were also lower in Wealth, Asset Finance and International as a result of the run-off of assets outside of the Group's risk appetite. Margins in Retail, however, were stable as the impact of higher funding costs and portfolio de-risking was largely mitigated by repricing of selected lending portfolios.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2013	2012[1]	2011
	£m	£m	£m
Fee and commission income:			
Current account fees	**973**	1,008	1,053
Credit and debit card fees	**984**	941	877
Other	**2,162**	2,701	3,005
	4,119	4,650	4,935
Fee and commission expense	**(1,385)**	(1,444)	(1,391)
Net fee and commission income	**2,734**	3,206	3,544
Net trading income	**16,467**	15,005	(368)
Insurance premium income	**8,197**	8,284	8,170
Gains on sale of available-for-sale financial assets	**629**	3,547	343
Liability management	**(142)**	(338)	599
Other[1]	**2,762**	1,491	1,857
Other operating income	**3,249**	4,700	2,799
Total other income	**30,647**	31,195	14,145

[1] Restated – see note 1 on page F-11.

2013 COMPARED WITH 2012

Other income was £548 million, or 2 per cent, lower at £30,647 million in 2013 compared to £31,195 million in 2012.

Fee and commission income was £531 million, or 11 per cent, lower at £4,119 million in 2013 compared with £4,650 million in 2012. Current account fees were £35 million, or 3 per cent, lower at £973 million in 2013 compared to £1,008 million in 2012. An increase of £43 million, or 5 per cent, in credit and debit card fees from £941 million in 2012 to £984 million in 2013 resulted from increased customer activity and merchanting charges. Other fees and commissions receivable were £539 million, or 20 per cent, lower at £2,162 million in 2013 compared with £2,701 million in 2012; £336 million of this reduction reflected the deconsolidation of St James's Place plc from March 2013.

Fee and commission expense was £59 million, or 4 per cent, lower at £1,385 million in 2013 compared to £1,444 million in 2012, again largely reflecting the deconsolidation of St James's Place plc.

Net trading income was £1,462 million, or 10 per cent, higher at £16,467 million in 2013 compared with £15,005 million in 2012. Net trading income within the insurance businesses was £1,347 million, or 9 per cent, higher at

£16,304 million in 2013 compared to £14,957 million in 2012, which reflects the improved market performance in 2013. However this increase, along with the small increase in long-term insurance premium income, was largely offset by the overall increase in insurance claims expense and the £293 million increase in the amounts payable to unit holders in those Open-Ended Investment Companies consolidated into the Group's results (within net interest income).

Insurance premium income was £8,197 million in 2013 compared with £8,284 million in 2012; a decrease of £87 million, or 9 per cent. Earned premiums in respect of the Group's long-term life and pensions business were £31 million higher at £7,200 million in 2013 compared to £7,169 million in 2012 with growth in corporate pension sales partly offset by lower sales through the branch network. General insurance earned premiums were £118 million, or 11 per cent, lower at £997 million in 2013 compared with £1,115 million in 2012 due to the continued run-off of the closed creditor insurance book and a greater focus on profitability of sales rather than volume.

Other operating income was £1,451 million, or 31 per cent, lower at £3,249 million in 2013 compared to £4,700 million in 2012. During 2013 the Group incurred liability management losses of £142 million, following a planned exit from repurchase agreement facilities and redemption of a tranche of covered bonds. During February 2012, the Group had completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012; this exchange resulted in a gain on the extinguishment of the existing securities of £59 million; additionally, during the second half of 2012 losses totalling £397 million arose on the buy-back of other debt securities.

Other operating income also includes gains and losses on sale of available-for-sale financial assets, which were £2,918 million, or 82 per cent, lower at £629 million in 2013 compared to £3,547 million in 2012; of this £787 million in 2013, compared to £3,207 million in 2012, related to the sale of government securities following the repositioning of the Group's government bond portfolio over 2012 and substantialy completed in the first half of 2013.

Excluding gains and losses on sale of available-for-sale financial assets and liability management, other operating income was £1,271 million, or 85 per cent, higher at £2,762 million in 2013 compared with 1,491 million in 2012; this was mainly driven by gains in relation to asset sales, including £540 million from the sale of the Group's shareholding in St James's Place plc, and £538 million following the sale of the Group's portfolio of US Residential Mortgage-Backed Securities. There was also a £147 million benefit from the improvement in the movement in value of the insurance in-force business.

2012 COMPARED WITH 2011

Other income was £17,050 million, or 121 per cent, higher at £31,195 million in 2012 compared to £14,145 million in 2011.

Fee and commission income was £285 million, or 6 per cent, lower at £4,650 million in 2012 compared with £4,935 million in 2011. Current account fees were £45 million, or 4 per cent, lower at £1,008 million in 2012 compared to £1,053 million in 2011. An increase of £64 million, or 7 per cent, in credit and debit card fees from £877 million in 2011 to £941 million in 2012 resulted from increased customer activity and merchanting charges. Other fees and commissions were £304 million, or 10 per cent, lower at £2,701 million in 2012 compared with £3,005 million in 2011.

Fee and commission expense was £53 million, or 4 per cent, higher at £1,444 million in 2012 compared to £1,391 million in 2011.

Net trading income was £15,373 million higher at £15,005 million in 2012 compared with a deficit of £368 million in 2011. Net trading income within the insurance businesses was £14,957 million in 2012 compared to a deficit of £518 million in 2011, which reflects the improved market performance in 2012, however this increase along with the small increase in long-term insurance premium income were largely offset by the overall increase in insurance claims expense. A gain of £249 million in 2012, compared with a loss in 2011 of £5 million, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group. Net trading income within the Group’s banking activities was £356 million lower at a loss of £201 million in 2012 compared with net gains of £155 million in 2011.

Insurance premium income was largely unchanged at £8,284 million in 2012 compared with £8,170 million in 2011; an increase of £114 million, or 1 per cent. Earned premiums in respect of the Group’s long-term life and pensions business were £215 million, or 3 per cent, higher at £7,169 million in 2012 compared to £6,954 million in 2011. General insurance earned premiums were £101 million, or 8 per cent, lower at £1,115 million in 2012 compared with £1,216 million in 2011.

Other operating income was £1,901 million, or 68 per cent, higher at £4,700 million in 2012 compared to £2,799 million in 2011. During February 2012, the Group completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012. This exchange resulted in a gain on the extinguishment of the existing securities of £59 million; additionally, during the second half of 2012 losses totalling

£397 million arose on the buy-back of other debt securities. These net losses of £338 million in respect of liability management compared to gains of £599 million in 2011.

Other operating income, excluding liability management, was £2,838 million, or 129 per cent, higher at £5,038 million in 2012 compared with £2,200 million in 2011; this was mainly driven by an increase of £3,204 million in gains on sale of available-for-sale financial assets, as the Group repositioned its portfolio of government securities, and an improvement in the movement in value of in-force business from a loss of £622 million in 2011 to a profit of £269 million in 2012.

OPERATING EXPENSES

	2013 £m	2012[1] £m	2011[1] £m
Administrative expenses:			
Staff:			
Salaries	3,331	3,411	3,784
Performance-based compensation	473	395	361
Social security costs	385	383	432
Pensions and other post-retirement benefit schemes:			
Past service credits and curtailment gains	104	(250)	–
Other	654	589	610
	758	339	610
Restructuring costs	111	217	124
Other staff costs	783	746	1,064
	5,841	5,491	6,375
Premises and equipment:			
Rent and rates	467	488	547
Hire of equipment	15	17	22
Repairs and maintenance	178	174	188
Other	310	270	294
	970	949	1,051
Other expenses:			
Communications and data processing	1,169	1,082	954
Advertising and promotion	313	314	398
Professional fees	425	550	576
UK bank levy	238	179	189
Other	971	1,108	1,301
	3,116	3,233	3,418
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,374	1,431	1,434
Amortisation of acquired value of in-force non-participating investment contracts	54	79	78
Amortisation of other intangible assets	512	616	663
	1,940	2,126	2,175
Impairment of tangible fixed assets	–	–	65
Total operating expenses, excluding regulatory provisions	11,867	11,799	13,084
Regulatory provisions:			
Payment protection insurance provision	3,050	3,575	–
Other regulatory provisions[2, 3]	405	600	175
	3,455	4,175	175
Total operating expenses	15,322	15,974	13,259
Cost:income ratio (%)[4]	82.9	77.9	63.7

1 Restated – see note 1 on page F-11.

2 In addition, in 2012 regulatory provisions of £50 million (2013: £nil; 2011: £nil) were charged against income.

3 Other regulatory provisions in 2013 include a fine of £28 million levied on the Group by the Financial Conduct Authority in relation to failings in control over sales incentive schemes in the Group's branch network.

4 Total operating expenses divided by total income, net of insurance claims.

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2013 COMPARED WITH 2012

Operating expenses decreased by £652 million, or 4 per cent, to £15,322 million in 2013 compared with £15,974 million in 2012. This decrease principally reflected the reduced regulatory provisions charge of £3,455 million in 2013, which was £720 million, or 17 per cent, lower than the charge of £4,175 million in 2013.

Staff costs were £350 million, or 6 per cent, higher in 2013 at £5,841 million compared to £5,491 million in 2012; reflecting a past service pension charge of £104 million in 2013 compared to a credit of £250 million in 2012. Excluding the past service pension amounts, staff costs were lower by £4 million at £5,737 million in 2013 compared to £5,741 million in 2012. Salaries were £80 million, or 2 per cent, lower at £3,331 million in 2013 compared with £3,411 million in 2012 as the impact of annual pay rises was more than offset by staff reductions, in part due to business disposals. Pension costs, excluding the past service pension items, were £65 million, or 11 per cent, higher at £654 million in 2013 compared to £589 million in 2012, principally as a result of the impact on the defined benefit charge of the increased net scheme liabilities at the end of 2012 and higher levels of defined contribution charges. Social security costs were £2 million, or 1 per cent, higher at £385 million in 2013 compared with £383 million in 2012. Staff restructuring costs were £106 million, or 49 per cent, lower at £111 million in 2013 compared with £217 million in 2012, and other staff costs were £37 million, or 5 per cent, higher at £783 million in 2013 compared with £746 million in 2012.

Premises and equipment costs were £21 million, or 2 per cent, higher at £970 million in 2013 compared to £949 million in 2012. Rent and rates was £21 million, or 4 per cent, lower at £467 million in 2013 compared to £488 million in 2012 as the Group continues to rationalise its property portfolio, in part through business disposals, but other premises and equipment costs increased by £40 million, or 15 per cent, from £270 million in 2012 to £310 million in 2013, partly due to lower profits on disposal of operating lease assets and other equipment.

Other expenses (excluding the regulatory provisions charges of £3,455 million from 2013 and £4,175 million from 2012) were £117 million, or 4 per cent, lower at £3,116 million in 2013 compared with £3,233 million in 2012. Communications and data processing costs were £87 million, or 8 per cent, higher at £1,169 million in 2013 compared with £1,082 million in 2012; professional fees were £125 million, or 23 per cent, lower at £425 million in 2013 compared to £550 million in 2012, in part due to lower spend in the Group's Simplification programme; and advertising and promotion costs were flat at £313 million in 2013 compared with £314 million in 2012. The charge in respect of the UK bank levy was £59 million, or 33 per cent, higher at £238 million in 2013 compared to £179 million in 2012; and other costs were £137 million, or 12 per cent, lower at £971 million in 2013 compared with £1,108 million in 2012, in part reflecting the deconsolidation of St James's Place plc from March 2013.

Depreciation and amortisation costs were £186 million, or 9 per cent, lower at £1,940 million in 2013 compared with £2,126 million in 2012. Charges for the depreciation of tangible fixed assets were £57 million, or 4 per cent, lower at

£1,374 million in 2013 compared to £1,431 million in 2012, largely due to lower levels of operating lease assets. The charge for the amortisation of acquired value of in-force non-participating investment contracts was £25 million, or 32 per cent, lower at £54 million in 2013 compared to £79 million in 2012 as a result of the deconsolidation of St James's Place plc from March 2013. The charge for the amortisation of other intangible assets was £104 million, or 17 per cent, lower at £512 million in 2013 compared to £616 million in 2012, partly as a result of the deconsolidation of St James's Place plc and certain core deposit intangibles becoming full amortised in 2012.

The Group incurred a regulatory provisions charge of £3,455 million in 2013 compared to £4,175 million in 2012 of which £3,050 million (2012: £3,575 million) related to payment protection insurance. For further details see note 11 to the financial statements. The charge in 2013 included a fine of £28 million levied on the Group by the Financial Conduct Authority in relation to failings in control over sales incentive schemes in the Group's branch network.

2012 COMPARED WITH 2011

Operating expenses increased by £2,715 million, or 20 per cent, to £15,974 million in 2012 compared with £13,259 million in 2011. This increase principally reflected the £3,575 million payment protection insurance provision made in 2012 (2011: nil).

Staff costs were £884 million, or 14 per cent, lower in 2012 at £5,491 million compared to £6,375 million in 2011; in part reflecting a past service pension credit of £250 million in 2012. Excluding the past service pension credit of £250 million in 2012, staff costs were lower by £634 million, a decrease of 10 per cent from £6,375 million in 2011. Salaries were £373 million, or 10 per cent, lower at £3,411 million in 2012 compared with £3,784 million in 2011 as the impact of annual pay rises was more than offset by staff reductions. Pension costs, excluding the past service pension credit in 2012, were £21 million, or 3 per cent, lower at £589 million in 2012 compared to £610 million in 2011, principally as a result of reduced expected returns on defined benefit scheme assets during 2012. Social security costs were £49 million, or 11 per cent, lower at £383 million in 2012 compared with £432 million in 2011 in line with the decrease in salaries. Staff restructuring costs were £93 million, or 75 per cent, higher at £217 million in 2012 compared with £124 million in 2011, and other staff costs were £318 million, or 30 per cent, lower at £746 million in 2012 compared with £1,064 million in 2011.

Premises and equipment costs were £102 million, or 10 per cent, lower at £949 million in 2012 compared to £1,051 million in 2011. Rent and rates was £59 million, or 11 per cent, lower at £488 million in 2012 compared to £547 million in 2011 as the Group continues to rationalise its property portfolio, and other premises and equipment costs decreased by £24 million or 8 per cent, in part due to increased profits on disposal of operating lease assets and other equipment.

Other expenses (excluding the regulatory provisions charges of £4,175 million from 2012 and £175 million from 2011) were £185 million, or 5 per cent, lower at £3,233 million in 2012 compared with £3,418 million in 2011. Communications and data processing costs were £128 million, or 13 per cent, higher at £1,082 million in 2012 compared with £954 million in 2011 as a result of project-related spend and increased demand for technology in the business. Advertising and promotion costs were £84 million, or 21 per cent, lower at £314 million in 2012 compared with £398 million in 2011 following reduced expenditure within the integration programme and scaling-back of marketing spend; and other costs were £189 million, or 17 per cent, lower at £933 million in 2012 compared with £1,122 million in 2011.

Depreciation and amortisation costs were £49 million, or 2 per cent, lower at £2,126 million in 2012 compared with £2,175 million in 2011, this reflects a reduction in the charge for the amortisation of acquisition intangibles.

A charge of £65 million arose in 2011 in respect of impairment of tangible fixed assets, all of which related to integration activities; however, there was no such charge in 2012.

The Group incurred a regulatory provisions charge of £4,175 million in 2012 compared to £175 million in 2011 of which £3,575 million (2011: £nil) related to payment protection insurance. For further details see note 43 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2013	2012	2011
	£m	£m	£m
Impairment losses on loans and receivables:			
Loans and advances to customers	2,725	5,125	8,020
Debt securities classified as loans and receivables	1	(4)	49
Total impairment losses on loans and receivables	2,726	5,121	8,069
Impairment of available-for-sale financial assets	15	37	80
Other credit risk provisions	–	(9)	(55)
Total impairment charged to the income statement	2,741	5,149	8,094

2013 COMPARED WITH 2012

Impairment losses decreased by £2,408 million, or 47 per cent, to £2,741 million in 2013 compared to £5,149 million in 2012 with reductions in all divisions.

The overall performance of the Group’s lending portfolio continues to improve reflecting the improved credit quality of the portfolio with better quality new lending, continued prudent management of impaired loans and a further reduction in assets which are outside of the Group’s risk appetite.

The impairment charge in respect of loans and advances to customers was £2,400 million, or 47 per cent, lower at £2,725 million compared to £5,125 million in 2012. In Retail, credit performance across the business improved, reflecting the application of the Group’s prudent risk appetite to new lending and the reduced value of assets going into arrears in 2013. The impairment charge reduced principally because of a lower charge against the secured lending portfolio reflecting an improved arrears position and higher house prices. Within Commercial Banking, impairment charges were lower in 2013 as a result of disposals of assets which are outside of the Group’s risk appetite and the better quality of new lending together with higher releases of provisions. In Wealth, Asset Finance and International, the reduced charge reflected asset reduction in the Irish portfolio, including the sale of a portfolio of non-performing mortgage loans.

There was no impairment charge in respect of loans and advances to banks in 2013 or 2012. The impairment charge in respect of debt securities classified as loans and receivables was £1 million in 2013 compared to a credit of £4 million in 2012. The impairment charge in respect of available-for-sale financial assets was £22 million, or 59 per cent, lower at £15 million in 2013 compared to £37 million in 2012.

There was no charge in respect of other credit provisions in 2013, while there had been a release of £9 million in 2012.

2012 COMPARED WITH 2011

Impairment losses decreased by £2,945 million, or 36 per cent, to £5,149 million in 2012 compared to £8,094 million in 2011.

The decrease in the Group's charge was seen across all divisions. The overall performance of the Group's lending portfolio continues to improve and benefits from low interest rates and broadly stable UK residential property prices, partly offset by the subdued UK economy, the weak commercial real estate market, and high, although improving, unemployment.

The impairment charge in respect of loans and advances to customers was £2,895 million, or 36 per cent, lower at £5,125 million compared to £8,020 million in 2011.

In Retail, credit performance across the business continued to be robust despite the subdued economic environment. This was supported by the Group's sustainable approach to risk, a continued focus on lending to existing customers and low interest rates. The unsecured impairment charge reduced as a result of the approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge decreased, reflecting further reductions in impaired loans in the secured portfolio.

Within Commercial Banking, impairment charges decreased following disposals of assets which are outside of the Group's risk appetite, particularly in Australia, and within the Acquisition Finance portfolio which mainly reflected de-risking and client deleveraging, partly offset by further deterioration in the Shipping portfolio as a result of a weak market. In addition, a number of specific large impairments in the Corporate book in 2011 have not been repeated.

In Wealth, Asset Finance and International, the reduced charge particularly reflected an improvement in the Irish business; the rate of increase in newly impaired loans in Ireland has slowed over 2012.

There was no impairment charge in respect of loans and advances to banks in 2012 or 2011. The impairment charge in respect of debt securities classified as loans and receivables was £53 million better at a credit of £4 million in 2012 compared to a charge of £49 million in 2011. The impairment charge in respect of available-for-sale financial assets was £43 million, or 54 per cent, lower at £37 million in 2012 compared to £80 million in 2011.

There was a release of £9 million in respect of other credit provisions in 2012 compared to a release of £55 million in 2011 when a number of commitments had been drawn down.

TAXATION

	2013	2012[1]	2011[1]
	£m	£m	£m
UK corporation tax:			
Current tax on profits for the year	(226)	(181)	(93)
Adjustments in respect of prior years	(205)	58	(146)
	(431)	(123)	(239)
Double taxation relief	–	–	–
	(431)	(123)	(239)
Foreign tax:			
Current tax on profits for the year	(60)	(86)	(90)
Adjustments in respect of prior years	26	(8)	36
	(34)	(94)	(54)
Current tax charge	(465)	(217)	(293)
Deferred tax	(752)	(564)	290
Taxation charge	(1,217)	(781)	(3)

[1] Restated – see note 1 on page F-11.

2013 COMPARED WITH 2012

The rate of tax is influenced by the geographic and business mix of profits. The Group's tax charge or credit is distorted, in particular, by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group's interests in Open Ended Investment Companies.

In 2013, a tax charge of £1,217 million arose on the profit before tax of £415 million and in 2012 a tax charge of £781 million arose on the loss before tax of £606 million. The statutory corporation tax rates were 23.25 per cent for 2013 and 24.5 per cent for 2012.

The tax charge in 2013 reflected a higher effective rate than the UK statutory rate due to the impact on the Group's net deferred tax asset of the reductions in the UK corporation tax rate that will come into effect in 2014 and 2015 and the sale of the Australian business during the year; together with the effect of policyholder taxes in the insurance businesses.

Reductions in the enacted UK corporation tax rates to 21 per cent with effect from 1 April 2014 and 20 per cent with effect from 1 April 2015 (2012 to 23 per cent) led to an additional deferred tax charge in both 2013 (£594 million) and 2012 (£320 million) on the revaluation of the Group's deferred tax asset.

The sale of the Group's Australian operations led to an additional deferred tax charge of £348 million in 2013 reflecting the write-down of a deferred tax asset in respect of Australian trading losses.

2012 COMPARED WITH 2011

In 2012, a tax charge of £781 million arose on the loss before tax of £606 million and in 2011 a tax charge of £3 million arose on the loss before tax of £551 million. The statutory corporation tax rates were 24.5 per cent for 2012 and 26.5 per cent for 2011.

The Finance Act 2012 introduced a new UK tax regime for life insurance companies from 1 January 2013. The impact of these new rules is reflected in the deferred tax balances at 31 December 2012. The consequence of these changes, combined with current economic forecasts, resulted in a debit of £780 million to the tax charge. In 2011, without the change in tax regime, there was a £146 million debit in respect of derecognition of deferred tax on policyholder tax credits.

Reductions in the enacted UK corporation tax rates to 23 per cent (2011 to 25 per cent) led to an additional deferred tax charge in both 2012 (£320 million) and 2011 (£423 million) on the revaluation of the Group's deferred tax asset.

LINE OF BUSINESS INFORMATION

The requirements for IFRS segmental reporting are set out in IFRS 8, *Operating Segments* which mandates that an entity's segmental reporting should reflect the way in which its operations are viewed and judged by its chief operating decision maker. As a consequence, the Group's statutory segmental reporting follows the underlying basis as explained below (see also note 4 to the financial statements).

The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer and the performance assessment includes a consideration of each segment's net interest revenue; consequently the total interest income and expense for all reportable segments is presented on a net basis. The internal reporting is on an underlying profit before tax basis. The Group Executive Committee believes that this basis better represents the underlying performance of the Group. IFRS 8 requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements.

The aggregate total of the underlying basis segmental results constitutes a non-GAAP measure as defined in the United States Securities and Exchange Commission's Regulation G. Management uses aggregate underlying profit before tax, a non-GAAP measure, as a measure of performance and believes that it provides important information for investors because it is a comparable representation of the Group's performance. Profit before tax is the comparable GAAP measure to aggregate underlying profit before tax. The table below sets out the reconciliation of this non-GAAP measure to its comparable GAAP measure.

At 31 December 2013 the Group's activities were organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance.

Comparative figures have been restated for the accounting policy changes explained in note 1 on page F-11.

Comparisons of results on a historical consolidated statutory basis are dominated by the impact of the acquisition of HBOS and the effects of the unwind of fair value adjustments made to the HBOS balance sheet on acquisition. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on an 'underlying' basis. The key principles adopted in the preparation of the underlying basis of reporting are described below.

•In order to reflect the impact of the acquisition of HBOS, the following have been excluded:

– the amortisation of purchased intangible assets; and

– the unwind of acquisition-related fair value adjustments.

•The following items, not related to acquisition accounting, have also been excluded from underlying profit:

– the effects of certain asset sales, liability management and volatile items;

– integration, simplification and EC mandated retail business disposal costs;

– volatility arising in insurance businesses;

– insurance gross-up;

– the payment protection insurance provision;

– other regulatory provisions; and

– certain past service pensions charges and credits in respect of the Group's defined benefit pension schemes.

Readers should be aware that the underlying basis has been presented for comparative purposes only and is not intended to provide proforma information or show the results of the Group as if the acquisition of HBOS had taken place at an earlier date.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The results of the businesses are set out below on the underlying basis:

	2013 £m	2012[1] £m	2011[1] £m
Retail	3,749	3,188	2,749
Commercial Banking	1,575	(324)	(812)
Wealth, Asset Finance and International	(42)	(929)	(2,785)
Insurance	1,090	1,107	1,465
Group Operations and Central items:			
Group Operations	(57)	(51)	(56)
Central items	(149)	(426)	(132)
	(206)	(477)	(188)
Underlying profit before tax	6,166	2,565	429

[1] Restated – see note 1 on page F-11.

Reconciliation of underlying profit to statutory profit (loss) before tax for the year

	Note	2013 **£m**	2012[1] £m	2011[1] £m
Profit before tax – Underlying basis		6,166	2,565	429
Asset sales	1	(687)	(660)	88
Sale of government securities	2	787	3,207	196
Liability management	3	(142)	(229)	1,295
Own debt volatility	4	(221)	(270)	248
Other volatile items	5	(457)	(478)	(986)
Volatility arising in insurance businesses	6	668	312	(838)
Fair value unwind	8	(228)	650	1,206
Integration, simplification and EC mandated retail business disposal costs	9	(1,517)	(1,246)	(1,452)
Payment protection insurance provision	10	(3,050)	(3,575)	–
Other regulatory provisions	11	(405)	(650)	(175)
Past service pension (charge) credit	12	(104)	250	–
Amortisation of purchased intangibles	13	(395)	(482)	(562)
Profit (loss) before tax – Statutory		415	(606)	(551)

[1] Restated – see note 1 on page F-11.

1. Asset sales

Asset sales comprise the gains and losses on asset disposals (2013: losses of £687 million; 2012: losses of £660 million; 2011: gains of £88 million), principally of assets which were outside of the Group's risk appetite.

2. Sale of government securities

These reflect gains on bond sales (2013: £787 million; 2012: £3,207 million; 2011: £196 million) as the Group has taken the opportunity afforded by the continuing low interest rate environment to reposition its holdings of available-for-sale government securities.

3. Liability management

Liability management losses of £142 million (2012: losses of £229 million; 2011: gains of £1,295 million) arose on transactions undertaken as part of the Group’s management of wholesale funding and capital, including a loss of £397 million resulting from debt repurchases and a gain of £168 million relating to the exchange of certain capital securities for other subordinated debt instruments. The liability management losses in 2013 were included in other income. In 2012 liability management gains of £109 million were recognised in net interest income and losses of £338 million in other income; and in 2011 gains of £696 million were recognised in net interest income and gains of £599 million in other income.

4. Own debt volatility

Own debt volatility includes a gain of £41 million relating to the change in fair value attributable to movements in the Group’s credit standing on the small proportion of the Group’s wholesale funding which was designated at fair value at inception (2012: charge of £437 million; 2011: gain of £189 million). Own debt volatility also includes a £209 million loss (2012: gain of £249 million; 2011: loss of £5 million) relating to the change in fair value of the equity conversion feature of the Enhanced Capital Notes.

5. Other volatile items

Other volatile items include the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting. A charge of £489 million was included in 2013 (2012: charge of £745 million; 2011: charge of £268 million) and reflected the market conditions that resulted in substantial changes in interest and foreign exchange rates in the year. Also included in 2013 was a positive net derivative valuation adjustment of £32 million (2012: credit of £267 million; 2011: charge of £718 million), reflecting a reduction in the market implied credit risk associated with customer derivative balances.

6. Volatility arising in insurance businesses

The Group’s statutory result before tax is affected by insurance volatility, caused by movements in financial markets, and policyholder interests volatility.

In 2013, the Group’s statutory result before tax included positive insurance and policyholder interests volatility totalling £668 million compared to positive volatility of £312 million in 2012.

Volatility comprises the following:

	2013	2012	2011
	£m	£m	£m

Insurance volatility	218	189	(557)
Policyholder interests volatility	564	143	(283)
Insurance hedging arrangements	(114)	(20)	2
Total	668	312	(838)

Management believes that excluding volatility from underlying profit before tax provides useful information for investors on the performance of the business as it excludes amounts included within profit before tax which do not accrue to the Group's equity holders and excludes the impact of changes in market variables which are beyond the control of management.

The most significant limitations associated with excluding volatility from the underlying basis results are:

(i) Insurance volatility requires an assumption to be made for the normalised return on equities and other investments; and

(ii) Insurance volatility impacts on the Group's regulatory capital position, even though it is not included within underlying profit before tax.

Management compensates for the limitations above by:

(i) Monitoring closely the assumptions used to calculate the normalised return used within the calculation of insurance volatility; these assumptions are disclosed below; and

(ii) Producing separate reports on the Group's current and forecast capital ratios.

Insurance volatility

The Group's insurance businesses have policyholder liabilities that are supported by substantial holdings of investments, including equities, property and fixed interest investments, all of which are subject to variations in their value. The value of the liabilities does not move exactly in line with changes in the value of the investments, yet IFRS requires that the changes in the value of both the liabilities and the investments be reflected within the income statement. As these investments are substantial and movements in their value can have a significant impact on the profitability of the Group, management believes that it is appropriate to disclose the results on the basis of an expected return in addition to results based on the actual return.

The expected gross investment returns used to determine the normalised profit of the business, which are based on prevailing market rates and published research into historical investment return differentials, are set out below:

United Kingdom (Sterling)	2013 %	2012 %	2011 %
Gilt yields (gross)	2.58	2.48	3.99
Equity returns (gross)	5.58	5.48	6.99
Property return (gross)	5.58	5.48	6.99
Fixed interest investments backing annuity liabilities (gross)	3.83	3.89	4.78
Corporate bonds	3.18	3.08	4.59

A review of investment strategy in the Group's insurance business resulted in investment being made in a wider range of assets. Expected investment returns in 2013 include appropriate returns for these assets. The 2013 rates also reflect the move to swap rates as the basis for calculations.

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The impact on the results due to the actual return on these investments differing from the expected return (based upon economic assumptions made at the beginning of the year, adjusted for significant changes in asset mix) is included within insurance volatility. Changes in market variables also affect the realistic valuation of the guarantees and options embedded within the with profit funds, the value of the in-force business and the value of shareholders' funds.

The positive insurance volatility of £218 million during 2013 primarily reflected the favourable performance of equity investments in the period relative to the expected return. This was partially offset by an increase in the long-term level of market implied inflation and lower cash returns compared to the long-term expectations. The positive insurance volatility of £189 million in 2012 primarily reflected the benefits of an increase in equity market values relative to the expected return and a reduction in gilt yields and a narrowing of corporate bond spreads. The negative insurance volatility of £557 million in 2011 primarily reflected the underperformance of equity markets in the second half of that year.

Policyholder interests volatility

The application of accounting standards results in the introduction of other sources of significant volatility into the pre-tax profits of the life, pensions and investments business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility.

In 2013, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £564 million (2012: credit of £143 million; 2011: charge of £283 million) relating to the rise in equity markets in the period.

Group hedging arrangements

To protect against deterioration in equity market conditions and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group purchased put option contracts in 2012 financed by selling some upside potential from equity market movements. These expired in 2013 and the charge booked in 2013 on these contracts was £9 million. New protection was acquired in 2013 to replace the expired contracts. On a mark-to-market valuation basis a loss of £105 million was recognised in relation to the new contracts in 2013.

The statutory results for the year ended 31 December 2012 included a charge of £20 million (2011: credit of £2 million).

7. Insurance gross-up

The Group's insurance businesses' income statements include income and expenditure which are attributable to the policyholders of the Group's long-term assurance funds. These items have no impact in total upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net on a separate line. These policyholder amounts relate principally to returns on policyholder investments (within net interest income and net trading income) and insurance premiums receivable, together with a matching amount within the insurance claims expense representing the allocation of these items to policyholders.

8. Fair value unwind

The statutory (IFRS) and the underlying basis results include the impact of the acquisition-related fair value adjustments arising from the acquisition of HBOS in 2009. On a statutory (IFRS) basis the acquisition-related fair value adjustments affect a number of line items whereas the Group's underlying basis presents the aggregate of the impact of these adjustments on the Group's income statement.

The principal financial effects of the fair value unwind are to reflect the effective interest rates applicable at the date of acquisition, on assets and liabilities that were acquired at values that differed from their original book value, and to recognise the reversal of credit and liquidity risk adjustments as underlying instruments mature or become impaired. Generally, this leads to higher interest expense as the value of HBOS's own debt accretes to par and a lower impairment charge reflecting the impact of acquisition balance sheet valuation adjustments.

9. Integration, simplification and EC mandated retail business disposal costs

Simplification programme costs in 2013 were £830 million (2012: £676 million; 2011: £185 million) and the total spent on the programme to the end of 2013 was £1,691 million. This had delivered annual run-rate cost savings of £1,457 million by December 2013.

No integration costs were incurred in 2013 (2012: £nil; 2011: £1,097 million).

The Group continues to progress the European Commission (EC) mandated business disposal (Verde), with an Initial Public Offering (IPO) planned for mid-2014. Subject to meeting a number of criteria, this plan has been agreed in principle by the EC but remains subject to final regulatory and EC approval. The Project Verde branches were rebranded in September 2013, and now operate as TSB as a separate business within the Lloyds Banking Group. The costs of building TSB were £687 million in the year ended 31 Decemer 2013 (2012: £570 million; 2011: £170 million) and, from inception to the end of December 2013, have totalled £1,468 million. For more information see Risk Factors – Government Related Risks.

10. Payment protection insurance (PPI) provision

The Group made a further provision in the fourth quarter of 2013 for expected PPI costs of £1,800 million, which brought the amount provided in 2013 for PPI to £3,050 million (2012: £3,575 million; 2011: nil), and the total amount provided to £9,825 million. Total costs incurred in the three months to 31 December 2013 were £687 million, including £165 million of administration costs, and as at 31 December 2013, £2,807 million of the total provision remained unutilised.

The volume of PPI complaints continues to fall. Average monthly complaint volumes (excluding complaints where no PPI was held) reduced to approximately 37,000 in the fourth quarter of 2013, and were 24 per cent below volumes in the third quarter, and 56 per cent below the fourth quarter of 2012. While fourth quarter volumes fell in line with the Group’s revised end of third quarter expectations, following further statistical modelling and the results of the most recent customer survey, the Group is now forecasting a slower decline in future volumes than previously expected. The additional provision taken in the fourth quarter is based on the assumption that the Group will receive approximately a further

550,000 complaints. Together with an increase in administrative costs, this revised forecast for future complaint volumes accounts for approximately £1.1 billion of the £1.8 billion additional provision taken in the fourth quarter.

A revision of the Group's forecasts for uphold rates and response rates to proactive mailings together account for approximately £0.4 billion of the increased provision, and reflect forecast rates above recent experience. The Group has also increased its estimates for remediation costs, which principally relate to the re-review of previously defended complaints, and this accounts for approximately £0.3 billion of the increased provision.

Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 40 per cent of the policies sold since 2000, covering both customer-initiated complaints and actual and expected proactive mailings undertaken by the Group. The proactive mailings arise from a detailed Past Business Review, carried out by the Group as agreed with the Financial Conduct Authority (FCA), as a result of which the Group is contacting customers identified as having the highest likelihood of required redress. These mailings are expected to be substantially complete by the end of the first half of 2014. In terms of customer-initiated complaints, the fourth quarter monthly average run-rate of approximately 37,000 complaints is around 70 per cent below its peak and complaints have declined in each of the last six quarters.

The total amount provided for PPI represents the Group's best estimate of the likely future costs, albeit a number of risks and uncertainties remain, in particular complaint volumes, uphold rates, average redress costs, the scope and cost of proactive mailings and remediation, and the outcome of the FCA Enforcement Team investigation. The cost of these factors could differ materially from the Group's estimates, with the risk that a further provision could be required.

11. Other regulatory provisions

A further provision of £130 million (2012: £400 million; 2011: nil) was made in 2013 relating to the sale of interest rate hedging products to certain small and medium-sized businesses. This brings the amount provided to £530 million, of which £218 million relates to administration costs. As at 31 December 2013, £368 million of the total provision remained unutilised.

In the course of its business, the Group is engaged in discussions with the Prudential Regulatory Authority, Financial Conduct Authority (FCA) and other UK and overseas regulators and governmental authorities on a range of matters; a provision is held against the costs expected to be incurred. In 2013 these provisions were increased by a further £200 million (2012: £100 million; 2011: nil), in respect of matters affecting the Retail, Commercial and Wealth and Asset Finance businesses, bringing the total amount to £300 million, of which £75 million had been utilised at 31 December 2013. This includes a fine of £28 million from the FCA following an investigation into its historic systems and controls governing legacy incentive schemes for branch advisors.

Other provisions also included £75 million (2012: £150 million; 2011: £175 million) recognised in the first half of 2013 for claims relating to policies issued by Clerical Medical Insurance Group Limited in Germany, bringing the total provision to £400 million, of which £246 million remains unutilised at 31 December 2013.

12. Past service pension (charge) credit

In 2013 the Group recorded a charge of £104 million as a result of changes to early retirement and commutation factors in two of its principal defined benefit schemes (2012: £250 million gain related to a change in policy in respect of discretionary pension increases; 2011: £nil).

13. Amortisation of purchased intangibles

The Group incurred a charge for the amortisation of intangible assets, recognised on the acquisition of HBOS in 2009, of £395 million (2012: charge of £482 million; 2011: charge of £562 million).

DIVISIONAL RESULTS

RETAIL

The Retail division is a leading provider of current accounts, savings, personal loans, credit cards and mortgages in the UK.

With its strong stable of brands including Lloyds Bank, Halifax, Bank of Scotland and TSB it serves over 30 million customers through the largest branch network in the UK and comprehensive digital, telephone and mobile services. Retail is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, protection and general insurance products.

From 2014, the Wealth business will move into the Retail division, ensuring it can better service the needs of the Group's wealthier Retail customers. Also, Retail Business Banking will transfer to the Retail division as it works to be the Group's small business champion, leveraging its infrastructure. At the same time, Credit Cards will move out of the Retail division into a new Consumer Finance division to support this growth area.

	2013 £m	2012 £m	2011 £m
Net interest income	7,536	7,195	7,497
Other income	1,410	1,462	1,660
Total underlying income	8,946	8,657	9,157
Operating expenses	(4,096)	(4,199)	(4,438)
Impairment	(1,101)	(1,270)	(1,970)
Underlying profit	3,749	3,188	2,749

2013 COMPARED WITH 2012

Underlying profit increased by £561 million, or 18 per cent to £3,749 million in 2013 compared to £3,188 million in 2012, driven by improved margins, reduced costs and favourable impairments.

Net interest income increased £341 million, or 5 per cent, to £7,536 million in 2013 compared to £7,195 million in 2012. Margin performance was strong, increasing 15 basis points to 2.23 per cent in 2013 compared to 2.08 per cent in 2012, driven by improved deposit mix and a favourable funding environment, more than offsetting reduced lending rates.

Other income decreased by £52 million, or 4 per cent, to £1,410 million in 2013 compared to £1,462 million in 2012, with lower income from bancassurance and protection, following the Retail Distribution Review in 2012, partially offset by the benefit of revised intra-group commission arrangements in relation to the home insurance book.

Total costs fell £103 million, or 2 per cent, to £4,096 million in 2013 compared to £4,199 million in 2012, primarily as a result of the Simplification programme and ongoing cost management activity.

Impairment reduced £169 million, or 13 per cent, to £1,101 million in 2013 compared to £1,270 million in 2012, with the unsecured book remaining stable and secured charges decreasing largely due to lower impaired loan balances.

Loans and advances to customers decreased £1,360 million to £341,950 million in 2013 broadly in line with 2012 at £343,310 million. Gross new mortgage lending increased £10,617 million, or 40 per cent, to £36,861 million in 2013 compared to £26,244 million in 2012.

Customer deposits increased £8,136 million, or 3 per cent, to £268,974 million in 2013 compared to £260,838 million at the end of 2012. Relationship balances (including Lloyds, Halifax, Bank of Scotland and TSB branded personal current accounts and savings) increased 6 per cent in 2013, ahead of market growth, driven by the effect of strong product offerings, particularly in the Lloyds Bank brand.

Risk-weighted assets decreased £9,793 million, or 10 per cent, to £85,677 million at 31 December 2013 compared to £95,470 million at the end of 2012, primarily due to improvements in credit quality as a result of effective portfolio management and the impact of macro-economic factors, including favourable movements in UK house prices.

2012 COMPARED WITH 2011

Underlying profit increased by £439 million, or 16 per cent, to £3,188 million in 2012 compared to £2,749 million in 2011. This increase was the result of strong cost control and continued improvements in credit performance.

Net interest income decreased by £302 million, or 4 per cent, to £7,195 million in 2012 compared to £7,497 million in 2011, driven by muted demand for lending, previous de-risking of the balance sheet and increased funding costs. While the prior de-risking of the lending portfolio has suppressed income growth, it also supported an offsetting reduction in impairment charges. Retail has taken a number of actions to offset the pressure on income which includes making strategic investments and re-pricing selected lending portfolios to reflect current funding costs.

Net interest margin was stable at 2.08 per cent in 2012 compared to 2.09 per cent in 2011. The net interest margin in the second half of the year particularly benefited from rate changes made to the lending portfolio, but continues to be affected by higher funding costs and the impact of portfolio de-risking.

Other income decreased by £198 million, or 12 per cent, to £1,462 million in 2012 compared to £1,660 million in 2011 largely as a result of lower Bancassurance income that reflected the subdued investment and protection market environment.

Total costs fell by £239 million, or 5 per cent, to £4,199 million in 2012 compared to £4,438 million in 2011, largely as a result of the Simplification programme. As part of this programme Retail delivered end-to-end process enhancements, migration of customers to self-service channels, and implemented further improvements in purchasing arrangements. Retail has also delivered other day-to-day cost benefits, which, when combined with the work on Simplification, more than offset on-going cost inflation and increased investment spend.

The impairment charge reduced by £700 million, or 36 per cent, to £1,270 million in 2012 compared to £1,970 million in 2011. Credit performance across the business continued to be strong considering the subdued economic environment. This was supported by the Group’s sustainable approach to risk, a continued focus on lending to existing customers and low interest rates. The unsecured impairment charge reduced by

£614 million, or 41 per cent, to £893 million in 2012 compared to £1,507 million in 2011, reflecting the impact of the sustainable approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge decreased by £86 million, or 19 per cent, to £377 million from £463 million in 2011, reflecting further reductions in impaired loans in the secured portfolio.

Loans and advances to customers decreased by 3 per cent. This was driven by a number of factors, including reduced customer demand for new credit, existing customers continuing to reduce their personal indebtedness, the run-off of lending which is outside of the Group's risk appetite and Retail maintaining a sustainable approach to risk. The reduction in lending to customers was in part due to the repayment of unsecured lending where balances reduced by £1,723 million, or 7 per cent, to £21,984 million. Secured balances reduced by £7,779 million, or 2 per cent, to £321,326 million.

Customer deposits increased by 6 per cent in 2012. This reflects the success of Retail's multi-brand customer propositions and the pricing strategy that has been developed. Retail continued to deliver sustained growth in the savings market despite the high levels of competition. Its strong stable of savings brands continues to provide customers with a market leading range of products to meet their savings needs.

Risk-weighted assets decreased by £7,767 million, or 8 per cent, to £95,470 at 31 December 2012 compared to £103,237 million at the end of 2011. This was the result of lower lending balances, effective portfolio management and prior de-risking of the balance sheet.

operating and financial review and prospects

COMMERCIAL BANKING

Commercial Banking continues to execute its strategy to be the best bank for clients. The division has reshaped the Small and Medium-sized Enterprises (SME) and Mid Markets segments to better serve client needs and improved relationship returns in Global Corporates and Financial Institutions through continued focus on capital optimisation.

The division strengthened its balance sheet and funding position by increasing the volume and quality of deposits and de-risking the balance sheet through a capital accretive asset reduction strategy. Investment in core infrastructure continues, with ongoing benefits from the Simplification programme and tight cost management enabling further scalability and functionality in the Transaction Banking and Markets businesses.

The division exited from Spain and Australia to focus on UK and UK-linked clients, actively supported the UK economy whilst maintaining a prudent risk appetite and played a leading role in the development of the UK retail bond market, becoming a market maker on the London Stock Exchange for retail bond investors. For the ninth year in a row, Commercial Banking has been awarded UK Business Bank of the Year at the FD’s Excellence Awards.

	2013	2012	2011
	£m	£m	£m
Net interest income	2,426	2,206	3,192
Other income	2,708	2,932	2,806
Total underlying income	5,134	5,138	5,998
Operating expenses	(2,392)	(2,516)	(2,600)
Impairment	(1,167)	(2,946)	(4,210)
Underlying profit (loss)	1,575	(324)	(812)

2013 compared with 2012

Commercial Banking returned to profitability with underlying profit increased by £1,899 million to £1,575 million in 2013 compared to a loss of £324 million in 2012; due to a reduction in impairments, as a result of lower charges in most of the businesses, reduced operating expenses, and increased net interest income, partly offset by reduced other income.

Net interest income increased by £220 million, or 10 per cent, to £2,426 million in 2013 compared to £2,206 million in 2012 driven by reduced funding costs and banking net interest margin expansion as a result of disciplined pricing of new business.

Other income decreased by £224 million, or 8 per cent to £2,708 million in 2013 compared to £2,932 million in 2012 primarily due to the asset reduction strategy partially offset by increases in most segments reflecting resilient performances despite subdued markets.

Operating expenses decreased by £124 million, or 5 per cent, to £2,392 million in 2013 compared to £2,516 million in 2012 reflecting continued focus on cost management, savings attributable to the Simplification programme and the reduction in assets. The benefits of these cost saving initiatives enabled further investment in developing product capabilities.

Impairments decreased by £1,779 million, or 60 per cent, to £1,167 million in 2013 compared to £2,946 million in 2012, reflecting continued proactive deleveraging of the portfolio, improved origination quality and higher releases in 2013.

2012 compared with 2011

Underlying loss for the division reduced by £488 million, or 60 per cent, to £324 million in 2012 compared to £812 million in 2011 due to the reduction in impairments as a result of lower charges in most of the businesses, increased other income, and lower total costs, partially offset by reduced net interest income.

Net interest income decreased by £986 million, or 31 per cent, to £2,206 million in 2012 compared to £3,192 million in 2011 as a result of decreasing average lending volumes, subdued corporate client demand continuing the current market trend of deleveraging, and compressed margins reflecting higher wholesale funding costs and improved recognition of the cost and value of funds across the Group.

Banking net interest margin decreased by 28 basis points to 1.58 per cent in 2012 compared to 1.86 per cent in 2011 primarily reflecting margin compression from increased wholesale funding costs, competition for customer deposits and limited opportunity for asset repricing.

Other income increased by £126 million, or 4 per cent, to £2,932 million in 2012 compared to £2,806 million in 2011, reflecting higher client activity despite difficult market conditions, and a resilient performance in the venture capital business.

Operating expenses decreased by £84 million, or 3 per cent, to £2,516 million in 2012 compared to £2,600 million in 2011, with continued focus on cost management, savings attributable to the Simplification programme and the reduction in assets. The benefits of these cost savings initiatives enabled further investment in developing product capabilities.

Impairment charges decreased by £1,264 million, or 30 per cent, to £2,946 million in 2012 compared to £4,210 million in 2011 driven by reduced charges in the Australasian and the Acquisition Finance portfolio, partly offset by further deterioration in the Shipping portfolio. Additionally, impairments decreased in some of the corporate lending portfolios where there were specific large impairments in 2011 which have not been repeated.

WEALTH, asset finance AND INTERNATIONAL

Wealth, Asset Finance and International division comprised the Group's private banking and asset management activities, its international retail businesses and its UK and international asset finance and online deposit businesses.

The business segments of the division were aligned during 2012 to reflect the operating model:

- **Wealth** – UK and International Wealth businesses, Scottish Widows Investment Partnership and St James's Place.
- **Asset Finance** – UK and International Asset Finance and on-line deposit businesses.
- **International** – banking businesses in Ireland, Europe, Asia and the rest of the world (excluding businesses transferred to the Commercial Banking division in 2012).

	2013	2012	2011
	£m	£m	£m
Net interest income	870	799	1,003
Other income	1,809	2,043	2,230
Total underlying income	2,679	2,842	3,233
Operating expenses	(1,991)	(2,291)	(2,414)
Impairment	(730)	(1,480)	(3,604)
Underlying loss	(42)	(929)	(2,785)

2013 compared with 2012

Underlying loss reduced by £887 million, or 95 per cent, to £42 million in 2013 compared to £929 million in 2012 primarily due to a £750 million reduction in impairments, mainly in Ireland, together with growth in net interest income, and cost savings.

Total underlying income decreased by £163 million, or 6 per cent, to £2,679 million in 2013 compared to £2,842 million in 2012, primarily due to the sale of the Group's shares in St. James's Place.

Net interest income increased by £71 million, or 9 per cent, to £870 million in 2013 compared to £799 million in 2012, driven by an improvement in margins following the repricing of deposits in Wealth and in the Online Deposits business within Asset Finance.

Other income decreased by £234 million, or 11 per cent, to £1,809 million in 2013 compared to £2,043 million in 2012, primarily due to the deconsolidation of St. James's Place from April 2013 and the impact of disposals from the International portfolio. Growth in Asset Finance and new Wealth revenue streams were offset by a reduction in trail income following implementation of the Retail Distribution Review.

Operating expenses decreased by £300 million, or 13 per cent, to £1,991 million in 2013 compared to £2,291 million in 2012. Savings from business disposals, from simplification of the organisational structure in both Wealth and Asset Finance, and increasing the use of direct channel customer service in Wealth, enabled investment in building the customer propositions in UK Wealth and Asset Finance.

The impairment charge reduced by £750 million, or 51 per cent, to £730 million in 2013 compared to £1,480 million in 2012, largely as a result of lower charges in the Irish business where the charge amounted to £608 million in 2013 compared to £1,245 million in 2012.

2012 compared with 2011

Underlying loss reduced by £1,856 million, or 67 per cent, to £929 million in 2012 compared to £2,785 million in 2011 primarily due to a £2,124 million reduction in impairments together with lower costs, partially offset by a fall in income as a result of balance sheet reduction activity during the year.

Total underlying income decreased by £391 million, or 12 per cent, to £2,842 million in 2012 compared to £3,233 million in 2011.

Net interest income decreased by £204 million, or 20 per cent, to £799 million in 2012 compared to £1,003 million in 2011. Strong deposit inflows within the Wealth and on-line deposit businesses were more than offset by higher funding costs, significant balance sheet run-off in the year and increased levels of impaired assets, mainly in Ireland.

Other income decreased by £187 million, or 8 per cent, to £2,043 million in 2012 compared to £2,230 million in 2011. Growth in Wealth against a background of subdued investment markets and customer appetite was more than offset by lower income in Asset Finance and International as a result of business sales in the year and continued balance sheet reduction.

Operating expenses decreased by £123 million, or 5 per cent, to £2,291 million in 2012 compared to £2,414 million in 2011 despite a 4 per cent increase in total customer balances and funds under management. This reflected continued focus on simplifying the Group's business model and reducing its international footprint.

The impairment charge reduced by £2,124 million, or 59 per cent, to £1,480 million in 2012 compared to £3,604 million in 2011, largely as a result of lower charges in the Irish business where the charge amounted to £1,245 million in 2012 compared to £3,187 million in 2011.

INSURANCE

The Insurance division provides long-term savings, protection and investment products and general insurance products to customers in the UK and Europe.

Life, Pensions and Investments

The UK Life, Pensions and Investments business provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels of the Lloyds Bank, TSB, Halifax, Bank of Scotland and Scottish Widows brands. The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands. The disposal of Heidelberger Lebensversicherung AG (Heidelberger Leben) was announced during 2013 and is expected to complete during 2014.

In common with other life assurance companies in the UK, the life and pensions business of each of the life assurance companies in the Lloyds Banking Group is written in a long-term business fund. The main long-term business funds are divided into one or both of With Profit and Non-Profit sub funds.

With-profits life and pensions products are written from the respective With Profit sub-funds in the Group. The benefits accruing from these policies are designed to provide a smoothed return to policyholders who hold their policies to maturity through a mix of annual and final (or terminal) bonuses added to guaranteed basic benefits. The guarantees generally only apply on death or maturity. The actual bonuses declared will reflect the experience of the With Profit sub-fund.

Other life and pensions products are generally written from Non-Profit sub-funds.

Examples include unit-linked policies, annuities, term assurances and health insurance (under which a predetermined amount of benefit is payable in the event of an insured event such as being unable to work through sickness). The benefits provided by linked policies are wholly or partly determined by reference to a specific portfolio of assets known as unit-linked funds.

General Insurance

The General Insurance business is a leading distributor of home insurance in the UK, with products sold through the branch network, direct channels and strategic corporate partners. The business also has brokerage operations for personal and commercial insurances. It operates primarily under the Lloyds Bank, TSB, Halifax and Bank of Scotland brands.

	2013 £m	2012 £m	2011 £m
Net interest income	(103)	(78)	(67)
Other income	2,236	2,294	2,687
Insurance claims	(356)	(365)	(343)
Total underlying income, net of insurance claims	1,777	1,851	2,277
Operating expenses	(687)	(744)	(812)
Underlying profit	1,090	1,107	1,465

2013 compared with 2012

Underlying profit from insurance was £17 million, or 2 per cent, lower at £1,090 million compared to £1,107 million in 2012. This primarily reflects a 4 per cent reduction in total underlying income, largely due to changes in intra group commission arrangements and the continued run-off of legacy creditor books within General Insurance net of lower costs and increased profit in UK Life and Pensions existing business reflecting the net benefit from a number of assumption changes.

Net interest expense increased by £25 million, or 32 per cent, to £103 million from £78 million in 2012, primarily due to intra group charges.

Other income decreased by £58 million, or 3 per cent, to £2,236 million from £2,294 million in 2012. This was primarily due to a reduction in general insurance income as a result of a change in intra-group commission arrangements and the continued run-off of the PPI book. This was partly offset by an increase in life, pensions and investments income due to higher existing business income driven by assumption changes.

Claims of £356 million were 9 million, or 2 per cent, lower than £365 million in 2012, mainly driven by lower weather-related claims than in 2012.

Operating expenses and other costs decreased by £57 million, or 8 per cent, from £744 million to £687 million reflecting the benefits of simplifying the business model and processes.

2012 compared with 2011

Underlying profit from insurance was £358 million, or 24 per cent, lower at £1,107 million compared to £1,465 million in 2011. This primarily reflects a 19 per cent reduction in total underlying income, largely due to the subdued economic climate and increased property claims, being partially offset by an 8 per cent decrease in costs.

Net interest expense increased by £11 million, or 16 per cent, to £78 million from £67 million in 2011, primarily due to higher interest payments following capital restructuring initiatives during 2011.

Other income decreased by £393 million, or 15 per cent, to £2,294 million from £2,687 million in 2011. This was due to a £293 million reduction in LP&I other income mainly as a result of the reduction in economic returns, the impact of prior year assumption benefits and reduced bancassurance volumes. Additionally General Insurance other income reduced by £100 million primarily reflecting the run-off of the PPI book and lower investment returns.

Claims of £365 million were £22 million, or 6 per cent, higher than £343 million in 2011, mainly driven by adverse property claims following weather events that have impacted during the year, with 2012 being the second wettest year on record. Weather related claims totalled £110 million which is £95 million higher than such claims in 2011. This was partly offset by lower underlying home claims reflecting the improved claims management processes which improved customer experience and reduced average claims costs as well as lower claims as a result of the reduction in the size of the PPI book.

Operating expenses and other costs decreased by £68 million, or 8 per cent, from £812 million to £744 million due mainly to a continued focus on cost management across the business and the ongoing delivery of Simplification cost saving initiatives.

IFRS underlying profit by product group

	2013					2012	2011
	Pensions & investments £m	Protection & annuities £m	General insurance £m	Other £m	Total £m	Total £m	Total £m
New business income	276	139	–	16	431	519	554

Existing business income	599	132	–	92	823	791	981
Assumption changes and experience variances	(158)	302	–	(78)	66	(31)	50
General insurance income net of claims	–	–	457	–	457	572	692
Total underlying income	717	573	457	30	1,777	1,851	2,277
Total costs	(360)	(128)	(160)	(39)	(687)	(744)	(812)
Underlying profit 2013	357	445	297	(9)	1,090	1,107	1,465
Underlying profit 2012	404	289	409	5	1,107		

2013 compared with 2012

New business income reduced by £88 million to £431 million driven by reduced protection and annuities new business income following changes to the basis of taxation on the life protection business in January 2013. Pensions and investments new business income increased slightly with a strong performance on corporate pensions being largely offset by reduced investments volumes following the Group's decision to stop providing investment advice to Retail customers with savings below £100,000.

Existing business income increased by £32 million largely due to increased income from protection and annuities which benefited from the increased returns on higher yielding assets. Pensions and investments existing business income increased slightly with increased income on pensions being largely offset by reduced income on the declining savings and investments portfolio.

Underlying profit in the protection and annuities business included a benefit of £302 million largely as a result of changes to long-term mortality and investment return assumptions which included the benefits of investing in higher yielding assets to match long duration liabilities. This was partly offset by a charge of £158 million in the pensions and investments business driven primarily by a revision of pensions lapse assumptions and allowance for the impact of the Office of Fair Trading review on fairness of legacy pension charges.

General insurance income reduced by £115 million to £457 million due to a £77 million impact of a revised commission arrangement with Retail on the home insurance portfolio in addition to the continued run off of legacy books.

2012 compared with 2011

Total new business income decreased by £35 million to £519 million, primarily reflecting a 3 per cent reduction in the present value of new business premiums (PVNBP) driven by lower bancassurance volumes, reflecting the impact of the economic environment on customers' desire to invest and the decision to only offer investment advice for Retail customers with savings above £100,000 ahead of of the implementation of the Financial Services Authority's Retail Distribution Review (RDR). High volumes of corporate pension sales through the intermediary channel partially offset this.

LP&I Existing business income reduced by £190 million to £791 million in 2012. This was primarily attributable to the subdued economic environment. For LP&I insurance contracts, returns on existing business reflect long-term economic assumptions for these policies. The subdued economic environment has resulted in the rate of return used in calculating the 2012 results being significantly lower than the comparable rate in the prior year and this was the main driver of the reduction in existing business income.

General insurance income net of claims decreased by £120 million to £572 million compared to £692 million in 2011. The decrease was primarily due to increased weather related claims in 2012, reduced investment returns and the impact of the continued run-off of the PPI book.

GROUP OPERATIONS

	2013 £m	2012[1] £m	2011[1] £m
Total income	6	30	42
Direct costs:			
Information technology	(1,172)	(1,171)	(1,214)
Operations	(825)	(822)	(887)
Property	(876)	(892)	(917)
Support functions	(92)	(93)	(89)
	(2,965)	(2,978)	(3,107)
Result before recharges to divisions	(2,959)	(2,948)	(3,065)
Total net recharges to divisions	2,902	2,897	3,009
Underlying loss	(57)	(51)	(56)

1 Comparative figures have also been amended to reflect the centralisation of operations across the Group. To ensure a fair comparison of 2013 performance, 2012 and 2011 direct costs have been changed with an equivalent offsetting adjustment in recharges to divisions.

2013 compared with 2012

Loss before tax from Group Operations increased by £6 million to £57 million in 2013 compared to £51 million in 2012.

Total income, excluding recharges to divisions, decreased by £24 million to £6 million in 2013 compared to £30 million in 2012.

Direct costs were £13 million lower at £2,965 million in 2013 compared to £2,978 million in 2012. Significant cost savings have been achieved through Simplification and tight cost control actions such as sourcing, the centralisation, automation and re-engineering of end-to-end processes, and consolidation and rationalisation of property and IT. These savings are offset by higher costs of supplying investment projects and the impact of regulatory costs and inflation.

Information Technology savings were offset by increased costs from delivering Group Strategic Initiatives that deliver income and cost benefits in other Divisions; Operations costs increased slightly from 2012 to 2013 with enhancements to our customer services processes and regulatory and compliance activities offset by Simplification savings; Group Property costs decreased by 2 per cent as the Group continued to consolidate its property portfolio with savings offsetting the costs of rebranding the Branch network. Support functions costs were £1 million, or 1 per cent, lower at

£92 million in 2013 compared to £93 million in 2012.

Recharges to divisions were £5 million higher at £2,902 million in 2013 compared to £2,897 million in 2012.

2012 compared with 2011

Loss before tax from Group Operations decreased by £5 million to £51 million in 2012 compared to £56 million in 2011.

Total income, excluding recharges to divisions, decreased by £12 million, to £30 million in 2012 compared to £42 million in 2011.

Direct costs were £129 million, or 4 per cent, lower at £2,978 million in 2012 compared to £3,107 million in 2011; this reflected Simplification savings and the continued focus on cost management which more than offset inflationary issues and incremental costs from Group investment projects.

Information Technology costs decreased by 4 per cent after absorbing increased costs from delivering Group Strategic Initiatives which deliver income and cost benefits in other Divisions; Operations costs decreased by 7 per cent through the continuing rationalisation of major Operations functions. Property costs decreased by 3 per cent with the continuing consolidation of the Group's property portfolio delivering further benefits. Support functions costs were £4 million, or 4 per cent, higher at £93 million in 2012 compared to £89 million in 2011.

Recharges to divisions were £112 million lower at £2,897 million in 2012 compared to £3,009 million in 2011 reflecting the lower direct cost position.

CENTRAL ITEMS

	2013 £m	2012[1] £m	2011[1] £m
Total underlying income	263	(132)	339
Operating expenses	(406)	(293)	(468)
Trading surplus	(143)	(425)	(129)
Impairment	(6)	(1)	(3)
Underlying loss	(149)	(426)	(132)

[1] Restated – see note 1 on page F-11.

Central items are comprised of three main elements:

1 The residual net interest position arising from the Group's processes to allocate the following elements of net interest income to the divisions:

– interest on the Group's equity position;

– net interest margin cost resulting from central capital activities, primarily arising on the management of subordinated debt and preference shares; and

– cost to the Group of funding wholesale and liquidity balances.

2 The charge for payments to the charitable foundations: the four independent Lloyds TSB Foundations and the independent Bank of Scotland Foundation support registered charities throughout the UK that enable people, particularly the disabled and disadvantaged, to play a fuller role in society.

3 Other unallocated central items include the on-going activities of central areas including those of Group Corporate Treasury (including the central hedge function), Group Audit, Group Risk and Group Finance.

2013 compared with 2012

Total underlying income increased by £395 million to £263 million compared to a net deficit of £132 million in 2012; the increase reflects the gain on sales of shares in St. James's Place plc of £540 million and other items retained at the Group centre.

Total costs were £113 million higher at £406 million compared to £293 million in 2012 as a result of an increase in the UK bank levy charge, which at £238 million was £59 million higher than in 2012, and increased pension costs held centrally. Costs held at the centre also include an element of the Group's Financial Services Compensation Scheme costs, and charges in respect of annual donations to the Group's charitable foundations.

An impairment charge of £6 million arose in 2013 (2012: £1 million).

2012 compared with 2011

Total underlying income fell by £471 million to a deficit of £132 million compared to net income of £339 million in 2011; this reflects the net impact of items retained at the Group centre, including the amortisation of adjustments arising from prior year liability management exercises.

Total costs were £175 million, or 37 per cent, lower at £293 million in 2012 compared to £468 million in 2011 as a result of a reduction in the centrally held element of the Group's pension charge. These costs also include the centrally held element of the Group's Financial Services Compensation Scheme costs, £175 million (2011: £161 million) of the Group's total charges of £175 million (2011: £179 million); the UK bank levy charge which was £10 million, or 5 per cent, lower at £179 million (2011: £189 million) in spite of an increase in the rate of the levy, as a consequence of the lower levels of wholesale funding, a reduction in the Group's balance sheet and an increase in the proportion of funding with a maturity of greater than one year; and charges in respect of annual donations to the Group's charitable foundations.

An impairment charge of £1 million arose in 2012 (2011: £3 million).

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Average balance sheet and net interest income

	2013 **Average balance £m**	**Interest income £m**	**Yield %**	2012[1] Average balance £m	Interest income £m	Yield %	2011[1] Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	102,190	457	0.45	111,643	603	0.54	81,001	628	0.78
Loans and advances to customers	520,305	19,928	3.83	548,350	21,600	3.94	594,152	23,950	4.03
Debt securities	2,102	32	1.52	9,080	433	4.77	18,616	590	3.17
Available-for-sale financial assets	38,767	746	1.92	31,304	624	1.99	34,305	886	2.58
Held-to-maturity investments	–	–	–	10,292	288	2.80	7,958	262	3.29
Total interest-earning assets of banking book	663,364	21,163	3.19	710,669	23,548	3.31	736,032	26,316	3.58
Total interest-earning trading securities and other financial assets at fair value through profit or loss	68,763	2,076	3.02	70,967	2,409	3.39	63,418	2,201	3.47
Total interest-earning assets	732,127	23,239	3.17	781,636	25,957	3.32	799,450	28,517	3.57
Allowance for impairment losses on loans and receivables	(14,381)			(17,487)			(19,548)		
Non-interest earning assets	176,465			206,899			200,886		
Total average assets and interest income	894,211	23,239	2.60	971,048	25,957	2.67	980,788	28,517	2.91

	2013 **Average interest earning assets £m**	**Net interest income £m**	**Net interest margin %**	2012[1] Average interest earning assets £m	Net interest income £m	Net interest margin %	2011 Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	663,364	7,338	1.11	710,669	7,718	1.09	736,032	12,698	1.73
Trading securities and other financial assets at fair value through profit or loss	68,763	1,757	2.56	70,967	1,908	2.69	63,418	1,722	2.72
	732,127	9,095	1.24	781,636	9,626	1.23	799,450	14,420	1.80

[1] Restated – see note 1 on page F-11.

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	2013 **Average balance £m**	**Interest expense £m**	**Cost %**	2012[1] Average balance £m	Interest expense £m	Cost %	2011[1] Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders' funds									
Deposits by banks	19,845	129	0.65	28,430	324	1.14	27,748	222	0.80
Liabilities to banks under sale and repurchase agreements	3,414	59	1.73	12,039	198	1.64	16,536	267	1.61
Customer deposits	399,118	6,119	1.53	393,820	6,637	1.69	365,418	6,080	1.66
Liabilities to customers under sale and repurchase agreements	3,101	20	0.64	4,663	47	1.01	7,572	68	0.90
Debt securities in issue	111,264	1,451	1.30	149,437	3,043	2.04	227,497	5,045	2.22
Other interest-bearing liabilities	25,585	3,091	12.08	31,443	2,798	8.90	19,242	(219)	(1.14)
Subordinated liabilities	34,486	2,956	8.57	37,537	2,783	7.41	33,918	2,155	6.35
Total interest-bearing liabilities of banking book	596,813	13,825	2.32	657,369	15,830	2.41	697,931	13,618	1.95
Total interest-bearing liabilities of trading book	37,760	319	0.84	37,533	501	1.33	26,407	479	1.81
Total interest-bearing liabilities	634,573	14,144	2.23	694,902	16,331	2.35	724,338	14,097	1.95
Interest-free liabilities									
Non-interest bearing customer accounts	35,994			30,039			31,519		
Other interest-free liabilities	180,407			200,299			180,213		
Non-controlling interests and shareholders' funds	43,237			45,808			44,718		
Total average liabilities and interest expense	894,211	14,144	1.58	971,048	16,331	1.68	980,788	14,097	1.44

[1] Restated – see note 1 on page F-11.

Loans and advances to banks and customers include impaired lending; interest on this lending has been recognised using the effective interest rate method, as required by IAS 39.

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Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013. The analysis of average balances and interest for 2012 and 2011 between domestic and international offices is as follows:

2012[1]	Domestic Average balance £m	Interest income £m	Yield %	Foreign Average balance £m	Interest income £m	Yield %	Total Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	81,662	534	0.65	29,981	69	0.23	111,643	603	0.54
Loans and advances to customers	499,464	20,248	4.05	48,886	1,352	2.77	548,350	21,600	3.94
Debt securities	9,080	433	4.77	–	–	–	9,080	433	4.77
Available-for-sale financial assets	27,411	601	2.19	3,893	23	0.59	31,304	624	1.99
Held-to-maturity investments	10,292	288	2.80	–	–		10,292	288	2.80
Total interest-earning assets of banking book	627,909	22,104	3.52	82,760	1,444	1.74	710,669	23,548	3.31
Total interest-earning trading securities and other financial assets at fair value through profit or loss	68,792	2,346	3.41	2,175	63	2.90	70,967	2,409	3.39
Total interest-earning assets	696,701	24,450	3.51	84,935	1,507	1.77	781,636	25,957	3.32
Allowance for impairment losses on loans and advances	(5,948)			(11,539)			(17,487)		
Non-interest earning assets	196,901			9,998			206,899		
Total average assets and interest income	887,654	24,450	2.75	83,394	1,507	1.81	971,048	25,957	2.67
Percentage of assets applicable to foreign activities (%)							8.59		

	Domestic Average balance £m	Interest expense £m	Cost %	Foreign Average balance £m	Interest expense £m	Cost %	Total Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders' funds									
Deposits by banks	16,011	221	1.38	12,419	103	0.83	28,430	324	1.14
Liabilities to banks under sale and repurchase agreements	11,779	189	1.60	260	9	3.46	12,039	198	1.64
Customer deposits	370,831	6,110	1.65	22,989	527	2.29	393,820	6,637	1.69
Liabilities to customers under sale and repurchase agreements	4,658	47	1.01	5	–	–	4,663	47	1.01
Debt securities in issue	136,842	2,617	1.91	12,595	426	3.38	149,437	3,043	2.04
Other interest-bearing liabilities	31,443	2,798	8.90	–	–	–	31,443	2,798	8.90
Subordinated liabilities	37,537	2,783	7.41	–	–	–	37,537	2,783	7.41

Total interest-bearing liabilities of banking book	609,101	14,765	2.42	48,268	1,065	2.21	657,369	15,830	2.41
Total interest-bearing liabilities of trading book	37,533	501	1.33	–	–		37,533	501	1.33
Total interest-bearing liabilities	646,634	15,266	2.36	48,268	1,065	2.21	694,902	16,331	2.35
Interest-free liabilities									
Non-interest bearing customer accounts	28,989			1,050			30,039		
Other interest-free liabilities	178,527			21,772			200,299		
Minority interests and shareholders' funds	33,504			12,304			45,808		
Total average liabilities and interest expense	887,654	15,266	1.72	83,394	1,065	1.28	971,048	16,331	1.68
Percentage of liabilities applicable to foreign activities (%)							7.68		

[1] Restated – see note 1 on page F-11.

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2011[1]	Domestic Average balance £m	Interest income £m	Yield %	Foreign Average balance £m	Interest income £m	Yield %	Total Average balance[1] £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	63,572	488	0.77	17,429	140	0.80	81,001	628	0.78
Loans and advances to customers	534,384	21,657	4.05	59,768	2,293	3.84	594,152	23,950	4.03
Debt securities	17,683	578	3.27	933	12	1.29	18,616	590	3.17
Available-for-sale financial assets	29,092	848	2.91	5,213	38	0.73	34,305	886	2.58
Held-to-maturity investments	7,958	262	3.29	–	–	–	7,958	262	3.29
Total interest-earning assets of banking book	652,689	23,833	3.65	83,343	2,483	2.98	736,032	26,316	3.58
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,640	1,998	3.35	3,778	203	5.37	63,418	2,201	3.47
Total interest-earning assets	712,329	25,831	3.63	87,121	2,686	3.08	799,450	28,517	3.57
Allowance for impairment losses on loans and advances	(7,557)			(11,991)			(19,548)		
Non-interest earning assets	192,661			8,225			200,886		
Total average assets and interest income	897,433	25,831	2.88	83,355	2,686	3.22	980,788	28,517	2.91
Percentage of assets applicable to foreign activities (%)							8.50		

	Domestic Average balance £m	Interest expense £m	Cost %	Foreign Average balance £m	Interest expense £m	Cost %	Total Average balance[1] £m	Interest expense £m	Cost %
Liabilities and shareholders' funds									
Deposits by banks	24,751	190	0.77	2,997	32	1.07	27,748	222	0.80
Liabilities to banks under sale and repurchase agreements	16,399	261	1.59	137	6	4.38	16,536	267	1.61
Customer deposits	350,762	5,754	1.64	14,656	326	2.22	365,418	6,080	1.66
Liabilities to customers under sale and repurchase agreements	7,554	68	0.90	18	–	–	7,572	68	0.90
Debt securities in issue	203,340	4,420	2.17	24,157	625	2.59	227,497	5,045	2.22
Other interest-bearing liabilities	19,242	(219)	(1.14)	–	–	–	19,242	(219)	(1.14)
Subordinated liabilities	33,918	2,155	6.35	–	–	–	33,918	2,155	6.35
Total interest-bearing liabilities of banking book	655,966	12,629	1.93	41,965	989	2.36	697,931	13,618	1.95
Total interest-bearing liabilities of trading book	26,407	479	1.81	–	–	–	26,407	479	1.81
Total interest-bearing liabilities	682,373	13,108	1.92	41,965	989	2.36	724,338	14,097	1.95
Interest-free liabilities									

Non-interest bearing customer accounts	30,606			913			31,519		
Other interest-free liabilities	153,947			26,266			180,213		
Minority interests and shareholders' funds	30,507			14,211			44,718		
Total average liabilities and interest expense	897,433	13,108	1.46	83,355	989	1.19	980,788	14,097	1.44
Percentage of liabilities applicable to foreign activities (%)							7.39		

[1] Restated – see note 1 on page F-11.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CHANGES IN NET INTEREST INCOME – VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between volume and rate for 2013 compared with 2012 and for 2012 compared with 2011. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2013 compared with 2012[1] Increase/(decrease)			2012[1] compared with 2011 Increase/(decrease)		
	Total change £m	Volume £m	Rate £m	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
Loans and receivables:						
Loans and advances to banks	(146)	(43)	(103)	(25)	166	(191)
Loans and advances to customers	(1,672)	(1,074)	(598)	(2,350)	(1,804)	(546)
Debt securities	(401)	(106)	(295)	(157)	(455)	298
Available-for-sale financial assets	122	143	(21)	(262)	(60)	(202)
Held-to-maturity investments	(288)	–	(288)	26	65	(39)
Total banking book interest receivable and similar income	(2,385)	(1,080)	(1,305)	(2,768)	(2,088)	(680)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	(333)	(67)	(266)	208	256	(48)
Total interest receivable and similar income	(2,718)	(1,147)	(1,571)	(2,560)	(1,832)	(728)
Interest payable						
Deposits by banks	(195)	(56)	(139)	102	8	94
Liabilities to banks under sale and repurchase agreements	(139)	(149)	10	(69)	(74)	5
Customer deposits	(518)	81	(599)	557	479	78
Liabilities to customers under sale and repurchase agreements	(27)	(10)	(17)	(21)	(29)	8
Debt securities in issue	(1,592)	(496)	(1,096)	(2,002)	(1,590)	(412)
Other interest bearing liabilities	293	(708)	1,001	3,017	1,086	1,931
Subordinated liabilities	173	(261)	434	628	268	360
Total banking book interest payable	(2,005)	(1,599)	(406)	2,212	148	2,064
Total interest payable on trading and other liabilities at fair value through profit or loss	(182)	2	(184)	22	149	(127)
Total interest payable	(2,187)	(1,597)	(590)	2,234	297	1,937

[1] Restated – see note 1 on page F-11.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK OVERVIEW

EFFECTIVE RISK MANAGEMENT, GOVERNANCE AND CONTROL

Managing risk effectively is important for any bank and fundamental to the Group's strategy. The Group is now a more efficient, low risk, UK focused retail and commercial bank. This has been achieved by maintaining a conservative business model which embodies a risk culture founded on a prudent appetite for risk.

The Group's approach to risk is founded on an effective control framework and a strong risk management culture which guides how Group employees approach their work, the way they behave and the decisions they make. The amount and type of risk that the Group is prepared to seek, accept or tolerate, otherwise known as risk appetite, works in tandem with its strategy and is approved by the Board. Risk appetite is then embedded within policies, authorities and limits across the Group.

All narrative and quantitative tables on pages 45 to 138 are unaudited unless otherwise stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

RISK AS A STRATEGIC DIFFERENTIATOR

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

Risks are identified, managed and mitigated using the Risk Management Framework (see pages 46 to 47). The principal risks the Group faces, which could significantly impact the delivery of its strategy, are discussed on pages 48 to 49.

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

- **Sustainable growth**
  The role of risk is to support the business in delivering sustainable growth, which is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

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

- **Strong control framework**
  This framework is the foundation for the delivery of effective risk management as it ensures appropriate engagement in developing risk appetite and that business units operate within approved parameters.

- **Effective risk analysis, management and reporting**
  This identifies opportunities as well as risks and ensures risks are managed appropriately and consistently with strategy. The Group's principal risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This enables us to understand the risk in the business at both an individual risk type and aggregate portfolio level.

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

ACHIEVEMENTS IN 2013

Underlying Impairment

Impairment charge improved by 47 per cent to £3,004 million, mainly driven by the reduction in assets outside of the Group's risk appetite and the sustained improvement in Group asset quality.

Complaints

During 2013 banking complaints fell to 1.0 per 1,000 accounts (excluding PPI), compared with 1.5 at the end of 2011, and 2.4 at the start of 2010. The 2014 reduction target was met and exceeded by September 2013.

Loan to deposit ratio

The Group's funding position remains strong with an improved loan to deposit ratio of 113 per cent, from 121 per cent at 31 December 2012.

Credit ratings

Credit ratings reflected the progress the Group had made on delivery of its strategy. During 2013 both Fitch and Standard & Poor's upgraded Lloyds Bank's standalone rating to bbb+, therefore affirming its long-term credit rating at A.

Improved capital position

The Group's common equity tier 1 (CET1) capital position has continued to build to 10.3 per cent on an estimated adjusted fully loaded CRD IV basis.

Reduction of assets outside the Group's risk appetite

The Group made substantial capital accretive reductions of assets outside its risk appetite during the year and the full year 2014 target of holding less than £70 billion of these assets was achieved.

State aid commitments

In line with strengthening the balance sheet, the Group continued its commitment to reduce its assets and met the target in December 2012, two years ahead of the mandated completion date. In May 2013, the Group received formal confirmation from the European Commission that the Group was released from this commitment.

Risk transformation

The Risk Transformation Programme has driven the clarity on where risk allocates transformational investment funding in order to deliver the most efficient and effective returns for the Group. This has ensured that the investments made deliver the benefits required and underpin the Group's targeted objective of sustainable growth.

PRIORITIES FOR 2014

– **Deliver the strategic plan**
  Underpin the Group's strategy to be the best bank for customers and support sustainable growth in the UK economy.

– **Customer focus**
  Put customers at the heart of the Group's business through a clear conduct led approach and a strong understanding of all the Group's stakeholders, supported by the codes of responsibility, applied to both current activities and historic legacy issues.

– **Operational agility**
  Evolve risk into an agile, flexible function that supports the business in its next phase of growth with effective working across the Group.

RISK GOVERNANCE

Risk management strategy and risk appetite are developed and reviewed in tandem with Group strategy. The Group uses an enterprise wide risk management framework to ensure a robust and consistent approach to risk management is applied across all business areas and all risk types in order to drive improvements in its risk profile in line with risk appetite.

The framework articulates individual and collective accountabilities for risk management, risk oversight and risk assurance and supports the discharge of responsibilities to customers, shareholders and regulators. It establishes a common risk language which assigns risks to which the Group is exposed into categories which are used consistently to support risk aggregation and reporting. It will evolve and be periodically updated to reflect any changes in the nature of the Group's business and the external environment.

The framework outlines the key risk management activities undertaken consistently across the Group for all types of risk.

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

The Group's approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions. Board-level engagement, coupled with the direct involvement of senior management in Group wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required. The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management. A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management. Performance is optimised by allowing business units to operate within approved parameters.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The most significant risks faced by the Group which could impact on the success of delivering against the Group's strategic objectives together with key mitigating actions are outlined below.

PRINCIPAL RISKS

CREDIT RISK

As a provider of credit facilities to personal and commercial customers, together with financial institutions and sovereigns, any adverse changes in the economic and market environment the Group operates in, or the credit quality and/or behaviour of the Group's borrowers and counterparties would reduce the value of the Group's assets and increase the Group's write-downs and allowances for impairment losses, adversely impacting profitability.

KEY MITIGATING ACTIONS

– Credit policy incorporating prudent lending criteria aligned with the Board approved risk appetite to effectively manage credit risk.

– Clearly defined levels of authority ensure the Group lend appropriately and responsibly with separation of origination and sanctioning activities.

– Robust credit processes and controls including well-established committees to ensure distressed and impaired loans are identified, considered and controlled with independent credit risk assurance.

CONDUCT RISK

As a major financial services provider the Group faces significant conduct risk, including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; and exhibiting behaviours which do not meet market or regulatory standards.

– Customer focused conduct strategy implemented to ensure customers are at the heart of everything the Group does.

– Product approval, review processes and outcome testing supported by conduct management information.

– Clearer customer accountabilities for colleagues, including rewards with customer-centric metrics.

– Learn from past mistakes, including root cause analysis.

MARKET RISK

The Group faces a number of key market risks including interest rate risk across the Banking and Insurance businesses. However, its most significant market risk is from the Defined Benefit Pension Schemes where asset and liability movements impact on its capital position.

– A rates hedging programme is in place to reduce liability risk.

– Board approved pensions risk appetite covering interest rate, credit spreads and equity risks.

– Credit assets and alternative assets are being purchased by the pension schemes as equities are sold.

– Stress and scenario testing.

OPERATIONAL RISK

The Group faces a number of key operational risks including fraud losses and failings in the Group's customer processes. The availability, resilience and security of the Group's core IT systems is the most significant.

– Continually review IT system architecture to ensure systems are resilient, readily available for the Group's customers and secure from cyber attack.

– Implement actions from IT resilience review conducted in 2013 to reflect enhanced demands on IT, both in terms of customer and regulator expectations.

FUNDING AND LIQUIDITY RISK

The Group's funding and liquidity position is supported by a significant and stable customer deposit base. However, a deterioration in either the Group's or the UK's credit rating or a sudden and significant withdrawal of customer deposits would adversely impact the Group's funding and liquidity position.

– Hold a large pool of liquid primary assets to meet cash and collateral outflows.

– Maintain a further large pool of secondary assets which can be used to access Central Bank liquidity facilities.

– Stress test the Group's liquidity position against a range of scenarios.

CAPITAL RISK

The Group's future capital position is potentially at risk from adverse financial performance and the introduction of higher capital requirements for distinct risks, sectors or as a consequence of a specific UK regulatory requirement. For example in 2013, the PRA introduced significant additional capital requirements on a PRA-adjusted basis that major UK banks are required to meet.

- Close monitoring of actual capital ratios to ensure that the Group complies with current regulatory capital requirements and are well positioned to meet future requirements.
- Internal stress testing results to evidence sufficient levels of capital adequacy for the Group under various scenarios.
- The Group can accumulate additional capital in a variety of ways including raising equity via a rights issue or debt exchange and by raising tier 1 and tier 2 capital.

REGULATORY RISK

Due to the nature of the industry the Group operates in it has to comply with a complex and demanding regulatory change agenda. Regulatory initiatives the Group has been working on in 2013 include CRD IV, Mortgage Market Review, Dodd-Frank and Foreign Account Tax Compliance Act 2010. The sanctions for failing to comply far outweigh the costs of implementation.

- The Legal, Regulatory and Mandatory Change Committee ensures the Group drives forward activity to develop plans for regulatory changes and track progress against those plans.
- Continued investment in the Group's people, processes and IT systems is enabling us to meet its regulatory commitments.

STATE AID

HM Treasury currently holds 32.7 per cent of the Group's share capital. The Group continues to operate without government interference in day-to-day management decisions, however there is a risk that a change in government priorities could result in the current framework agreement being replaced, leading to interference in the operations of the Group. Failure to meet the EU State aid commitments arising from this government support could lead to sanctions.

- Most EU State aid commitments now met with the divestment of the rebranded (TSB) retail banking business outstanding.
- Now progressing the divestment of TSB through an Initial Public Offering subject to regulatory and European Commission approval, to ensure best value for the Group's shareholders and certainty for its customers and colleagues.
- The divested business, rebranded TSB, has operated as a separate business within Lloyds Banking Group since September 2013.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT CHARGE	**ASSET QUALITY RATIO**[1]	**COMMENTARY** Through asset reduction and effective risk management of both existing and new business, the Group has seen sustained improvements in credit quality and reduction in impairments.	– Continue to support the UK economy through appropriate lending to SMEs and first-time buyers.
BANKING COMPLAINTS PER 1,000 ACCOUNTS[1] **(EXCL. PPI)**		**COMMENTARY** The Group is continuing its journey to embed the conduct strategy and be the industry leader for complaints performance.	– Continued reduction in complaint levels and improvements in complaints handling.
PENSIONS DEFICIT		**COMMENTARY** Volatility in the Defined Benefit Pension Schemes is reducing as the Group targets rates hedging and equity sales.	– Continue to effectively manage the Defined Benefit Pension Scheme to secure pensions provisions to members and minimise the impact on the Group.
AVAILABILITY OF CORE SYSTEMS		**COMMENTARY** Through effective control activities interruptions to customer service and operational losses for 2013 have remained within the Board approved appetite limits.	– Increased investment in IT resilience. – Risk appetite monitoring for critical business processes.
PRIMARY LIQUIDITY/ WHOLESALE FUNDING <1 YR MATURITY	**LOAN TO DEPOSIT RATIO**[1]	**COMMENTARY** The primary and secondary liquidity assets provide a substantial buffer in the event of an extended market dislocation. The Group continued to see an improvement in its loan to deposit ratio.	– Continue to meet all current regulatory ratios and ensure the Group meet all future regulatory ratios. – Further reduction of the loan to deposit ratio.
CRD IV FULLY LOADED CET1 RATIO[1]	**RISK-WEIGHTED ASSETS (PREVAILING RULES)**	**COMMENTARY** Significant progress has been made in strengthening the balance sheet and capital position through the Group's strongly capital generative strategy.	– Implement remaining asset run-off and disposals to be net capital accretive. – Expect, prior to any dividend, to generate fully loaded CET1 capital of

around 2.5 percentage points over the next 2 years.

LEGAL, REGULATORY AND MANDATORY INVESTMENT SPEND	**COMMENTARY** The Group continues to build constructive relationships with its regulators in order to effectively manage the regulatory change agenda.	– Ongoing constructive engagement with regulators. – Continued compliance with the regulatory change agenda.
GOVERNMENT SHAREHOLDING	**COMMENTARY** The Group continues to work closely with the European Commission, HM Treasury, PRA, FCA and the Monitoring Trustee appointed by the European Commission to ensure the successful implementation of the Restructuring Plan and mitigate customer impact.	– TSB will be divested through an Initial Public Offering, subject to regulatory and European Commission approval. – Continue to support the government in the process of returning the Group back to private ownership.

[1] These key risk indicators are also key performance indicators (KPIs).
[2] Adjusted basis.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT

Risk Management is at the heart of the Group's strategy to become the best bank for customers.

The mission for Risk Division is to support the business in delivering sustainable growth. This is achieved through informed risk decision making and superior risk and capital management, supported by a consistent risk-focused culture across the Group.

The Risk Overview (pages 45 to 49) provides a summary of Risk Management within the Group. It highlights the important role of risk as a strategic differentiator, risk achievements in 2013 and priorities for 2014 along with a brief overview of the Group's risk governance structure and the principal risks faced by the Group and key mitigating actions.

The Risk Management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's appetite for risk (page 50), emerging risks (pages 52 to 53), approach to stress testing, risk governance and committee structure (pages 53 to 58) and a full analysis of the primary risk drivers (pages 59 to 134) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk driver is described and managed using the following standard headings: definition, appetite, exposure, measurement, mitigation and monitoring.

THE GROUP'S APPROACH TO RISK

The Group operates a prudent approach to risk with rigorous management controls to keep the Group safe, support sustainable business growth and minimise losses within risk appetite. The Group has a strong and independent risk function (Risk Division) with a mission to maintain a robust control framework, identify and escalate emerging risks and support sustainable business growth within risk appetite through good risk reward decisioning.

RISK CULTURE

The Board ensures that senior management implements risk policies and risk appetites that either limit or, where appropriate, prohibit activities, relationships and situations that could be detrimental to the Group's risk profile.

The Group has a conservative business model embodied by a risk culture founded on a prudent approach to managing risk. The Group refreshed its Codes of Business and Personal Responsibility in 2013 reinforcing its approach where colleagues are accountable for the risks they take and the needs of customers are paramount.

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

RISK APPETITE

- The Group defines risk appetite as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate.'
- The Group's strategy operates in tandem with its high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2013. This incorporated recommendations from the Non-Executive Directors and is fully aligned with Group strategy.
- Risk appetite is embedded within principles, policies, authorities and limits across the Group.
- Risk appetite will continue to evolve to reflect external market developments and the composition of the Group.

GOVERNANCE AND CONTROL

- Governance is maintained through delegation of authority from the Board down through the management hierarchy, supported by a committee-based structure designed to ensure open challenge and that the Group's risk appetite, principles, policies, procedures, controls and reporting are fully in line with regulations, law, corporate governance and industry good-practice.
- Board-level engagement, coupled with the direct involvement of senior management in Group wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated where required.
- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.
- A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.

–The Group optimises performance by allowing business units to operate within approved risk appetite and limits.
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RISK DECISION MAKING AND REPORTING

- Taking risks which are well understood, consistent with strategy and with appropriate margin is a key driver of shareholder value.
- Risk analysis and reporting supports the identification of opportunities as well as risks.
- An aggregate view of the Group's overall risk profile, key risks and management actions, and performance against risk appetite, is reported to and discussed monthly at the Group Risk Committee (and as a subset at the Group Asset and Liability Committee), with regular reporting to the Board Risk Committee and the Board.
- Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.
- The Chief Risk Officer regularly informs the Board Risk Committee (BRC) of the aggregate risk profile and has direct access to the Chairman and members of the Board Risk Committee. The Chief Risk Officer was appointed to the Board on 29 November 2013.

Table 1.1: **Exposure to risk arising from the business activities of the Group**

The table below provides a high level guide to the how the Group's business activities are reflected in its risk measures and balance sheet.

1 As a separate regulated entity with its own Board, the Insurance Division maintains its own regulatory risk capital and liquidity requirements, including appropriate management buffers. The Insurance Division operates within the Group's overall risk framework against agreed risk appetites, with Risk Division, represented by the Insurance Divisional Risk Officer, and Group Audit providing assurance to both the Insurance Board and Group Board through the respective risk and audit committees.

2 Predominantly relates to various non-financial assets, including fixed assets, cash, items in the course of collection, prepayments, sundry debtors and deferred tax assets; the RWAs for which are reported within credit risk for regulatory capital purposes.

PRINCIPAL RISKS

The Group's principal risks are shown in the Risk Overview (pages 48 to 49). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk drivers are on pages 59 to 134.

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EMERGING RISKS

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group.

COMPETITION

Interventions by the competition authorities in response to a return to profitability or to perceived or actual market inefficiencies could change the competition landscape and possibly impact market structures and margins. This risk is underlined by the creation of the new Competition and Markets Authority and the introduction of a competition mandate for the FCA.

Key mitigating actions

- Implementation of the Group's Conduct Strategy, applying value for money principles, and ensuring that the customer is at the heart of the Group's business planning.
- The Group is working with the FCA on using behavioural economics and customer trials to improve customer outcomes.
- Application of the risk management framework to competition risks across the Group.

EVOLUTION OF CONDUCT EXPECTATIONS

The Consumer Credit regulatory regime is in a period of transition and will be transferred from the Office of Fair Trading (OFT) to the FCA in April 2014 to complement its current mandate. It is possible that the FCA will adopt a different approach and apply a wide range of enforcement powers.

Key mitigating actions

- Rigorous implementation of Conduct Strategy across the Group.
- Proactive regulatory advice and challenge to be applied across the Group.
- Programmes in place to deliver redress for customers where identified.

– Continue work to prepare for the FCA approach on consumer credit regulation.

RING-FENCING AND RESOLUTION PLANNING

Ring-fencing legislation and final rules on Resolution Planning will impact the Group's strategy and the capacity/cost to serve customers effectively. The dimensions of the ring-fence may challenge the Group's future shape and the scope of its activities while an effective Resolution Plan may prompt structural change in order to make the Group more resolvable in a crisis. Without a robust Resolution Plan, the Group could face higher costs of capital/liquidity.

Key mitigating actions

– Ongoing engagement with HM Treasury, PRA and the BoE on the evolving UK regulatory framework, and impact of EU Directives.
– Coordinated scenario analysis and planning through the Ring-Fencing and Resolution Programme under GEC sponsorship.

– Mobilisation of resources across the Group to assess impacts and propose potential responses aligned to Group strategy.

EVOLVING REQUIREMENTS ON CAPITAL

While there is now greater clarity on regulatory capital requirements, there remains some uncertainty as UK and European regulatory frameworks continue to evolve. For example, in 2013, the PRA introduced significant additional capital requirements on a PRA-adjusted basis that major UK banks are required to meet. Areas of uncertainty include the calibration of the leverage ratio in the UK, evolving CRD IV technical standards and potential changes to the calculation of capital requirements (i.e. risk-weighted assets).

Key mitigating actions

– The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group.
– The Group has strong governance, processes and controls which, combined with the Group's proactive management of risk, result in an appropriate level of capital.

TECHNOLOGY

Internet and mobile technologies are changing customer behaviour, leading to changes in the banking model. Major changes in payments are also expected over next two to five years. The cyber risk landscape has continued to evolve over the last 18 months.

Key mitigating actions

- Increased focus on digital, demonstrated by the creation of the 'Digital, Marketing and Customer Development' function.
- IT resilience improvement programme following the 2013 review.
- Development of customer focused IT risk appetite and refreshed cyber strategy with refined risk appetite.

CULTURE

A cultural change is needed in banking to restore trust, with greater evidence of genuinely client-centred behaviour and enterprise-wide management of risks.

Key mitigating actions

- Further embedding and implementation of the Group's Risk Management Framework.
- Continuing work to embed a strong, customer-centric and robust risk culture, alongside wider Group Cultural Transformation activities.

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- Engagement in Chartered Banker: Professional Standards Board and roll out of the Foundation Standards and planning for the Leadership Standards.
- Assessment of Group actions against the findings of the Barclay's Salz Review and response to the various components of the Banking Reform Act.

SCOTTISH INDEPENDENCE

The impact of a 'yes' vote in favour of Scottish independence is uncertain. The outcome could have a material impact on compliance costs, the tax position, and cost of funding for the Group.

Key mitigating actions

- Monitoring and assessment of the potential impact on the Group's business and impact on customers of a vote in favour of Scottish independence.

STRESS TESTING

OVERVIEW

Stress testing is recognised as an essential risk management tool within the Group by the Board, senior management, the businesses and the risk and finance functions. Stress testing is embedded in the planning process of the Group and is applied to the base case plan. This allows senior management and Board to assess the base case plan in adverse circumstances and to adjust strategies/propose mitigating actions if the plan does not meet risk appetite in a stressed scenario. A rigorous review and challenge process ensures that senior management are actively involved in stress testing.

The Group uses scenario stress testing to:

- Provide an assessment of strategic plans against Board Risk Appetite, alongside a comparison of portfolio performance in adverse circumstances against risk appetite limits, to ensure the Group is managed within risk appetite.
- Drive the development of potential actions and contingency plans to mitigate the impacts of adverse scenarios. Stress testing also links directly to the Group's recovery planning process.
- Support the Internal Capital Adequacy Assessment Process (ICAAP) and setting of Individual Capital Guidance (ICG).

– Meet the standards required and information needs of internal and external stakeholders, including regulators.

At least on an annual basis, the Group conducts a detailed macroeconomic stress testing exercise based on the five year operating plan, which is supplemented with higher-level refreshes of the stress testing exercise when necessary. The exercise aims to highlight the key vulnerabilities of the Group to adverse changes in the economic environment and to ensure that there are adequate financial resources in the event of a downturn. The exercise includes a range of economic scenarios, including the 'PRA Anchor Scenarios' (these are the PRA's published supervisory recommended scenarios for the UK, details of which are publically available on the Bank of England's website). Ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requirements. The Group also takes part in regular external, industry-wide stress testing exercises, such as those run by the European Banking Authority and will take part in the forthcoming UK-wide Bank of England stress testing exercise.

In addition to the running of macroeconomic scenarios, the Group's stress testing programme involves undertaking assessment of operational risk scenarios, liquidity scenarios, financial market disruption scenarios, market risk sensitivities, reverse stress testing and business specific scenarios (see relevant risk section for further information on risk specific level stress testing). This provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

METHODOLOGY

The Chief Economist's Office develops the macroeconomic scenarios to be used by the Group. Internal scenarios are developed based on key uncertainties for the economic outlook. A wide set of economic parameter assumptions is constructed, with over 150 metrics provided such as Gross Domestic Product, Base Rate, Unemployment, Property Indices, Insolvencies, Corporate Failures to facilitate modelling of scenarios across the Group. Where an external scenario is provided, the Chief Economist's Office broadens the supplied parameter to the level of detail required by the Group.

The stress tests at all levels must comply with all legal and regulatory requirements, and are put through a rigorous review and challenge process. This is supported by analysis and insight into impacts on customers and business drivers. The engagement of all required risk and control areas is built into the preparation process, so that the appropriate analysis of each risk drivers' impact upon the business plans are understood and documented.

The methodologies and modelling approach used for stress testing ensures that a clear link is shown between the macro-economic scenarios, the business drivers for each area and the resultant stress testing outputs. All material assumptions used in modelling are documented and justified, with a clearly communicated review and sign off process. Modelling is supported by expert judgement is subject to the Group Risk Model Governance Policy.

Below is an overview of the principal output responsibilities by team.

- Finance teams in the business prepare and review finance related stress testing results including, but not limited to, income, margins, costs, lending and deposit volumes.
- Credit Risk and Market Risk teams prepare and review risk-related stress outputs, including, but not limited to, impairment charges, risk-weighted assets, expected loss, probability of default, loss given default and trading losses.
- The Central Group Stress testing team which sits in Risk Division reviews the finance and risk stress submissions and produces a consolidated Group view of the results, including analysis packs for the Group's senior committees.

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The Group Capital and Regulatory Reporting team, supported by Group Corporate Treasury, reviews all capital related stress outputs, including the calculation of indicative capital ratios. The Group Corporate Treasury team also reviews the stress outputs from divisions and evaluates the impact upon the Group's Capital and Funding Plan.

REVERSE STRESS TESTING

Reverse stress testing is used to explore the vulnerabilities of the Group's strategies and plans to extreme adverse events, and to help improve contingency planning. The scenarios used in such a stress test are those that would cause a failure in the business model. Where reverse stress testing reveals plausible scenarios with an unacceptably high risk when considered against the Group's risk appetite, the Group will undertake measures to prevent or mitigate that risk, which are then reflected in strategic plans.

GOVERNANCE

Clear accountabilities and responsibilities for stress testing are assigned to senior management and the risk and finance functions throughout the Group. This is formalised through the Business Planning and Stress Testing Policy and Procedure, which are reviewed at least annually.

The Group Financial Risk Committee (GFRC), chaired by the Chief Risk Officer, is the Committee that has primary responsibility for overseeing the development and execution of the Group's stress tests.

The main economic assumptions developed by the Chief Economist's Office are reviewed and challenged at Group Risk Committee (GRC), Group Executive Committee (GEC) and Board Risk Committee (BRC), and approved by the Board before being cascaded across the Group.

The stress test outputs go through a rigorous review and challenge process at divisional level, including sign-off by the divisional Finance Directors and Risk Directors. The outputs are then presented to GFRC, GRC and BRC for review and challenge, before being approved by the Board.

RISK GOVERNANCE

The Group's Risk Management Framework (RMF) provides a robust and consistent approach to risk management across the Group in order to drive its risk profile in line with risk appetite. It articulates individual and collective accountabilities for risk management, risk oversight and risk assurance; supports the discharge of responsibilities to customers, shareholders and regulators; and establishes a common risk language which assigns the risks to which the Group is exposed into categories which are used consistently to support risk aggregation and reporting.

The risk governance structure below is integral to implementing the RMF across the Group and by ensuring risk is appropriately represented on key committees ensures that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and Risk Division to the Group Executive Committee (GEC) and Board. Conversely, strategic direction and guidance is cascaded down from the Board and GEC.

TABLE 1.2: **RISK GOVERNANCE STRUCTURES**

The components of the RMF can be found in the Risk Overview on page 47.

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BOARD, EXECUTIVE AND RISK COMMITTEES

The Group's risk governance structure (see table 1.2) strengthens risk evaluation and management, while also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 164 to 185, for further information on Board committees.

The Insurance Division, as a separate regulated entity, has its own Board and governance structure. The Insurance Board, assisted by a Risk Oversight Committee and Audit Committee, approves the governance, risk and control frameworks for insurance and insurance risk appetite, ensuring it aligns with the Group's framework and risk appetite.

TABLE 1.3: **EXECUTIVE AND RISK COMMITTEES**

Committees	Risk focus
Group Executive Committee	
Group Executive Committee (GEC)	Supports the Group Chief Executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, while also reviewing the Group's aggregate risk exposures and concentrations of risk.
The Group Executive is supported by:	
Group Risk Committee	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, material Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/reward returns and approves material risk models.
Group Asset and Liability Committee	Responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
Executive Compensation Committee	Provides governance and oversight for Group wide remuneration matters and policies.
Group Executive Committee Members' Committees	
Group Product Governance Committee	Provides strategic and senior oversight over design, launch and management of products including new product approval, annual product reviews and management of risk in the back book.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC, the Group Individual Liquidity Adequacy Assessment and Internal Capital Adequacy Assessment Process submissions,

	the Group Recovery Plan, and the annual stress testing of the Group's operating plan based on internal and PRA recommended scenarios, annual European Banking Authority stress tests, and other Group wide macroeconomic stress tests.
Group Rectification Committee	Ensures appropriate control and oversight of material events which have a customer impact.

The Group Risk Committee is supplemented by the following committees to ensure effective oversight of risk management:

Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Group Operational Risk Committee	Responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group's operational risk management framework.
Group Compliance and Conduct Risk Committee	Responsible for monitoring and challenging the Group's compliance and conduct risk management framework, aggregated compliance and conduct risk profile, and its alignment with agreed risk appetite.
Group Financial Crime Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than material models which are approved by the Group Risk Committee. This also meets PRA requirements regarding the governance and approval for Internal Ratings Based models.

HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

RISK MANAGEMENT IN THE BUSINESS

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

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

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

RISK MANAGEMENT FRAMEWORK (RMF)

The RMF (see Risk Overview, page 47) is structured around nine components which meet and align with the industry-accepted internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

Role of the Board and senior management – key responsibilities of the Board and senior management include:

– setting risk appetite and approval of the RMF;
– approval of Group-wide risk principles and policies;
– the cascade of delegated authority (e.g. to Board sub-committees and the Group Chief Executive);
– effective oversight over risk management consistent with the risk appetite.

Risk appetite – the business plan is aligned to the Risk Appetite Statement so that the Group's short and medium-term business objectives match its risk tolerances which are translated into relevant risk limits for business units.

Governance frameworks – the Board-approved frameworks set out key principles for the overall management of risk in the organisation, aligned with Group strategy and risk appetite; based on a current and comprehensive risk profile that identifies all material risks to the organisation. These Governance Frameworks are underpinned by a hierarchy of policies that is coherent, consistent, and accessible.

Three Lines of Defence model – the RMF is implemented through a 'Three Lines of Defence' model which defines clear responsibilities and accountabilities and ensures effective independent assurance activities take place covering key decisions.

– Business lines (first line) have primary responsibility for risk decisions, measuring, monitoring and controlling risks within their areas of accountability. They are required to establish effective governance, and control frameworks for their business compliant with Group Policy requirements, to maintain appropriate risk management skills, mechanisms and toolkits, and to act within Group Risk Appetite parameters set and approved by the Board.

– Risk Division (second line) is a centralised function providing oversight and independent challenge to the effectiveness of risk decisions taken by business management, providing advice and guidance reviewing, challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.

– Group Audit (third line) provides independent, objective assurance and consulting activity designed to add value and improve the organisation's operations. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Mandate of the Risk Division – the objective of Risk Division is to provide both expert advice and review and challenge to the business. It also has a key role in promoting the implementation of a strategic approach to risk management reflecting the risk appetite and RMF agreed by the Board that encompasses:

– embedded and effective risk management processes;
– transparent and focused risk monitoring and reporting;
– provision of expert and high quality advice and guidance to the Board, Executives and Management on strategic issues and horizon scanning for pending regulatory changes; and
– provision of a constructive working environment in which Risk Division is trusted and respected, and promotes a constructive dialogue with the first line through advice, development of common methodologies, understanding, education, training, and development of new tools.

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

The Chief Risk Officer is accountable for developing and leading an industry-wide recognised Risk function that adds value to the Group by:

- providing a regular comprehensive view of the Group's risk profile, key risks both current and emerging, and management actions;
- (with input from the business areas and Risk Division) proposing Group Risk Appetite to the Board for approval, and oversighting performance of the Group against Risk Appetite;
- developing an effective RMF meeting regulatory requirements for approval by the Board, and oversighting execution and compliance; and
- challenging management on emerging risks and providing expert risk and control advice to help management maintain an effective risk and control framework.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk directors

- provide independent advice, oversight and challenge to the business;
- design, develop and maintain policies, specific risk frameworks and guidance to ensure alignment with business imperatives and regulatory requirements;
- establish and maintain appropriate governance structures, culture, oversight and monitoring arrangements which ensure robust and efficient compliance with relevant risk-type risk appetites and policies;
- lead regulatory liaison on behalf of the Group including horizon scanning and regulatory development for their risk type; and
- set risk appetite and oversight of the associated risk profile across the Group.

Risk identification, measurement and control – the process for risk identification, measurement and control is integrated into the overall framework for risk governance. Risk identification processes are forward-looking to ensure emerging risks are identified. Risks are captured in comprehensive risk logs/registers, and measured using robust and consistent quantification methodologies. The measurement of risks includes the application of sound stress testing and scenario analysis, and considers whether relevant controls are in place before risks are incurred.

Risk monitoring, aggregation and reporting – identified risks are logged and reported on a monthly basis or as frequently as necessary to the appropriate committee. The extent of the risk is compared to the overall risk appetite as well as specific limits or triggers. When thresholds are breached, committee minutes are clear on the actions and timeframes required to resolve the breach and bring risk within given tolerances. There is a clear process for escalation of risks.

Culture – supporting the formal frameworks of the RMF is the underlying culture, or shared behaviours and values, which sets out in clear terms what constitutes good behaviour and good practice. In order to effectively manage risk across the organisation, the functions encompassed within the Three Lines of Defence have a clear understanding of risk appetite, business strategy and an understanding of (and commitment to) the role they play in delivering it. A number of levers are used to reinforce the risk culture, including tone from the top, governance and role definition, capability development, performance management and reward.

Resources and capabilities – appropriate mechanisms are in place to avoid over-reliance on key personnel or system/technical expertise within the Group. Adequate resources are in place to deal with customers both under normal working conditions and in times of stress, and monitoring procedures are in place to ensure that the level of available resource can be increased if required. Colleagues undertake appropriate training to ensure they have the skills and knowledge necessary to enable them to deliver fair outcomes for customers, being mindful of the Group’s

Conduct Strategy, Customer Treatment Policy/Standards and Financial Conduct Authority requirements.

There is ongoing investment in risk systems and models alongside the Group's investment in customer and product systems and processes. This drives improvements in risk data quality, aggregation and reporting leading to effective and efficient risk decisions.

INDEPENDENT CHALLENGE

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FULL ANALYSIS OF RISK DRIVERS

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. A detailed description of each category is provided below.

PRIMARY RISK DRIVERS

[1] The Group considers these to be principal risks. See Risk Overview pages 48 to 49 for further details.

SECONDARY RISK DRIVERS

CREDIT RISK

DEFINITION

Credit risk is defined as the risk that parties with whom the Group has contracted fail to meet their obligations (both on and off-balance sheet).

RISK APPETITE

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

This statement of the Group's overall appetite for credit risk is reviewed and approved annually by the Board.

With the support of the Group Risk Committee, the Group Chief Executive allocates this risk appetite across the Group.

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 54 on page F-113. Credit risk exposures are categorised as 'retail', arising primarily in the Retail and Wealth, Asset Finance and International divisions, 'commercial' and 'corporate', 'financial institutions' or 'sovereigns' arising in the Commercial Banking and Wealth, Asset Finance and International divisions.

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

Loans and advances, contingent liabilities, commitments, debt securities and derivatives also expose the Group to refinance risk. Refinance risk is the possibility that an outstanding exposure cannot be repaid at its contractual maturity date. If the Group does not wish to refinance the exposure then there is refinance risk if the obligor is unable to repay by securing alternative finance. This may be because the borrower is in financial difficulty, or because the terms required to refinance are outside acceptable market appetite at the time. Refinance risk exposures are managed in accordance with the Group's existing credit risk policies, processes and controls, and are not considered to be material given the Group's prudent and through the cycle credit risk appetite. Where refinance risk exists (such as in the interest only retail mortgage portfolio and the Commercial Banking book outside the Group's risk appetite) exposures are minimised through intensive account management and are impaired where appropriate.'

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2013 is shown on page F-41. 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. Such amounts are reflected in note 54 on page F-113.

Credit risk exposures in the Insurance business largely result from holding fixed income assets in the shareholder funds (including the annuity portfolio) and from exposure to reinsurers. Second order credit risk exposure exists within the unit-linked funds, through the value of future fee income, and with-profits funds, through any guarantees.

Credit risk exposure also arises in the Group's defined benefit pension schemes from holding investments. Note 41 on page F-63 provides further information on the defined benefit schemes' assets and liabilities.

MEASUREMENT

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components: (i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

For regulatory capital purposes the Group's rating systems assess probability of default and if appropriate, exposure at default and loss given default, in order to derive an expected loss. If not appropriate, regulatory prescribed exposure at default and loss given default values are used in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes. Note 2(H) on page F-16 provides details of the Group's approach to the impairment of financial assets.

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

The models vary, inter alia, in the extent to which they are point in time versus through the cycle. The models are subject to rigorous validation and oversight/governance including, where appropriate, benchmarking to external information.

In commercial portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' through local scales to a single Corporate (non-retail) Master Scale comprising of 19 non-default ratings. Together with 4 default ratings the Corporate Master Scale forms the basis on which internal reporting is completed.

In its principal retail portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis combined, where appropriate, with external data and subject matter expert judgement.

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

Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Group models, is delegated to the Group Model Governance Committee.

MITIGATION

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

Internal control

Credit principles and policy: Risk Division sets out the credit principles and policy according to which credit risk is managed. Principles and policies are reviewed regularly, and any changes are subject to a review and approval process. Policies, where appropriate, are supported by lending guidelines, which also define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. These policies and lending guidelines define chosen target market and risk acceptance criteria. Risk Division also use early warning indicators to help anticipate future areas of concern and allow the Group to take early and proactive mitigating actions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Oversight and reviews are also undertaken by Group Audit and Credit Risk Assurance.

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

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual limit guidelines. Credit policy is aligned to the Group's risk appetite and restricts exposure to higher risk countries and more vulnerable sectors and segments. Note 20 on page F-45, provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk and single name concentrations. 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 certain minimum policy and/or guideline requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

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

Specialist expertise: Credit quality is managed and controlled by a number of specialist units within Risk Division providing, for example: intensive management and control (see Intensive care of customers in financial difficulty); security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Stress testing and scenario analysis: The Group's credit portfolios are also subjected to regular stress testing, with stress scenario assessments run at various levels of the organisation from Group led exercises to individual divisions/portfolios exercises. For further information on the stress testing process, methodology and governance refer to page 53.

Credit risk assurance and review: A specialist team within Group Audit, comprising experienced credit professionals, is in place to perform credit risk assurance. This team carries out independent risk based internal control audits and credit quality reviews, providing an assessment of the effectiveness of internal controls, risk management practices, credit risk classification, as well as the accuracy of impairment provisions. These audits and reviews cover the diverse range of the Group's businesses and activities, and include both 'standard' risk based audits and reviews as well as bespoke assignments to respond to any emerging risks or regulatory requirement. The work of Group Audit therefore continues to provide executive and senior management (and Audit Committee) with assurance and guidance on credit quality, effectiveness of credit risk controls and Business Support Unit (BSU) work out strategies, as well as accuracy of impairments.

Credit risk assurance within Commercial Banking is also undertaken by Commercial Risk Assurance. Commercial Risk Assurance is an independent credit risk oversight function operating within Commercial Banking Risk, part of the Group's second line of defence, while Group Audit performs third line of defence assurance.

Additional mitigation for retail customers (lending to individuals in Retail and Wealth, Asset Finance and International divisions)

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using information held by credit reference agencies (CRA). The Group also assesses the affordability of the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral.

Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

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

For UK mortgages, the Group's policy is to reject all standard applications with a LTV greater than 90 per cent. Applications with a LTV up to 95 per cent are permitted for certain schemes, for example Help to Buy and Lend a Hand. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

Table 1.4: **Loan to value analysis**

Loan size From	**To**	**Maximum LTV**
£1	£600,000	95%
£600,001	£750,000	90%
£750,001	£1,000,000	85%
£1,000,001	£2,000,000	80%
£2,000,001	£5,000,000	70%

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

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

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

The Group uses credit scorecards for decision making, both at an application stage and throughout the credit lifecycle. The scorecards are developed in-house using a variety of data sources. These sources include the customer's application for credit (for example, number of dependants, address and loan term); data held internally by the Group (for example, other account holdings and the performance of these other accounts); public information (for example, electoral roll data and County Court Judgments, bankruptcies); and CRA data (for example, performance of credit lines with other lenders and applications for credit to other lenders). The selection of data characteristics and the weightings associated with the characteristics are determined by the Group in accordance with industry-recognised standards for scorecard development. Scorecards are approved and monitored in accordance with Group Model Governance policies.

The Group has developed over 60 scorecards, which are currently in use, based on product and customer segment. The scorecard cut-offs are determined based on the inherent risk of the product / segment, the product pricing and the Group's appetite for the risk of the product / customer segment for which the scorecard has been developed; no direct comparison can be made against scorecards developed by other lenders or external providers.

The United Kingdom has a number of credit reference agencies which, as well as providing lenders with data, have also developed commercially-available credit scores to lenders and consumers. However, unlike the US, there is no dominant provider of credit scores and significantly less consumer awareness of these scores. The Group does not base its lending decisions on these commercially-available scores and instead uses the scorecards developed in-house, as detailed above.

Additional mitigation for commercial customers

Individual credit assessment and independent sanction: With the exception of low exposures on SME customers where relationship managers have some limited delegated sanctioning authority, credit risk in commercial customer portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities and limit guidelines. Approval requirements for each decision are based on a number of factors including the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting is generally the same as that for assets intended to be held over the period to maturity.

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

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

Collateral

The principal collateral types for loans and advances, contingent liabilities and derivatives with commercial counterparties/customers are:

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

The Group maintains appetite 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 bills are generally unsecured, with the exception of asset-backed securities and similar instruments such as covered bonds, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

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

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

Refer to note 54 on page F-113 for further information on collateral.

Master netting agreements

Where it is appropriate and likely to be effective, the Group seeks to enter into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes 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 this is the net position of all trades under the master netting agreement.

Other credit risk transfers

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

MONITORING

In conjunction with Risk Division, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular

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portfolio monitoring reports for review by senior management. Risk Division in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to the GRC and the BRC.

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

Intensive care of customers in financial difficulty

The Group operates a number of treatments to assist borrowers who are experiencing financial stress. The material elements of these treatments through which the Group has granted a concession, whether temporarily or permanently, are set out below and in note 54 on page F-113.

Retail customers

The Group's aim in offering forbearance and other assistance to retail customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and by bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes. The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance and the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

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

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

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

- Reduced contractual monthly payment: a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example temporary interest only arrangements and short-term payment holidays granted in collections. Any arrears existing at the commencement of the arrangement are retained.
- Reduced payment arrangements: a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay.
- Term extensions: a permanent account change for customers in financial distress where the overall term of the mortgage is extended, resulting in a lower contractual monthly payment.
- Repair: a permanent account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

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

- Income Support for Mortgage Interest – This is a government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the government. Payments are made directly to the Group by the appropriate government department.
- Mortgage Rescue Scheme – This is a government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

Commercial customers

Early identification, control and monitoring are key in order to support the customer and protect the Group. All non-retail loans and advances in Commercial Banking are reviewed at least annually by the independent Risk Division (and more frequently where required). As part of the Group's established Credit Risk Classification system, every loan and advance in the good book is categorised as either ‘good’ or ‘watchlist’. This complements the Group’s risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. All watchlist names are reviewed by the business and Risk Division at least once a month, and the classification is updated if required. This process seeks to ensure that relationship managers act promptly to identify, and highlight to senior management those customers who have the possibility to become higher risk in the future.

It is Group policy that where forbearance has been granted for a commercial customer, it must be managed either within the Group’s good book watchlist Credit Risk Classification framework or within a BSU. Any concession requested by a customer is reviewed and must be approved by the independent Risk Division. If approved and Risk Division determines that the customer is in financial difficulty, then any off market concession granted is treated as forbearance and the loan reviewed monthly. Any event that causes concern over future payments from the customer is likely to result in the asset being assessed for impairment and, if required, an impairment allowance recognised. If impairment is identified, the customer is immediately transferred to BSU and will be treated as an impaired asset. If no impairment is identified, the Risk Division will determine if the customer should remain in the good book (categorised as watchlist), or transfer to BSU for more intensive monitoring.

Customers requiring intensive care are transferred at an early stage to one of the Group's BSUs (or Customer Support for smaller Commercial Banking small and medium-sized enterprises with debt facilities below £1 million). The over-arching aim of the BSU is to provide support and work with each customer to try and resolve the issues, to restore the business to a financially viable position and thereby bring about a business turnaround. This may involve debt restructuring and forbearance.

Cases in BSU or outside the Group's risk appetite are managed by case officers who are part of the independent Risk Division. They are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and close scrutiny by senior management. Risk is minimised through a combination of appropriate work-out strategies, such as asset/loan sales and debt restructuring.

A detailed assessment is undertaken by the specialist risk team for cases in BSU or outside of the Group's risk appetite to assist in reducing risk exposure and to highlight potential strategic options. A range of information is required to fully appraise and understand the customer's business, cashflow (and therefore debt serviceability) and will involve the Group, in addition to using its own internal sector experts, engaging professional advisers to perform asset valuations, strategic reviews and where applicable independent business reviews. The assessment may also involve:

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

The above assessment, monitoring and control processes continue throughout the period the case is managed within the BSU. All the analysis performed around cash flows is used to determine appropriate impairment provisions.

The Group's accounting policy for loan renegotiations and forbearance is set out in note 2 on page F-12.

Income statement information set out in the credit risk tables is on an underlying basis (see page 27).

THE GROUP CREDIT RISK PORTFOLIO IN 2013

Overview

- Impairment charge decreased by 47 per cent to £3,004 million in the year to 31 December 2013, continuing the improvement seen in 2012. The impairment charge has decreased across all divisions.

- The impairment charge as a percentage of average loans and advances to customers improved to 0.57 per cent compared to 1.02 per cent at 31 December 2012.

- Impaired loans as a percentage of closing advances reduced to 6.3 per cent at 31 December 2013, from 8.6 per cent at 31 December 2012, driven by improvements in Retail and Commercial Banking portfolios.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.5: **Impairment charge by division**

	2013 £m	2012 £m	Change %
Retail	1,101	1,270	13
Commercial Banking	1,167	2,946	60
Wealth, Asset Finance and International	730	1,480	51
Central items	6	1	
Total impairment charge	3,004	5,697	47
Impairment charge as a % of average advances	0.57%	1.02%	(45)bp

Table 1.6: **Total impairment charge**

	2013 £m	2012 £m	Change %
Loans and advances to customers	2,988	5,654	47
Debt securities classified as loans and receivables	1	15	93
Available-for-sale financial assets	15	37	59
Other credit risk provisions	–	(9)	
Total impairment charge	3,004	5,697	47

Table 1.7: **Movement in gross impaired loans**

	2013 £m
At 1 January	46,293
Classified as impaired during the year	9,552
Transferred to not impaired during the period	(3,054)
Repayments	(1,603)
Amounts written off	(9,520)
Impact of disposal of businesses and asset sales	(9,377)
Exchange and other movements	(32)
At 31 December	32,259

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.8: **Impairments on loans and advances**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as % of closing advances %	Impairment **provisions**[1] **£m**	Impairment provision as % of **impaired loans**[2] **%**
At 31 December 2013					
Retail	344,673	7,187	2.1	2,050	32.5
Commercial Banking	132,602	14,714	11.1	6,415	43.6
Wealth, Asset Finance and International	31,450	10,358	32.9	7,242	69.9
Reverse repos and other items	2,779	–		–	
Total gross lending	511,504	32,259	6.3	15,707	50.1
Impairment provisions	(15,707)				
Fair value adjustments[3]	(516)				
Total Group (audited)	495,281				

1 Impairment provisions include collective unimpaired provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding retail unsecured loans in recoveries (£881 million).

3 The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated expected lives of the related assets (until 2014 for wholesale loans and 2018 for retail loans) although if an asset is written-off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £512 million for the period ended 31 December 2013. The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written-off, and will reduce to zero over time.

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as % of closing advances %	Impairment provisions[1] £m	Impairment provision as % of impaired loans[2] %
At 31 December 2012					
Retail	346,560	8,320	2.4	2,335	32.5
Commercial Banking	144,770	23,965	16.6	9,984	41.7

Wealth, Asset Finance and International	42,927	14,008	32.6	9,453	67.5
Reverse repos and other items	5,814	–		–	
Total gross lending	540,071	46,293	8.6	21,772	48.2
Impairment provisions	(21,772)				
Fair value adjustments[3]	(1,074)				
Total Group (audited)	517,225				

1 Impairment provisions Include collective unimpaired provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding Retail unsecured loans in recoveries (£1,129 million).

3 The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated expected lives of the related assets (until 2014 for wholesale loans and 2018 for retail loans) although if an asset is written-off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £868 million for the period ended 31 December 2012. The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written-off, and will reduce to zero over time.

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Table 1.9: **Derivative credit risk exposures**

Notional balances	Traded on recognised exchanges £bn	Traded over the counter Settled by central counterparties £bn	Not settled by central counterparties £bn	Total £bn
At 31 December 2013				
Foreign exchange	–	11	422	433
Interest rate	234	3,881	926	5,041
Credit	–	–	7	7
Equity and other	4	–	15	19
Total	238	3,892	1,370	5,500

The fair value of derivatives settled by central counterparties was a net liability of £419 million, comprising assets of £3,220 million and liabilities of £3,639 million.

The fair value of derivatives not settled by central counterparties was £2,344 million, comprising assets of £28,808 million and liabilities of £26,464 million.

Credit risk – Retail

Overview

- The Retail impairment charge decreased by 13 per cent to £1,101 million primarily driven by a reduction in impaired loans in the secured portfolio.

- The Retail impairment charge, as an annualised percentage of average loans and advances to customers, improved to 0.32 per cent in 2013 from 0.36 per cent in 2012.

- The overall value of assets entering arrears in 2013 was lower in both unsecured and secured lending compared to 2012.

Table 1.10: **Retail impairment charge**

	2013 £m	2012 £m	Change %
Secured	253	377	33
Unsecured	848	893	5

Total impairment charge	1,101	1,270	13
Impairment charge as a % of average advances	0.32%	0.36%	(4)bp

Impaired loans and provisions

Retail impaired loans decreased by £1,133 million to £7,187 million compared with 31 December 2012 and, as a percentage of closing loans and advances to customers, decreased to 2.1 per cent from 2.4 per cent at 31 December 2012. Impairment provisions as a percentage of impaired loans (excluding unsecured loans in recoveries) are stable at 32.5 per cent.

Table 1.11: **Impairments on Retail loans and advances**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment **provisions**[1] £m	Impairment provisions as a % of impaired **loans**[3] %
At 31 December 2013					
Secured	323,107	5,641	1.7	1,472	26.1
Unsecured:					
Collections		665		578	86.9
Recoveries[2]		881		–	
	21,566	1,546	7.2	578	
Total gross lending	344,673	7,187	2.1	2,050	32.5
Impairment provisions	(2,050)				
Fair value adjustments	(673)				
Total	341,950				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

[3] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.
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	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[3] %
At 31 December 2012					
Secured	323,862	6,321	2.0	1,616	25.6
Unsecured:					
Collections		870		719	82.6
Recoveries[2]		1,129		–	
	22,698	1,999	8.8	719	
Total gross lending	346,560	8,320	2.4	2,335	32.5
Impairment provisions	(2,335)				
Fair value adjustments	(915)				
Total	343,310				

[1] Impairment provisions include collective unimpaired provisions.

[2] Recoveries assets are written down to the present value of future expected cash flows on these assets.

[3] Impairment provisions as a percentage of impaired loans are calculated excluding unsecured loans in recoveries.

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The Retail division's loans and advances to customers are analysed in the following table:

Table 1.12: **Retail loans and advances to customers**

	2013 £m	2012 £m
Secured:		
Mainstream	246,586	248,735
Buy to let	52,791	49,568
Specialist	23,730	25,559
	323,107	323,862
Unsecured:		
Credit cards	9,373	9,465
Personal loans	9,595	10,523
Overdrafts	2,598	2,710
	21,566	22,698
Total gross lending	344,673	346,560

Secured lending

Impairment

The impairment charge decreased by £124 million, to £253 million compared with 2012. The annualised impairment charge as a percentage of average loans and advances to customers was 0.08 per cent at 31 December 2013 compared to 0.12 per cent in 2012. Impairment provisions were £1,472 million at 31 December 2013 compared to £1,616 million at 31 December 2012. Impaired loans have fallen for four consecutive years and were £5,641 million at 31 December 2013 compared to £6,321 million at 31 December 2012. As a result of this continued trend in 2013, impairment provisions as a percentage of impaired loans increased to 26.1 per cent from 25.6 per cent at 31 December 2012.

The impairment provisions held against secured assets reflect the Group's view of appropriate allowance for incurred losses. The Group holds appropriate impairment provisions for customers who are experiencing financial difficulty, either on a forbearance arrangement or who may be able to maintain their repayments only whilst interest rates remain low.

Arrears

The value of mortgages greater than three months in arrears (excluding repossessions) decreased by £819 million to £8,818 million at 31 December 2013 compared to £9,637 million at 31 December 2012.

Table 1.13: **Mortgages greater than three months in arrears (excluding repossessions)**

	Number of cases		Total mortgage accounts %		**Value of loans[1]**		**Total mortgage balances %**	
	2013 Cases	2012 Cases	2013 %	2012 %	2013 £m	2012 £m	2013 %	2012 %
Mainstream	52,687	55,905	2.1	2.2	5,898	6,287	2.4	2.5
Buy to let	6,338	7,306	1.3	1.6	869	1,033	1.6	2.1
Specialist	11,870	13,262	7.3	7.6	2,051	2,317	8.6	9.1
Total	70,895	76,473	2.3	2.4	8,818	9,637	2.7	3.0

[1] Value of loans represents total book value of mortgages more than three months in arrears.

The stock of repossessions decreased to 2,229 cases at 31 December 2013 compared to 2,438 cases at 31 December 2012.

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Secured loan to value analysis

The average indexed loan to value (LTV) on the mortgage portfolio at 31 December 2013 decreased to 52.8 per cent compared with 56.4 per cent at 31 December 2012. The average LTV for new mortgages and further advances written in 2013 was 63.6 per cent compared with 62.6 per cent for 2012.

The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 5.2 per cent at 31 December 2013, compared with 11.7 per cent at 31 December 2012.

Table 1.14: **Actual and average LTVs across the Retail mortgage portfolios**

	Mainstream %	Buy to let %	**Specialist**[1] %	Total %
At 31 December 2013				
Less than 60%	37.0	20.4	20.1	33.1
60% to 70%	16.9	21.3	15.7	17.5
70% to 80%	19.8	26.0	19.3	20.8
80% to 90%	14.7	15.1	20.1	15.1
90% to 100%	7.1	11.1	14.3	8.3
Greater than 100%	4.5	6.1	10.5	5.2
Total	100.0	100.0	100.0	100.0
Average loan to value:[2]				
Stock of residential mortgages	49.5	66.9	66.2	52.8
New residential lending	63.6	64.0	**n/a**	63.6
Impaired mortgages	66.6	90.1	80.8	71.6

	Mainstream %	Buy to let %	Specialist[1] %	Total %
At 31 December 2012				
Less than 60%	31.9	12.8	14.7	27.6
60% to 70%	12.8	12.9	9.7	12.6
70% to 80%	18.3	26.2	17.2	19.4
80% to 90%	16.6	16.5	19.1	16.8
90% to 100%	10.5	15.4	18.5	11.9
Greater than 100%	9.9	16.2	20.8	11.7
Total	100.0	100.0	100.0	100.0
Average loan to value:[2]				
Stock of residential mortgages	52.7	73.6	72.6	56.4
New residential lending	62.3	64.5	n/a	62.6
Impaired mortgages	72.2	99.3	88.1	78.3

1 Specialist lending is closed to new business and is in run-off.

[2] Average loan to value is calculated as total loans and advances as a percentage of the total collateral of these loans and advances.

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Interest only mortgages

The Group provides interest only mortgages to customers, whereby payments made by the customer comprise of only interest for the term of the mortgage, with the customer responsible for repaying the principal outstanding at the end of the loan term. Retail has reduced its exposure to residential interest only mortgages throughout 2013. New residential interest only mortgages are limited to a maximum LTV of 75 per cent, with a verified repayment vehicle capable of repaying the loan. Interest only mortgages represented 0.5 per cent of new residential mortgages in 2013 (3.8 per cent in 2012).

Table 1.15: **Analysis of residential interest-only balances excluding Buy to Let mortgages**

	At 31 Dec 2013 £m	At 31 Dec 2012 £m
Interest only balances[1]	**108,504**	119,569
Impaired loans	**2,910**	3,221
Interest only balances as a % of total mortgage book	**41.0%**	44.6%
Average loan to value (%)	**55.2%**	58.9%

1 In addition the Group has Buy to Let interest only balances of £47,261 million (2012: £44,585 million) and certain other interest only balances of £4,750 million (2012: £6,046 million).

For existing interest only mortgages, a contact strategy is in place throughout the term of the mortgage to ensure that customers are aware of their obligation to repay the principal upon maturity of the loan. The weighted-average term to maturity of the interest only balances included in the table above is 13 years; mortgages totalling £12,003 million are due to mature in the next five years, with mortgages totalling £1,846 million due to mature in the next 12 months. Treatment strategies exist to help customers who may not be able to fully repay the full amount of principal balance at maturity. Of the residential interest only mortgages which have missed the payment of principal at the end of term, balances of £959 million remain at 31 December 2013 (£523 million at 31 December 2012). The average loan to value of these accounts is 27.3 per cent at 31 December 2013 (27.0 per cent at 31 December 2012). Of these accounts, 7.4 per cent are impaired (7.2 per cent at 31 December 2012).

Unsecured lending

Impairment

In 2013 the impairment charge on unsecured loans and advances to customers reduced by £45 million compared with 2012. The annualised impairment charge as a percentage of average loans and advances to customers increased to 3.80 per cent in 2013 from 3.73 per cent in 2012.

Impaired loans decreased by £453 million since 31 December 2012 to £1,546 million at 31 December 2013 which represented 7.2 per cent of closing loans and advances to customers, compared with 8.8 per cent at 31 December 2012. The reduction in impaired loans is a result of the Group's prudent risk appetite and ongoing effective portfolio management. Retail's exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers' changing financial circumstances.

Impairment provisions decreased by £141 million, compared with 31 December 2012. This reduction was driven by fewer assets entering arrears and recoveries assets being written down to the present value of future expected cash flows. Impairment provisions as a percentage of impaired loans in collections increased to 86.9 per cent at 31 December 2013 from 82.6 per cent at 31 December 2012.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK – COMMERCIAL BANKING

Overview

- Commercial Banking impairment charge decreased by 60 per cent to £1,167 million, driven by lower charges mainly in portfolios outside the Group's risk appetite, reflecting continued proactive management and deleveraging. As well as, reflecting better quality origination, together with higher releases in 2013 compared to the same period in 2012.
- The overall quality of the Commercial Banking portfolio remains good with the Group's prudent through the cycle approach to risk appetite, and the continuing low interest rate environment helping to maintain defaults at a relatively low level. New business is of good quality and better than the back book average.
- The impairment charge as a percentage of average loans and advances improved to 0.83 per cent from 1.85 per cent in 2012.

Table 1.16: **Commercial Banking impairment charge**

	2013 £m	2012 £m	Change %
Total impairment charge	**1,167**	2,946	60
Impairment charge as a % of average advances	**0.83%**	1.85%	(102)bp

Impaired loans and provisions

Commercial Banking impaired loans reduced substantially by 38.6 per cent to £14,714 million compared with 31 December 2012. As a percentage of closing loans and advances to customers, impaired loans reduced to 11.1 per cent from 16.6 per cent at 31 December 2012, despite a reducing portfolio. Impairment provisions as a percentage of impaired loans improved to 43.6 per cent from 41.7 per cent at 31 December 2012 driven by increased provisions made on a number of existing impaired connections and the disposal of impaired loans with lower coverage.

Table 1.17: **Impairments on loans and advances**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment **provisions** [1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2013					
Total Commercial Banking	132,602	14,714	11.1	6,415	43.6
Reverse repos	120				

Impairment provisions	(6,415)
Fair value adjustments	176
Total	126,483

[1] Includes collective unimpaired provisions of £523 million.

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	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions [1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Total Commercial Banking	144,770	23,965	16.6	9,984	41.7
Reverse repos	5,087				
Impairment provisions	(9,984)				
Fair value adjustments	(131)				
Total	139,742				

[1] Includes collective unimpaired provisions of £894 million.

Lending which is within the Group's risk appetite

At 31 December 2013 £112 billion of gross loans and advances to customers in the Commercial Banking portfolio are segmented across four different coverage segments as follows:

SME

SME serves business customers with turnover up to £25 million. Impaired loans decreased by £399 million to £2,271 million compared with £2,670 million at 31 December 2012. The impairment charge has reduced to £188 million in 2013 compared to £259 million in 2012 reflecting stable or improved portfolio credit quality across all key metrics.

The SME portfolio continues to grow within prudent and consistent credit risk appetite parameters with net lending increasing 6 per cent year-on-year. These results reflect the Group's continuing commitment to support the UK economy and government schemes such as Funding for Lending and Enterprise Finance Guarantee.

SME's control and monitoring activities have continued to play a fully effective role in identifying and supporting customers showing early signs of financial stress. As part of this, the Group's dedicated SME Business Support function continues to work with customers through their difficulties.

Mid Markets

Mid Markets serves business customers with turnover of £25 million to £750 million. The business remains predominantly UK-focused and is closely linked to the performance of the domestic economy. Impaired loans decreased by £261 million to £1,591 million compared with £1,852 million at 31 December 2012. The impairment charge has reduced to £157 million in 2013 compared to £238 million in 2012. Overall credit quality has remained stable during 2013.

The real estate business within the Group's Mid Markets portfolio is focused predominantly on unquoted private real estate portfolios. Credit quality continues to improve and the number of new non-performing customers continues to reduce. New business propositions are being written under robust policy parameters and in line with agreed risk appetite, with particular focus on cashflow. Tenant default is an area of potential focus particularly when the lending is supported by secondary or tertiary assets.

Global Corporates

Global Corporates is a coverage business operating across the UK, Europe and North America and is responsible for the overall management of relationships with major corporate clients. Impaired loans increased slightly by £37 million to £1,173 million compared with £1,136 million at 31 December 2012. The impairment charge has reduced to £75 million in 2013 compared to £195 million in 2012.

The portfolio related to trading companies continues to be predominantly investment grade focused; the overall portfolio asset quality remains good; and corporate balance sheets generally remain conservatively structured following a period of de-leveraging through the downturn.

The real estate business within the Group's Global Corporate portfolio is focused on the larger end of the UK property market with a bias to the quoted public listed companies and funds sector. Portfolio credit quality remains strong being underpinned by seasoned management teams with proven asset management skills generating predictable cash flows from their income producing portfolios.

Financial Institutions

Commercial Banking maintains relationships with a number of major UK and International Finance Institutions, which are predominantly investment grade rated. These relationships are either client focused or held to support the Group's funding, liquidity and general hedging requirements. The impairment charge in Financial Institutions remained low at £4 million.

Trading exposures continue to be predominantly short-term and/or collateralised with inter bank activity mainly undertaken with strong investment grade counterparties. While conditions in the Eurozone stabilized during 2013, the Group continues to adopt a conservative stance maintaining close portfolio scrutiny and oversight. Detailed contingency plans are in place and exposures to financial institutions domiciled in peripheral Eurozone countries are kept modest and managed within tight risk parameters. Overall, portfolio credit quality remains good and outlook is stable.

The majority of funding and risk management activity is transacted with investment grade counterparties including Sovereign central banks and much of it is on a collateralised basis, such as repos and swaps facing a Central Counterparty (CCP). Bilateral derivative transactions with Financial Institution counterparties are typically collateralised under a credit support annex in conjunction with the ISDA Master Agreement. The Group continues to consolidate its counterparty risk via CCP's as part of an ongoing move to reduce bilateral counterparty risk by clearing standardised derivative contracts.

Lending which is outside of the Group's risk appetite

The portfolio includes elements of the Corporate Real Estate and Specialist Finance portfolios which are classified as outside the Group's risk appetite.

Corporate Real Estate and other Corporate

Loans and advances to customers include the Corporate Real Estate Business Support Unit (BSU) portfolio which is outside the Group's risk appetite. Following successful asset reduction progress, this portfolio is now managed together with European assets and other Corporate assets previously disclosed as Other which are outside the Group's risk appetite.

The impairment charge in this portfolio fell to £522 million compared to £1,453 million in 2012. The fall in the impairment charge reflects lower gross charges on a reduced portfolio, favourable market movements on impaired derivatives and the continuing proactive management enabling some write backs on previously impaired loans.

The portfolio has reduced significantly ahead of expectations primarily due to the momentum on various deleveraging strategies including consensual asset sales by customers, loan sales and asset disposals which totalled £7.4 billion (net book value) in the year. The Corporate Real Estate BSU element of the portfolio which is outside the Group's risk appetite reduced from £15.7 billion to £8.9 billion during 2013 and there was considerable progress on the European exposure within this portfolio where loan balances fell from £3.7 billion to £0.7 billion.

Specialist Finance

Loans and advances to customers include the Acquisition Finance (leverage lending) portfolio which is outside the Group's risk appetite, and the Asset Based Finance portfolios (which include Ship Finance, Aircraft Finance and Infrastructure which are outside the Group's risk appetite). Total gross loans and advances reduced by £6.5 billion from £15.5 billion to £9.0 billion as at 31 December 2013 mainly due to disposals of £4.5 billion (net book value).

Ship Finance gross drawn lending (excluding leasing) totalled £1,074 million (net £965 million) as at 31 December 2013. This portfolio still suffers some stress due to volatile asset values and ongoing financial restructures. As a consequence, impairment charges are running at similar levels to those experienced in 2012, however continued strategic disposals through 2013 have materially de-risked the residual portfolio.

Secured loan to value analysis for UK Direct Real Estate lending

The Group classifies Direct Real Estate as exposure which is directly supported by cash flows from property activities, as opposed to trading activities (such as hotels, care homes and housebuilders). The Group manages its exposures to Direct Real Estate across a number of different coverage segments.

UK Direct Real Estate within the Group's risk appetite

Approximately three quarters of loans and advances relate to commercial real estate with the remainder mostly residential real estate. A large element of the residential exposure is to professional landlords in the Group's SME business where performance has been good. Approximately two thirds of the commercial real estate portfolio was originated under heritage Lloyds TSB credit risk criteria. The Group's risk appetite requires it to look first at the underlying cash flows as part of credit assessment, alongside key requirements for good quality counterparties and a well spread tenant profile.

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UK Direct Real Estate outside the Group's risk appetite

The Group considers this portfolio to be appropriately provided for after taking into account the value of the collateral held. In the case of impaired UK Direct Real Estate exposures (over £5 million) there is a net property collateral shortfall of approximately £0.1 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indexes, models and subject matter expert judgement. Loan to value ratios (indexed or actual if within last 12 months) for the Group's largest transactions (over £5 million) are detailed in the table below.

Table 1.18: **LTV – UK direct real estate**

	Loans and advances within the Group's risk appetite (gross)		Loans and advances outisde the Group's risk appetite (gross)	
	£m	%	£m	%
At 31 December 2013				
Exposures > £5 million:				
Less than 60%	4,444	42	437	7
61% to 70%	2,182	21	268	4
71% to 80%	1,159	11	145	2
81% to 100%	407	4	1,896	29
101% to 125%	385	4	766	12
More than 125%	571	5	2,961	46
Unsecured	1,342	13	23	–
	10,490	100	6,496	100
Exposures < £5 million	9,280		1,143	
Total	19,770		7,639	
At 31 December 2012[1]				
Exposures > £5 million:				
Less than 60%	3,722	35	703	7
61% to 70%	1,785	17	292	3
71% to 80%	2,028	19	886	9
81% to 100%	1,282	12	2,188	21
101% to 125%	393	4	1,398	14
More than 125%	563	5	4,405	43
Unsecured	849	8	332	3
	10,622	100	10,204	100
Exposures < £5 million	8,976		1,727	
Total	19,598		11,931	

[1] Restated to reflect a change in methodology from registered address of borrower to location of underlying collateral.

Acquisition (Leverage) Finance lending

Gross drawn lending in the Acquisition Finance portfolio within the Group's risk appetite totalled £2,128 million (net £2,111 million) as at 31 December 2013. The portfolio comprises leveraged financing facilities made available, predominantly, to UK borrowers owned by private equity sponsors. The majority of transactions have been structured in the past three years and all are in line with the Group's risk appetite. Refinancing risk is not considered a material issue for the portfolio due to the relatively young vintage of the book and conservative risk parameters.

Gross drawn lending in the Acquisition Finance portfolio outisde the Group's risk appetite totalled £836 million (net £667 million) as at 31 December 2013. Impairment charges in the Acquisition Finance portfolio which is outside the Group's risk appetie continue to decline significantly, reflecting further material reductions in the size of the portfolio and stabilising market conditions. Disposals of £1,566 million (net book value) were achieved during 2013.

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CREDIT RISK – WEALTH, ASSET FINANCE AND INTERNATIONAL

Overview

- The Wealth, Asset Finance and International impairment charge was £730 million in 2013, 51 per cent lower than 2012. The improvement was primarily driven by the Irish portfolio.
- In the Irish wholesale portfolios, 88.3 per cent (31 December 2012: 85.2 per cent) is now impaired with an impairment provisions as a percentage of impaired loans of 73.1 per cent (31 December 2012: 68.0 per cent), primarily reflecting continued deterioration in the Irish commercial property market. Net exposure in Ireland wholesale has fallen to £3.4 billion (31 December 2012: £5.4 billion).
- In the Irish retail mortgage portfolio, impairment provisions as a percentage of impaired loans decreased to 63.4 per cent (31 December 2012: 71.2 per cent), driven by the sale of a portfolio of non performing mortgages.

Table 1.19: **Impairment charge**

	2013 £m	2012 £m	Change 2012 %
Wealth	18	23	22
International:			
Ireland retail	(26)	108	
Ireland commercial real estate	219	739	70
Ireland corporate	415	398	(4)
Spain retail	17	51	67
Netherlands retail	17	23	26
Asia retail	(1)	35	
Latin America and Middle East	–	(33)	
	641	1,321	51
Asset Finance:			
United Kingdom	57	121	53
Australia	14	15	7
	71	136	48
Total impairment charge	730	1,480	51

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Impaired loans and provisions

Total impaired loans decreased by £3,650 million to £10,358 million compared with £14,008 million at 31 December 2012 and, as a percentage of closing loans and advances to customers, increased to 32.9 per cent from 32.6 per cent at 31 December 2012. This is primarily driven by reductions in Ireland wholesale.

Impairment provisions as a percentage of impaired loans increased to 69.9 per cent from 67.5 per cent at 31 December 2012. This increase was driven by the International portfolios.

Table 1.20: **Impairments on loans and advances**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions [1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2013					
Wealth	3,218	349	10.8	70	20.1
International:					
Ireland retail	5,944	1,002	16.9	638	63.7
Ireland commercial real estate	5,512	5,087	92.3	3,775	74.2
Ireland corporate	3,918	3,235	82.6	2,305	71.3
Spain retail	–	–		–	
Netherlands retail	5,478	86	1.6	45	52.3
Asia retail	1,645	109	6.6	39	35.8
Latin America and Middle East	23	17	73.9	24	
	22,520	9,536	42.3	6,826	71.6
Asset Finance:					
United Kingdom	5,712	473	8.3	346	73.2
Australia	–	–		–	
	5,712	473	8.3	346	73.2
Total gross lending	31,450	10,358	32.9	7,242	69.9
Impairment provisions	(7,242)				
Fair value adjustments	(19)				
Total	24,189				

[1] Impairment provisions include collective unimpaired provisions.

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	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions [1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Wealth	4,325	284	6.6	73	25.7
International:					
Ireland retail	6,656	1,534	23.0	1,111	72.4
Ireland commercial real estate	7,408	6,720	90.7	4,695	69.9
Ireland corporate	5,467	4,247	77.7	2,768	65.2
Spain retail	1,458	104	7.1	94	90.4
Netherlands retail	5,689	79	1.4	41	51.9
Asia retail	1,978	80	4.0	46	57.5
Latin America and Middle East	46	36	78.3	31	86.1
	28,702	12,800	44.6	8,786	68.6
Asset Finance:					
United Kingdom	5,848	885	15.1	541	61.1
Australia	4,052	39	1.0	53	
	9,900	924	9.3	594	64.3
Total gross lending	42,927	14,008	32.6	9,453	67.5
Impairment provisions	(9,453)				
Fair value adjustments	(28)				
Total	33,446				

[1] Impairment provisions include collective unimpaired provisions.

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INTERNATIONAL

Ireland

The Group continues to reduce its exposure to Ireland with gross loans and advances reducing by £4,157 million during 2013 mainly due to disposals, write-offs and net repayments.

Total impaired loans decreased by £3,177 million, or 25 per cent to £9,324 million compared with £12,501 million at 31 December 2012. The reduction was driven primarily by commercial real estate and corporate loans. Impaired loans as a percentage of closing loans and advances decreased to 60.6 per cent compared to 64.0 per cent at December 2012. Continuing weakness in the Irish real estate markets resulted in a further increase in Ireland wholesale coverage in 2013 to 73.1 per cent.

Impairment charges decreased by £637 million to £608 million compared to 2012. The impairment charge as an annualised percentage of average loans and advances to customers improved to 3.28 per cent from 5.53 per cent in 2012.

Ireland retail loans and advances to customers decreased to £5,944 million in 2013 from £6,656 million at 31 December 2012. Impaired loans as a percentage of loans and advances decreased to 16.9 per cent from 23.0 per cent at 31 December 2012. In the Irish retail mortgage portfolio impairment provisions as a percentage of impaired loans decreased to 63.4 per cent (from 71.2 per cent at 31 December 2012). These decreases have all been driven by the sale of a portfolio of non performing mortgages.

The most significant contribution to impaired loans in Ireland is the Commercial Real Estate portfolio. 92.3 per cent of the portfolio is now impaired compared to 90.7 per cent at 31 December 2012. The impairment provisions as a percentage of impaired loans increased in the year to 74.2 per cent from 69.9 per cent 31 December 2012 reflecting the continued deterioration in commercial real estate prices in Ireland.

Secured loan to value analysis – Ireland Retail Mortgages

The average loan to value (LTV) on the Irish mortgage portfolio decreased to 102.3 per cent at 31 December 2013 compared with 113.8 per cent at 31 December 2012. The percentage of loans and advances with an indexed LTV in excess of 100 per cent decreased to 53.8 per cent at 31 December 2013, compared with 63.1 per cent at 31 December 2012. The table below shows the LTV distribution of the retail mortgage portfolio.

Table 1.21: **Actual and average LTVs across the Ireland Retail mortgage portfolio**

	At 31 December 2013 Total %	At 31 December 2012 Total %
Less than 60%	15.3	11.7
60% to 70%	6.0	5.0
70% to 80%	7.5	5.9
80% to 90%	8.1	6.8
90% to 100%	9.3	7.5
Greater than 100%	53.8	63.1
Total	100.0	100.0
Average loan to value:		
Stock of residential mortgages	102.3	113.8
Impaired mortgages	104.7	123.5

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Commercial Real Estate lending in Ireland: secured loan to value analysis

Loan to value ratios (indexed or actual if within last 18 months) for the Group's largest transactions (over €5 million) are detailed in the table below. The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each transaction and the value of the collateral held. In the case of impaired Ireland commercial real estate exposures (over €5 million) there is a net property collateral shortfall of approximately £0.2 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. The Group makes use of a variety of methodologies to assess the value of property collateral where external valuations are not available. These include use of market indexes, models and subject matter expert judgement.

Table 1.22: **LTV – Ireland Wholesale Commercial Real Estate**

	At 31 December 2013		At 31 December 2012	
	£m	%	£m	%
Gross exposures > €5 million:				
Less than 60%	84	2	119	2
61% to 70%	11	–	20	–
71% to 80%	15	–	27	–
81% to 100%	88	2	165	3
101% to 125%	81	2	182	3
More than 125%	3,555	83	4,927	81
Unsecured	440	11	674	11
	4,274	100	6,114	100
Gross exposures < €5 million	1,238		1,294	
Total	5,512		7,408	

Other international

Total impaired loans decreased to £212 million at 31 December 2013 compared to £299 million at 31 December 2012, driven by the sale of the Spain retail portfolio. In the Netherlands impairment provisions as a percentage of impaired loans increased to 52.3 per cent from 51.9 per cent at 31 December 2012.

Asset Finance

United Kingdom: the impairment charge reduced by 53 per cent to £57 million (of which £43 million related to assets which are outside of the Group's risk appetite) compared with £121 million in 2012, driven by continued strong credit management and further improved credit quality. The retail portfolio saw fewer customers failing to meet their payment arrangements resulting in a lower proportion of people falling into arrears. The retail impairments also benefited from debt sale activity during the course of the year. The number of defaults in all areas of the commercial and corporate lending book was low relative to the last three years, reflecting effective previous and ongoing credit risk management actions.

Australia: the portfolio was fully disposed of in the second half of 2013.

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EXPOSURES TO EUROZONE COUNTRIES

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2013. The exposures comprise on-balance sheet exposures based on their balance sheet carrying values and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

Identified indirect exposure information is also taken into account when setting limits and determining credit risk appetite for individual counterparties. This forms part of the Group's credit analysis undertaken at least annually for counterparty and sector reviews, with interim updates performed as necessary. Interim updates would usually be triggered by specific credit events such as rating downgrades, sovereign events or other developments such as spread widening. Examples of indirect risk which have been identified are: European Banking groups with lending and other exposures to certain Eurozone countries; corporate customers with operations or significant trade in certain European jurisdictions; major travel operators known to operate in certain Eurozone countries; and international banks with custodian operations based in certain European locations.

The Group Financial Stability Forum (GFSF) monitors developments within the Eurozone, carries out stress testing through detailed scenario analysis and completes appropriate due diligence on the Group's exposures.

The GFSF has carried out a number of scenario analyses and rehearsals to test the Group's resilience in the event of further instability in certain Eurozone countries. The Group has developed and refined pre-determined action plans that would be executed in such scenarios. The plans set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

The Group has included certain amounts on a net basis to better reflect the overall risk to which the Group is exposed. The gross IFRS reported values for the exposures to Eurozone countries are detailed in the following tables. Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross IFRS basis and are disclosed based on the counterparty rather than the collateral (repos and stock lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Reverse repurchase exposures to institutional funds secured by UK gilts are excluded from all Eurozone exposures as detailed in the footnotes. Exposures to central clearing counterparties are shown net.

For multi-country asset backed securities exposures, the Group has reported exposures based on the largest country exposure. The country of exposure for asset backed securities is based on the location of the underlying assets which are predominantly residential mortgages not in the domicile of the issuer.

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Exposures to selected Eurozone countries

The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.23: **Selected Eurozone exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2013									
Ireland	–	–	30	392	177	3,851	5,308	116	9,874
Spain	6	5	554	116	23	1,857	41	24	2,626
Portugal	–	–	153	–	193	195	9	–	550
Italy	–	–	74	1	–	106	–	10	191
Greece	–	–	–	–	–	111	–	–	111
	6	5	811	509	393	6,120	5,358	150	13,352
At 31 December 2012									
Ireland	–	–	115	88	305	5,972	5,559	111	12,150
Spain	5	14	1,170	7	132	2,110	1,472	25	4,935
Portugal	–	–	118	–	224	187	10	–	539
Italy	5	–	44	–	10	150	–	37	246
Greece	–	–	–	–	–	277	–	–	277
	10	14	1,447	95	671	8,696	7,041	173	18,147

[1] Excludes reverse repurchase exposure to institutional funds domiciled in Ireland secured by UK gilts of £4,590 million (2012: £556 million) on a gross basis.

In addition to the exposures detailed above, the Group has the following exposures to sovereigns, financial institutions, asset backed securities, corporates and personal customers in the following Eurozone countries:

Table 1.24: **Other Eurozone Exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures	Cash at central banks	Banks £m	Other[1] £m	Asset backed securities	Corporate £m	Personal £m	Insurance assets	Total £m

	£m	£m			£m			£m	
At 31 December 2013									
Netherlands	–	8,683	741	188	216	2,025	5,434	798	18,085
France	–	–	1,425	17	42	3,199	115	1,017	5,815
Germany	174	1,831	1,107	495	442	1,613	–	721	6,383
Luxembourg	–	–	1	1,337	–	1,595	–	46	2,979
Belgium	–	–	700	1	–	582	–	53	1,336
All other Eurozone countries	127	–	5	–	–	306	–	172	610
	301	10,514	3,979	2,038	700	9,320	5,549	2,807	35,208
At 31 December 2012									
Netherlands	1	33,232	478	2	268	2,207	5,649	977	42,814
France	6	–	853	–	77	3,226	312	1,457	5,931
Germany	284	1,809	389	414	400	2,117	–	977	6,390
Luxembourg	–	2	–	752	–	1,841	–	71	2,666
Belgium	–	–	309	25	–	568	–	64	966
All other Eurozone countries	–	–	56	–	–	438	–	214	708
	291	35,043	2,085	1,193	745	10,397	5,961	3,760	59,475

[1] Excludes reverse repurchase exposure to institutional funds domiciled in Luxembourg secured by UK Gilts of £1,559 million (2012: £82 million) on a gross basis.

Total balances with other Eurozone countries have decreased from £59,475 million to £35,208 million. This is primarily due to a decrease in Dutch central bank balances. Derivatives with sovereigns and sovereign referenced credit default swaps are insignificant.

ENVIRONMENTAL RISK MANAGEMENT

The Group ensures appropriate management of the environmental impact of its lending activities. The Group wide Credit Risk principles require all credit risk to be incurred with due regard to environmental legislation and the Group’s Code of Business Responsibility.

Within Commercial Banking, an electronic environmental risk screening system has been the primary mechanism for assessing environmental risk in lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Identified risk sees the transaction referred to the Group's expert in-house Environmental Risk team for further review and assessment, as outlined below. Where required, the Group's panel of environmental consultants provide additional expert support.

The Group provides colleague training in environmental risk management as part of the standard suite of credit risk courses. Supporting this training, a range of online resource is available to colleagues and includes environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

The Group has been a signatory to the Equator Principles since 2006 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance Project-Related Corporate loans and Bridge loans. Further information is contained within the Group's Responsible Business Report.

Table 1.25: **Environmental risk management approach**

UK renewable energy policy

Over the past two years, the UK government has undertaken an Electricity Market Reform review, in line with its aim to introduce a more stable investment regime – Contract for Difference (CFD). Primary legislation for this was passed in December 2013, with secondary legislation likely to be passed by July 2014. From then on, the current Renewables Obligation will run alongside CFD through to 2017. At present, it appears that given the limited availability of commercially acceptable or bankable Power Purchase Agreements under the Renewable Obligation regime, independent generators are restricting their investment in the UK.

These market reforms are intended to encourage investment of around £200 billion by 2020 in projects designed to provide clean, secure, affordable energy. Clearly, UK and EU policy have impacts on the Group's customers. It influences the decisions they take about whether or not to invest in sustainable projects or initiatives. However, the Group's focus is on promoting the commercial benefits of sustainability to its customers. The Group is working with them and the UK government to help meet Britain's renewable energy objectives.

Renewable Energy Project Finance

As an active participant in the Project Finance Market, the Group is already playing a key role in finding solutions to current and future ‘green’ funding requirements. For example, at the end of 2013, the Group was involved in renewable energy projects across Britain, with a combined capacity of more than 3580MW.

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loan portfolio

In the following tables, where lending and the related impairment allowances are analysed between domestic and international, the classification as domestic or international is based on the location of the office recording the transaction, except for certain lending of the international business booked in London including the Group's lending in Ireland which, following the merger of Bank of Scotland (Ireland) Limited into Bank of Scotland plc, is held on the balance sheet of Bank of Scotland plc in the UK but is reported as international.

Analysis of loans and advances to banks and customers

The following table analyses loans and advances to banks and customers by category of loan at 31 December for each of the five years listed.

	2013 **£m**	2012[1] £m	2011 £m	2010 £m	2009 £m
Loans and advances to banks	**25,365**	32,760	32,620	30,292	35,510
Loans and advances to customers:					
Mortgages	**335,611**	337,879	348,210	356,261	362,667
Other personal lending	**23,230**	28,334	30,014	36,967	42,958
Agriculture, forestry and fishing	**6,051**	5,531	5,198	5,558	5,130
Energy and water supply	**4,414**	3,321	4,013	3,576	3,031
Manufacturing	**7,650**	8,530	10,061	11,495	14,912
Construction	**7,024**	7,526	9,722	7,904	10,830
Transport, distribution and hotels	**22,294**	26,568	32,882	34,176	31,820
Postal and telecommunications	**2,364**	1,397	1,896	1,908	1,662
Financial, business and other services	**44,807**	49,190	64,046	59,363	66,923
Property companies	**44,277**	52,388	64,752	78,263	83,820
Lease financing	**4,435**	6,477	7,800	8,291	9,307
Hire purchase	**5,090**	5,334	5,776	7,208	8,710
Total loans	**532,612**	565,235	616,990	641,262	677,280
Allowance for impairment losses	**(11,966)**	(15,253)	(18,746)	(18,393)	(14,950)
Total loans and advances net of allowance for impairment losses	**520,646**	549,982	598,244	622,869	662,330

[1] Restated - see note 1 on page F-11.

Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013. The analysis of loans and advances at 31 December 2012, 2011, 2010 and 2009 between domestic and international offices is as follows:

	2012 £m	2011[1] £m	2010 £m	2009 £m
Domestic				
Loans and advances to banks	32,073	31,852	28,544	29,475
Loans and advances to customers:				
Mortgages	322,687	331,715	334,531	344,151
Other personal lending	26,119	28,244	34,610	40,790
Agriculture, forestry and fishing	5,482	5,010	5,429	4,829
Energy and water supply	1,773	1,689	1,583	1,141
Manufacturing	7,246	8,055	9,599	11,480
Construction	6,481	7,885	6,814	6,554
Transport, distribution and hotels	22,205	27,232	26,156	22,713
Postal and telecommunications	1,239	1,491	1,391	973
Financial, business and other services	44,616	56,721	49,931	58,132
Property companies	43,683	49,561	59,163	64,069
Lease financing	5,306	6,792	7,351	8,426
Hire purchase	4,970	5,237	6,319	7,671
Total loans	523,880	561,484	571,421	600,404
Allowance for impairment losses	(7,076)	(8,025)	(9,786)	(10,785)
Total loans and advances net of allowance for impairment losses	516,804	553,459	561,635	589,619

[1] Restated - see note 1 on page F-11.

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	2012 £m	2011 £m	2010 £m	2009 £m
Foreign				
Loans and advances to banks	687	768	1,748	6,035
Loans and advances to customers:				
Mortgages	15,192	16,495	21,730	18,516
Other personal lending	2,215	1,770	2,357	2,168
Agriculture, forestry and fishing	49	188	129	301
Energy and water supply	1,548	2,324	1,993	1,890
Manufacturing	1,284	2,006	1,896	3,432
Construction	1,045	1,837	1,090	4,276
Transport, distribution and hotels	4,363	5,650	8,020	9,107
Postal and telecommunications	158	405	517	689
Financial, business and other services	4,574	7,325	9,432	8,791
Property companies	8,705	15,191	19,100	19,751
Lease financing	1,171	1,008	940	881
Hire purchase	364	539	889	1,039
Total loans	41,355	55,506	69,841	76,876
Allowance for impairment losses	(8,177)	(10,721)	(8,607)	(4,165)
Total loans and advances net of allowance for impairment losses	33,178	44,785	61,234	72,711

	2012 £m	2011[1] £m	2010 £m	2009 £m
Total				
Loans and advances to banks	32,760	32,620	30,292	35,510
Loans and advances to customers:				
Mortgages	337,879	348,210	356,261	362,667
Other personal lending	28,334	30,014	36,967	42,958
Agriculture, forestry and fishing	5,531	5,198	5,558	5,130
Energy and water supply	3,321	4,013	3,576	3,031
Manufacturing	8,530	10,061	11,495	14,912
Construction	7,526	9,722	7,904	10,830
Transport, distribution and hotels	26,568	32,882	34,176	31,820
Postal and telecommunications	1,397	1,896	1,908	1,662
Financial, business and other services	49,190	64,046	59,363	66,923
Property companies	52,388	64,752	78,263	83,820
Lease financing	6,477	7,800	8,291	9,307
Hire purchase	5,334	5,776	7,208	8,710
Total loans	565,235	616,990	641,262	677,280
Allowance for impairment losses	(15,253)	(18,746)	(18,393)	(14,950)
Total loans and advances net of allowance for impairment losses	549,982	598,244	622,869	662,330

[1] Restated - see note 1 on page F-11.

Summary of loan loss experience

The following table analyses the movements in the allowance for impairment losses on loans and advances to banks and customers for each of the five years listed.

	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Balance at beginning of year	15,253	18,746	18,393	14,950	3,594
Exchange and other adjustments	291	(380)	(369)	(7)	112
Disposal of businesses	(176)	–	–	–	–
Advances written off:					
Loans and advances to customers:					
Mortgages	(601)	(133)	(86)	(145)	(77)
Other personal lending	(1,437)	(2,267)	(2,617)	(3,344)	(3,063)
Agriculture, forestry and fishing	(11)	(45)	(11)	(47)	(5)
Energy and water supply	(102)	(77)	(48)	(36)	(28)
Manufacturing	(130)	(226)	(137)	(385)	(148)
Construction	(84)	(654)	(92)	(365)	(336)
Transport, distribution and hotels	(798)	(458)	(329)	(742)	(80)
Postal and telecommunications	(14)	(7)	(1)	–	(9)
Financial, business and other services	(1,030)	(1,071)	(1,120)	(881)	(308)
Property companies	(1,891)	(3,554)	(2,630)	(846)	(51)
Lease financing	(10)	(75)	(224)	(15)	(26)
Hire purchase	(121)	(130)	(192)	(160)	(69)
Loans and advances to banks	(3)	(10)	(6)	(111)	–
Total advances written off	(6,232)	(8,707)	(7,493)	(7,077)	(4,200)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	28	53	26	12	1
Other personal lending	408	757	326	176	107
Energy and water supply	–	–	–	4	–
Manufacturing	–	–	–	2	–
Construction	–	–	–	1	–
Transport, distribution and hotels	–	1	1	4	–
Financial, business and other services	–	–	–	1	2
Property companies	–	4	–	16	–
Lease financing	–	2	–	–	–
Hire purchase	20	26	68	–	–
Total recoveries of advances written off	456	843	421	216	110
Total net advances written off	(5,776)	(7,864)	(7,072)	(6,861)	(4,090)

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	2013	2012	2011	2010	2009
	£m	£m	£m	£m	£m
Effect of unwinding of discount recognised through interest income	(351)	(374)	(226)	(403)	(446)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	224	278	444	196	343
Other personal lending	920	881	1,669	3,431	4,314
Agriculture, forestry and fishing	–	54	27	20	29
Energy and water supply	95	71	105	17	105
Manufacturing	31	236	206	203	747
Construction	66	326	350	463	842
Transport, distribution and hotels	421	649	884	800	1,553
Postal and telecommunications	(3)	8	15	32	24
Financial, business and other services	552	824	1,464	1,293	1,913
Property companies	457	1,725	2,776	4,114	5,418
Lease financing	(26)	26	60	57	261
Hire purchase	(12)	47	20	101	234
Loans and advances to banks	–	–	–	(13)	(3)
Total allowances for impairment losses charged against income for the year	2,725	5,125	8,020	10,714	15,780
Total balance at end of year	11,966	15,253	18,746	18,393	14,950
Ratio of net write-offs during the year to average loans outstanding during the year	**1.1%**	1.4%	1.2%	1.1%	0.6%

The Group's impairment allowances in respect of loans and advances to banks and customers decreased by £3,287 million, or 22 per cent, from £15,253 million at 31 December 2012 to £11,966 million at 31 December 2013. This decrease resulted from a charge to the income statement of £2,725 million being more than offset by net advances written off of £5,776 million (advances written off of £6,232 million less recoveries of £456 million). The reduction in the charge to the income statement of £2,400 million, or 47 per cent, from £5,125 million in 2012 to £2,725 million in 2013 particularly reflects lower charges in Commercial Banking and in respect of the Group's Irish portfolio. The charge in Retail also fell, following a reduction in impaired lending in the secured portfolio. By category of lending, the most significant elements of the charge to the income statement were £457 million in respect of property companies and £920 million in respect of other personal lending. Of the net advances written off of £5,776 million, £1,029 million related to other personal lending, £1,030 million related to financial, business and other services and £1,891 million to property companies. The reducing level of write-offs compared to recent years reflects the fall in levels of impaired lending, particularly in Commercial Banking and in the Irish portfolio, as a result of improving credit quality and the impact of asset sales.

Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013. The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the years ended 31 December 2012, 2011, 2010 and 2009 between domestic and international offices is as follows:

Domestic	2012 £m	2011 £m	2010 £m	2009 £m
Balance at beginning of year	8,025	9,786	10,785	3,575
Exchange and other adjustments	(24)	68	42	171
Advances written off:				
Loans and advances to customers:				
Mortgages	(96)	(56)	(130)	(77)
Other personal lending	(2,258)	(2,605)	(3,322)	(3,062)
Agriculture, forestry and fishing	(11)	(8)	(8)	(5)
Energy and water supply	(68)	(48)	(16)	(28)
Manufacturing	(75)	(105)	(196)	(147)
Construction	(477)	(38)	(192)	(336)
Transport, distribution and hotels	(140)	(247)	(234)	(80)
Postal and telecommunications	(1)	(1)	–	(9)
Financial, business and other services	(919)	(894)	(827)	(308)
Property companies	(528)	(1,594)	(740)	(51)
Lease financing	(74)	(120)	(15)	(25)
Hire purchase	(129)	(57)	(160)	(69)
Loans and advances to banks	(10)	(6)	(111)	–
Total advances written off	(4,786)	(5,779)	(5,951)	(4,197)
Recoveries of advances written off:				
Loans and advances to customers:				
Mortgages	53	26	12	1
Other personal lending	751	326	176	107
Agriculture, forestry and fishing	–	–	–	–
Energy and water supply	–	–	–	–
Manufacturing	–	–	–	–
Construction	–	–	–	–
Transport, distribution and hotels	1	1	–	–
Postal and telecommunications	–	–	–	–
Financial, business and other services	–	–	–	1
Property companies	–	–	12	–
Lease financing	2	–	–	–
Hire purchase	26	68	–	–
Total recoveries of advances written off	833	421	200	109
Total net advances written off	(3,953)	(5,358)	(5,751)	(4,088)

operating and financial reView and prospects

Domestic	2012 £m	2011 £m	2010 £m	2009 £m
Effect of unwinding of discount recognised through interest income	(405)	(406)	(474)	(446)
Allowances for impairment losses charged against income for the year:				
Loans and advances to customers:				
Mortgages	32	24	(27)	275
Other personal lending	1,121	1,670	2,690	3,714
Agriculture, forestry and fishing	15	19	5	2
Energy and water supply	77	130	30	24
Manufacturing	81	110	78	544
Construction	221	168	318	593
Transport, distribution and hotels	289	298	217	717
Postal and telecommunications	–	(8)	31	19
Financial, business and other services	734	1,188	696	1,670
Property companies	776	287	1,059	3,685
Lease financing	37	48	26	198
Hire purchase	50	1	74	135
Loans and advances to banks	–	–	(13)	(3)
Total allowances for impairment losses charged against income for the year	3,433	3,935	5,184	11,573
Total balance at end of year – Domestic	7,076	8,025	9,786	10,785

operating and financial reView and prospects

Foreign	2012 £m	2011 £m	2010 £m	2009 £m
Balance at beginning of year	10,721	8,607	4,165	19
Exchange and other adjustments	(356)	(437)	(49)	(59)
Advances written off:				
Loans and advances to customers:				
Mortgages	(37)	(30)	(15)	–
Other personal lending	(9)	(12)	(22)	(1)
Agriculture, forestry and fishing	(34)	(3)	(39)	–
Energy and water supply	(9)	–	(20)	–
Manufacturing	(151)	(32)	(189)	(1)
Construction	(177)	(54)	(173)	–
Transport, distribution and hotels	(318)	(82)	(508)	–
Postal and telecommunications	(6)	–	–	–
Financial, business and other services	(152)	(226)	(54)	–
Property companies	(3,026)	(1,036)	(106)	–
Lease financing	(1)	(104)	–	(1)
Hire purchase	(1)	(135)	–	–
Loans and advances to banks	–	–	–	–
Total advances written off	(3,921)	(1,714)	(1,126)	(3)
Recoveries of advances written off:				
Loans and advances to customers:				
Mortgages	–	–	–	–
Other personal lending	6	–	–	–
Agriculture, forestry and fishing	–	–	–	–
Energy and water supply	–	–	4	–
Manufacturing	–	–	2	–
Construction	–	–	1	–
Transport, distribution and hotels	–	–	4	–
Postal and telecommunications	–	–	–	–
Financial, business and other services	–	–	1	1
Property companies	4	–	4	–
Hire purchase	–	–	–	–
Total recoveries of advances written off	10	–	16	1
Total net advances written off	(3,911)	(1,714)	(1,110)	(2)

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Foreign	2012 £m	2011 £m	2010 £m	2009 £m
Effect of unwinding of discount recognised through interest income	31	180	71	–
Allowances for impairment losses charged against income for the year:				
Loans and advances to customers:				
Mortgages	246	420	223	68
Other personal lending	(240)	(1)	741	600
Agriculture, forestry and fishing	39	8	15	27
Energy and water supply	(6)	(25)	(13)	81
Manufacturing	155	96	125	203
Construction	105	182	145	249
Transport, distribution and hotels	360	586	583	836
Postal and telecommunications	8	23	1	5
Financial, business and other services	90	276	597	243
Property companies	949	2,489	3,055	1,733
Lease financing	(11)	12	31	63
Hire purchase	(3)	19	27	99
Loans and advances to banks	–	–	–	–
Total allowances for impairment losses charged against income for the year	1,692	4,085	5,530	4,207
Total balance at end of year – Foreign	8,177	10,721	8,607	4,165

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Total	2012 £m	2011 £m	2010 £m	2009 £m
Balance at beginning of year	18,746	18,393	14,950	3,594
Exchange and other adjustments	(380)	(369)	(7)	112
Advances written off:				
Loans and advances to customers:				
Mortgages	(133)	(86)	(145)	(77)
Other personal lending	(2,267)	(2,617)	(3,344)	(3,063)
Agriculture, forestry and fishing	(45)	(11)	(47)	(5)
Energy and water supply	(77)	(48)	(36)	(28)
Manufacturing	(226)	(137)	(385)	(148)
Construction	(654)	(92)	(365)	(336)
Transport, distribution and hotels	(458)	(329)	(742)	(80)
Postal and telecommunications	(7)	(1)	–	(9)
Financial, business and other services	(1,071)	(1,120)	(881)	(308)
Property companies	(3,554)	(2,630)	(846)	(51)
Lease financing	(75)	(224)	(15)	(26)
Hire purchase	(130)	(192)	(160)	(69)
Loans and advances to banks	(10)	(6)	(111)	–
Total advances written off	(8,707)	(7,493)	(7,077)	(4,200)
Recoveries of advances written off:				
Loans and advances to customers:				
Mortgages	53	26	12	1
Other personal lending	757	326	176	107
Energy and water supply	–	–	4	–
Manufacturing	–	–	2	–
Construction	–	–	1	–
Transport, distribution and hotels	1	1	4	–
Financial, business and other services	–	–	1	2
Property companies	4	–	16	–
Lease financing	2	–	–	–
Hire purchase	26	68	–	–
Total recoveries of advances written off	843	421	216	110
Total net advances written off	(7,864)	(7,072)	(6,861)	(4,090)

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Total	2012 £m	2011 £m	2010 £m	2009 £m
Effect of unwinding of discount recognised through interest income	(374)	(226)	(403)	(446)
Allowances for impairment losses charged against income for the year:				
Loans and advances to customers:				
Mortgages	278	444	196	343
Other personal lending	881	1,669	3,431	4,314
Agriculture, forestry and fishing	54	27	20	29
Energy and water supply	71	105	17	105
Manufacturing	236	206	203	747
Construction	326	350	463	842
Transport, distribution and hotels	649	884	800	1,553
Postal and telecommunications	8	15	32	24
Financial, business and other services	824	1,464	1,293	1,913
Property companies	1,725	2,776	4,114	5,418
Lease financing	26	60	57	261
Hire purchase	47	20	101	234
Loans and advances to banks	–	–	(13)	(3)
Total allowances for impairment losses charged against income for the year	5,125	8,020	10,714	15,780
Total balance at end of year – Total	15,253	18,746	18,393	14,950

The following table analyses the coverage of the allowance for loan losses by category of loans.

	2013 Allowance £m	**2013 Percentage of loans in each category to total loans %**	2012 Allowance £m	2012 Percentage of loans in each category to total loans %	2011 Allowance £m	2011 Percentage of loans in each category to total loans %	2010 Allowance £m	2010 Percentage of loans in each category to total loans %	2009 Allowance £m	2009 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	**–**	**4.8**	3	5.8	14	5.3	20	4.7	149	5.2
Loans and advances to customers:										
Mortgages	**657**	**63.1**	1,113	59.9	948	56.4	526	55.5	464	53.6
Other personal lending	**919**	**4.4**	1,147	5.0	1,895	4.9	3,541	5.8	3,419	6.3
	38	**1.1**	67	1.0	51	0.8	16	0.9	33	0.8

Agriculture, forestry and fishing										
Energy and water supply	**149**	**0.8**	191	0.6	165	0.7	108	0.6	120	0.4
Manufacturing	**296**	**1.4**	337	1.5	475	1.6	540	1.8	709	2.2
Construction	**395**	**1.3**	504	1.3	898	1.6	588	1.2	527	1.6
Transport, distribution and hotels	**1,954**	**4.2**	2,162	4.7	2,117	5.3	1,400	5.3	1,391	4.7
Postal and telecommunications	**11**	**0.4**	40	0.2	62	0.3	50	0.3	15	0.2
Financial, business and other services	**2,293**	**8.4**	2,764	8.7	3,075	10.4	2,451	9.3	2,108	9.9
Property companies	**5,145**	**8.3**	6,664	9.3	8,710	10.5	8,546	12.2	5,394	12.4
Lease financing	**6**	**0.8**	33	1.1	92	1.3	287	1.3	244	1.4
Hire purchase	**103**	**0.1**	228	0.9	244	0.9	320	1.1	377	1.3
Total balance at year end	**11,966**	**100.0**	15,253	100.0	18,746	100.0	18,393	100.0	14,950	100.0

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Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013. The analysis of the coverage of the allowance for loan losses at 31 December 2012, 2011, 2010 and 2009 between domestic and international offices is as follows:

2012	Domestic		Foreign		Total	
	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %
Balance at year end applicable to:						
Loans and advances to banks	3	6.1	–	1.7	3	5.8
Loans and advances to customers:						
Mortgages	106	61.9	1,007	36.8	1,113	59.9
Other personal lending	1,064	5.0	83	5.4	1,147	5.0
Agriculture, forestry and fishing	57	1.0	10	0.1	67	1.0
Energy and water supply	177	0.3	14	3.7	191	0.6
Manufacturing	194	1.4	143	3.1	337	1.5
Construction	215	1.2	289	2.5	504	1.3
Transport, distribution and hotels	715	4.2	1,447	10.6	2,162	4.7
Postal and telecommunications	10	0.2	30	0.4	40	0.2
Financial, business and other services	2,008	8.5	756	11.1	2,764	8.7
Property companies	2,307	8.3	4,357	21.0	6,664	9.3
Lease financing	14	1.0	19	2.8	33	1.1
Hire purchase	206	0.9	22	0.8	228	0.9
Total	7,076	100.0	8,177	100.0	15,253	100.0

2011	Domestic		Foreign		Total	
	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %
Balance at year end applicable to:						
Loans and advances to banks	14	5.7	–	1.4	14	5.3
Loans and advances to customers:						
Mortgages	123	59.1	825	29.7	948	56.4
Other personal lending	1,555	5.0	340	3.2	1,895	4.9

Agriculture, forestry and fishing	39	0.9	12	0.3	51	0.8
Energy and water supply	137	0.3	28	4.2	165	0.7
Manufacturing	318	1.4	157	3.6	475	1.6
Construction	531	1.4	367	3.3	898	1.6
Transport, distribution and hotels	668	4.9	1,449	10.2	2,117	5.3
Postal and telecommunications	35	0.3	27	0.7	62	0.3
Financial, business and other services	2,172	10.1	903	13.2	3,075	10.4
Property companies	2,153	8.8	6,557	27.4	8,710	10.5
Lease financing	63	1.2	29	1.8	92	1.3
Hire purchase	217	0.9	27	1.0	244	0.9
Total	8,025	100.0	10,721	100.0	18,746	100.0

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2010	Domestic Allowance £m	Domestic Percentage of loans in each category to total loans %	Foreign Allowance £m	Foreign Percentage of loans in each category to total loans %	Total Allowance £m	Total Percentage of loans in each category to total loans %
Balance at year end applicable to:						
Loans and advances to banks	20	5.0	–	2.5	20	4.7
Loans and advances to customers:						
Mortgages	269	58.4	257	31.1	526	55.5
Other personal lending	2,212	6.1	1,329	3.4	3,541	5.8
Agriculture, forestry and fishing	16	1.0	–	0.2	16	0.9
Energy and water supply	55	0.3	53	2.9	108	0.6
Manufacturing	385	1.7	155	2.7	540	1.8
Construction	364	1.2	224	1.6	588	1.2
Transport, distribution and hotels	546	4.6	854	11.5	1,400	5.3
Postal and telecommunications	50	0.2	–	0.7	50	0.3
Financial, business and other services	1,630	8.7	821	13.5	2,451	9.3
Property companies	3,844	10.4	4,702	27.3	8,546	12.2
Lease financing	189	1.3	98	1.3	287	1.3
Hire purchase	206	1.1	114	1.3	320	1.1
Total	9,786	100.0	8,607	100.0	18,393	100.0

2009	Domestic Allowance £m	Domestic Percentage of loans in each category to total loans %	Foreign Allowance £m	Foreign Percentage of loans in each category to total loans %	Total Allowance £m	Total Percentage of loans in each category to total loans %
Balance at year end applicable to:						
Loans and advances to banks	149	4.9	–	7.9	149	5.2
Loans and advances to customers:						
Mortgages	398	57.2	66	24.0	464	53.6
Other personal lending	2,822	6.8	597	2.8	3,419	6.3
Agriculture, forestry and fishing	6	0.8	27	0.4	33	0.8
Energy and water supply	42	0.2	78	2.5	120	0.4
Manufacturing	504	1.9	205	4.5	709	2.2
Construction	277	1.1	250	5.6	527	1.6
Transport, distribution and hotels	606	3.8	785	11.8	1,391	4.7
Postal and telecommunications	10	0.2	5	0.9	15	0.2

Financial, business and other services	1,842	9.7	266	11.4	2,108	9.9
Property companies	3,666	10.7	1,728	25.7	5,394	12.4
Lease financing	182	1.4	62	1.1	244	1.4
Hire purchase	281	1.3	96	1.4	377	1.3
Total	10,785	100.0	4,165	100.0	14,950	100.0

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RISK ELEMENTS IN THE LOAN PORTFOLIO

The Group's credit risk elements analysed by categories reflecting US lending and accounting practices, which differ from those employed in the UK, are detailed below:

NON-PERFORMING LENDING

In the US, it is the normal practice to stop accruing interest when payments are 90 days or more past due or when recovery of both principal and interest is doubtful. When the loans are transferred to non-accrual status, accrued interest is reversed from income and no further interest is recognised until it becomes probable that the principal will be repaid in full. Loans on which interest has been accrued but suspended would be included in risk elements as loans accounted for on a non-accrual basis.

In the US non-performing loans and advances are typically written off more quickly than in the UK. Consequently a UK bank may appear to have a higher level of non-performing loans and advances than a comparable US bank although the reported income may be similar in both the US and the UK.

The Group complies with IFRS 7, which requires more detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, the table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, not requiring a provision and (iv) impaired with a provision.

	Loans and	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
(audited)	**advances to banks £m**	**Retail – mortgages £m**	**Retail – other £m**	**Wholesale £m**	**Total £m**	
31 December 2013						
Neither past due nor impaired	**25,219**	**318,668**	**36,789**	**110,093**	**465,550**	**29,443**
Past due but not impaired	**146**	**12,329**	**580**	**786**	**13,695**	**–**
Impaired – no provision required	**–**	**637**	**1,284**	**1,824**	**3,745**	**–**
– provision held	**–**	**6,229**	**1,456**	**20,829**	**28,514**	**–**
Gross	**25,365**	**337,863**	**40,109**	**133,532**	**511,504**	**29,443**

31 December 2012[1]						
Neither past due nor impaired	32,726	319,613	41,223	117,613	478,449	14,551
Past due but not impaired	31	12,880	922	1,527	15,329	–
Impaired – no provision required	–	741	1,530	1,504	3,775	–
– provision held	3	7,391	2,124	33,003	42,518	–
Gross	32,760	340,625	45,799	153,647	540,071	14,551
31 December 2011						
Neither past due nor impaired	32,494	330,727	41,448	146,655	518,830	11,121
Past due but not impaired	15	12,742	1,093	2,509	16,344	–
Impaired – no provision required	6	1,364	1,604	3,544	6,512	–
– provision held	105	6,701	2,940	44,116	53,757	–
Gross	32,620	351,534	47,085	196,824	595,443	11,121
31 December 2010						
Neither past due nor impaired	30,259	339,509	45,058	159,274	543,841	12,545
Past due but not impaired	–	13,215	1,289	3,427	17,931	–
Impaired – no provision required	–	2,189	433	5,313	7,935	–
– provision held	20	5,591	5,149	45,931	56,671	–
Gross	30,279	360,504	51,929	213,945	626,378	12,545
31 December 2009						
Neither past due nor impaired	35,333	347,292	48,429	185,872	581,593	19,082
Past due but not impaired	–	12,587	1,873	5,118	19,578	–
Impaired – no provision required	–	2,034	449	6,603	9,086	–
– provision held	153	5,918	5,902	37,927	49,747	–
Gross	35,486	367,831	56,653	235,520	660,004	19,082

[1] Restated for the implementation of IFRS 10 (see note 1 on page F-11)

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.

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The loans that are past due but not impaired are further analysed in the table below according to the number of days that have elapsed since the last payment was due from the borrower.

(audited)	Loans and advances to banks £m	Loans and advances to customers Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss £m
31 December 2013						
0-30 days	**146**	**5,596**	**489**	**347**	**6,432**	**–**
30-60 days	**–**	**2,639**	**87**	**102**	**2,828**	**–**
60-90 days	**–**	**1,734**	**4**	**57**	**1,795**	**–**
90-180 days	**–**	**2,360**	**–**	**41**	**2,401**	**–**
Over 180 days	**–**	**–**	**–**	**239**	**239**	**–**
Total	**146**	**12,329**	**580**	**786**	**13,695**	**–**
31 December 2012						
0-30 days	–	5,996	744	860	7,600	–
30-60 days	3	2,667	138	131	2,936	–
60-90 days	2	1,750	29	328	2,107	–
90-180 days	6	2,467	5	56	2,528	–
Over 180 days	20	–	6	152	158	–
Total	31	12,880	922	1,527	15,329	–
31 December 2011						
0-30 days	1	5,989	868	1,163	8,020	–
30-60 days	9	2,618	195	481	3,294	–
60-90 days	4	1,833	25	260	2,118	–
90-180 days	–	2,302	4	159	2,465	–
Over 180 days	1	–	1	446	447	–
Total	15	12,742	1,093	2,509	16,344	–
31 December 2010						
0-30 days	–	6,498	1,004	1,331	8,833	–
30-60 days	–	2,674	246	498	3,418	–
60-90 days	–	1,811	29	394	2,234	–
90-180 days	–	2,223	10	337	2,570	–
Over 180 days	–	9	–	867	876	–
Total	–	13,215	1,289	3,427	17,931	–
31 December 2009						
0-30 days	–	6,018	1,316	2,347	9,681	–
30-60 days	–	2,649	376	825	3,850	–
60-90 days	–	1,702	74	825	2,601	–
90-180 days	–	2,216	48	560	2,824	–

Over 180 days	–	2	59	561	622	–
Total	–	12,587	1,873	5,118	19,578	–

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

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POTENTIAL PROBLEM LOANS

Potential problem loans are loans where known information about possible credit problems causes management to have concern as to the borrower's ability to comply with the present loan repayment terms.

IFRS 7 requires the disclosure of information about the credit quality of loans and advances that are neither past due nor impaired. The Group's disclosures analyse these loans between those that the Group believes are of good quality, satisfactory quality, and lower quality and those that are below standard but not impaired. The below standard but not impaired balances represent potential problem loans.

(audited)	Loans and advances to banks £m	Loans and advances to customers Retail – mortgages £m	Retail – other £m	Wholesale £m	Total £m	Loans and advances designated at fair value through profit or loss
31 December 2013						
Good quality	**25,044**	**314,749**	**29,129**	**68,674**		**29,432**
Satisfactory quality	**171**	**2,948**	**6,414**	**29,038**		**7**
Lower quality	**2**	**308**	**501**	**9,991**		**3**
Below standard, but not impaired	**2**	**663**	**745**	**2,390**		**1**
Total	**25,219**	**318,668**	**36,789**	**110,093**	**465,550**	**29,443**
31 December 2012						
Good quality	32,173	313,372	30,924	60,510		14,514
Satisfactory quality	174	4,532	8,579	33,477		28
Lower quality	10	552	862	18,153		6
Below standard, but not impaired	369	1,157	858	5,473		3
Total	32,726	319,613	41,223	117,613	478,449	14,551
31 December 2011						
Good quality	32,141	323,060	29,123	71,907		11,065
Satisfactory quality	171	5,432	9,747	42,311		45
Lower quality	9	970	1,127	24,676		11
Below standard, but not impaired	173	1,265	1,451	7,761		–
Total	32,494	330,727	41,448	146,655	518,830	11,121
31 December 2010						
Good quality	29,835	332,614	30,076	57,552		12,220
Satisfactory quality	265	5,259	11,084	42,906		163
Lower quality	16	834	1,170	45,750		83
Below standard, but not impaired	143	802	2,728	13,066		79

Total	30,259	339,509	45,058	159,274	543,841	12,545
31 December 2009						
Good quality	34,434	335,482	30,743	61,810		18,702
Satisfactory quality	135	9,614	12,654	59,752		267
Lower quality	15	746	1,480	45,986		90
Below standard, but not impaired	749	1,450	3,552	18,324		23
Total	35,333	347,292	48,429	185,872	581,593	19,082

For further details see page F-117.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2013
	£m
Interest income that would have been recognised under original contract terms	**1,199**
Interest income included in profit	**901**
Interest foregone	**298**

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TROUBLED DEBT RESTRUCTURINGS

In the US, loans whose terms have been modified due to problems with the borrower are required to be separately disclosed. If the new terms were in line with market conditions at the time of the restructuring and the restructured loan remains current as to repayment of principal and interest then the disclosure is discontinued at the end of the first year. The Company's accounting policy for loans that are renegotiated is set out in note 1(H)(i) on page F-16. The table below sets out loans that are forborne at 31 December 2013, separately identifying those loans that are also impaired:

	Total forborne loans and advances which are not impaired £m	Total forborne loans and advances which are impaired £m	Total loans and advances which are forborne £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2013				
Secured retail	**6,086**	**1,020**	**7,106**	**5.8**
Unsecured retail	**170**	**395**	**565**	**31.1**
Asset Finance UK	**28**	**249**	**277**	**53.2**
Commercial Banking	**6,221**	**14,714**	**20,935**	**30.6**
Ireland Wholesale	**1,108**	**8,322**	**9,430**	**64.5**

The Group assesses whether a loan benefitting from a UK Government-sponsored programme is impaired or a troubled debt restructuring using the same accounting policies and practices as it does for loans not benefitting from such a programme.

Further information on the schemes operated by the Group to assist borrowers who are experiencing financial stress and on the Group's forborne loans is set out in note 54(F) to the financial statements and in *Intensive care of customers in financial difficulty* on pages 63 to 64.

ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES

In most circumstances in the US, title to property securing residential real estate transfers to the lender upon foreclosure. The loan is written off and the property acquired in this way is reported in a separate balance sheet category with any recoveries recorded as an offset to the provision for loan losses recorded in the year. Upon sale of the acquired property, gains or losses are recorded in the income statement as a gain or loss on acquired property.

In the UK, although a bank is entitled to enforce a first charge on a property held as security, it typically does so only to the extent of enforcing its power of sale. In accordance with IFRS and industry practice, Lloyds Banking Group usually takes control of a property held as collateral on a loan at repossession without transfer of title. Loans subject to repossession continue to be reported as loans in the balance sheet. Any gains or losses on sale of the acquired property are recorded within the provision for loan losses during the reporting period.

The difference in practices has no effect on net income reported in the UK compared to that reported in the US but it does result in a difference in classification of losses and recoveries in the income statement. It also has the effect of causing UK banks to report an increased level of non-performing loans compared with US banks.

In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group’s balance sheet and are classified according to the Group’s accounting policies.

CROSS BORDER OUTSTANDINGS

The business of Lloyds Banking Group involves significant exposures in non-local currencies. These cross border outstandings comprise loans (including accrued interest), acceptances, interest-bearing deposits with other banks, other interest-bearing investments and any other monetary assets which are denominated in non-local currency. The following table analyses, by type of borrower, foreign outstandings which individually represent in excess of 1 per cent of Lloyds Banking Group's total assets.

	% of assets	Total £m	Governments and official institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m
At 31 December 2013:					
United States of America	1.7	14,064	7,330	5,282	1,452
Republic of Ireland	1.1	9,214	2	380	8,882
At 31 December 2012:					
United States of America	2.1	19,192	8,320	5,459	5,413
Republic of Ireland	1.3	12,055	33	444	11,578
At 31 December 2011:					
United States of America	4.3	42,215	7,686	20,509	14,020
Republic of Ireland	1.6	15,966	80	738	15,148

At 31 December 2013, United States of America had commitments of £341 million and Republic of Ireland had commitments of £57 million.

At 31 December 2013 no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2012 the country with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £8,879 million in total was France.

At 31 December 2011, the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £17,133 million in total were France and Germany.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CONDUCT RISK

DEFINITION

Conduct risk is defined as the risk of customer detriment or regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

RISK APPETITE

The Group has no appetite for systemic unfair customer outcomes arising from any of its activities: through product design, sales or other after sales processes. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

EXPOSURES

Conduct risk affects all aspects of the Group’s operations, all types of customers and other stakeholders. The Group faces significant conduct risks, for example, through products or services not meeting the needs of its customers, sales processes resulting in poor advice or failure to deal with a customer’s complaint effectively where the Group has got something wrong and not met customer expectations. Given the high level of scrutiny regarding financial institutions’ treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Group’s current or legacy business may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

MEASUREMENT

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite. Conduct Risk Appetite Metrics (CRAMs) have been designed for all products offered by the Group; these contain a range of product, sales and post-sales metrics to provide a more holistic view of conduct risks. CRAMs being put in place include complaints, FOS upheld, outcome testing, customer feedback, colleague survey, whistleblowing and rectification metrics. Strong governance is in place to ensure that CRAMs are presented at relevant governance forums for review, challenge and action. The Group will also measure how effectively the overall conduct strategy is embedded across all divisions and functions.

MITIGATION

The Group takes a range of mitigating actions with respect to this risk. These actions are being embedded throughout the Group as part of the Group's Conduct Strategy.

This includes:

- Enhanced approach to business planning and strategy with customers at the heart;
- Cultural transformation, linked to the Group's values and Codes of Responsibility, to deliver the best bank for customers;
- Enhanced product governance framework to ensure products continue to offer customers value for money, and meet the needs of the relevant target market;
- Sales processes and governance framework to deliver consistently fair outcomes;
- CRAMs to identify where the Group may be operating outside its risk appetite;
- Continuing the journey to become the industry leader for complaints performance; and
- Enhanced recruitment and training, and a focus on how the Group manages colleagues' performance with clearer customer accountabilities.

The Group's leadership team is committed to embedding the Conduct Strategy within the business and to creating the right customer centric culture. The Board and Group Risk Committees receive regular reports and metrics to track progress on how the Group is meeting customer needs and minimising conduct risk.

All Group divisions have applied significant resources to the Conduct Strategy and set ambitious conduct transformation plans.

The Group's Conduct Strategy continues to evolve and be enhanced. The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns to ensure that the implementation of the Group's conduct strategy meets evolving stakeholder expectations.

MONITORING

A robust outcomes testing regime is in place to test performance of customer critical activities end-to-end. Customer metrics are proactively used when reviewing business performance and feedback loops have been established to take learnings from root cause/outcome testing.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MARKET RISK

DEFINITION

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

RISK APPETITE

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

EXPOSURES

Defined benefit pension schemes

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 real interest rate, credit spread and equity risk. Interest rate risk arises from the liability discount rate, with partial offsets from fixed interest assets such as gilts and corporate bonds, and swaps. Credit spread risk also arises from the liability discount rate, with partial offsets from the credit portfolio. Equity risk arises from direct equity holdings.

For further information on defined benefit pension scheme assets and liabilities please refer to note 41 on page F-63.

Trading portfolios

The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities. All the trading Value at Risk (VaR) resides within Commercial Banking. The average 95 per cent 1-day trading VaR was £4.1 million for the year to 31 December 2013 (2012: £7.0 million). The Group's trading activity is undertaken to meet the requirements of wholesale and retail customers for foreign exchange, credit spread and interest rate products.

Trading market risk measures are applied to all the Group's regulatory trading books where positions arise from supporting customer flow and market making. All positions are held with trading intent. Measures include daily VaR (Table 1.29), sensitivity based measures, and stress testing. The Group's trading book assets and liabilities are substantially originated by Financial Markets within the Commercial Banking Division. Within the Group's balance sheet these fall under the trading assets and liabilities and derivative financial instruments (see Table 1.26 below).

Table 1.26: **Market risk linkages to the balance sheet for trading portfolios and Banking activity items**

	Balance sheet total £m	Trading books £m	Relevant notes from financial **statements**
31 December 2013			
Assets			
Trading and other financial assets at fair value through profit or loss	142,683	42,376	Note 17
Derivative financial instruments	33,125	25,531	Note 18
Loans and advances to customers	495,281	–	Note 20
Liabilities			
Trading and other financial liabilities at fair value through profit or loss	43,625	38,319	Note 34
Derivative financial instruments	30,464	25,086	Note 18
Customer deposits	441,311	–	Note 33

Table 1.26 above shows relevant balance sheet items relating to banking and trading activities. The trading book VaR sensitivity inputs are separately identified.

Banking activities

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

Interest rate risk in the Group's divisional portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets, liabilities (see loans and advances to customers and customer deposits in Table 1.26 above) and off balance sheet positions of the Group. Interest rate risk arises predominantly from the mismatch between interest rate sensitive assets and liabilities, but also to the investment term of capital and reserves, and the need to minimise income volatility.

Margin compression risk also arises from the current low rate environment, which may restrict the ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Prepayment risk arises, predominantly in the Retail division, as customer balances amortise more quickly or slowly than anticipated due to economic conditions or customer’s response to changes in economic conditions.

Pipeline and pre hedge risk arises where new business volumes are higher or lower than forecasted, requiring the business to unwind or execute additional hedging at rates which may differ to what was expected.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Basis risk arises from the possible changes in spreads, for example where the bank lends with reference to a central bank rate but funds with reference to LIBOR and the spread between these widens or tightens.

Foreign currency risk arises from:

(a) translational exposure: the Group's investment in its overseas operations. Net investment exposures are disclosed (see note 56 on page F-114) and it is Group policy to hedge non-functional currency exposures; and

(b) transactional exposure: where assets and liabilities are denominated in currencies other than the business' functional currency. The Group has a policy of forward hedging its forecasted currency income less impairments to year end.

Insurance portfolios

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

- With-profits funds are managed with the aim of generating smoothed returns consistent with policyholders' expectations. Exposure arises where the value of the underlying funds are insufficient to meet the obligations, termed burnthrough.
- Unit-linked funds where policyholders select their investments. Exposure arises as future fee income is dependent upon the performance of those assets. This fee income forms part of the Value of in-force business, see note 28 on page F-51.
- Annuities where policyholders' future cashflows are guaranteed at retirement. Exposure arises if the assets, predominantly fixed income, backing the liabilities do not perform in line with expectations.
- Insurance's surplus assets also result in market risk exposure. These assets are held primarily in three portfolios: (i) in the long-term funds within the life insurance companies; (ii) in the corresponding shareholder funds; and (iii) in investment portfolios within the general insurance business.
- The majority of Insurance's equity risk exposure relates to unit-linked funds, through the value of future fee income, and with-profits funds, through burnthrough. Credit spread risk exposure largely results from holding fixed income assets in the annuity portfolio with the aim of providing additional returns.

Table 1.27: **Key market risks for the Group (PBT impact measured against Group single stress scenarios)**

	Risk type					
	Interest rate	Basis risk	FX	Credit spread	Equity	Inflation
Defined benefit pension schemes	p		¢	˜	p	p
Trading portfolios	¢	¢	¢	¢		¢
Banking activities	˜	¢	¢	¿	˜	¢
Insurance portfolios	p		¢	¿	˜	p

Key:	
Profit before tax:	
>£500m	¿
£250-£500m	˜
<£250m	p
<£50m	¢

MEASUREMENT

Market risk is managed within a Board approved framework and risk appetite. This is supplemented by divisional market risk appetite limits and triggers. A variety of risk measures are used such as:

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

Scenario based measures include the use of five different economic multi-risk scenarios which the Group introduced as part of its Board risk appetite. These assess the impact of unlikely, but plausible adverse scenarios on income, with the worst case for defined benefit pensions, trading portfolios, banking activities and insurance portfolios being reported against the Board risk appetite.

Internal market risk models for trading book activities comprise VaR, Stressed VaR and Incremental Risk Charge and these are explained in detail in the Group's Market Risk section of the Pillar 3 Disclosures.

Although an important market standard measure of risk, VaR has limitations. These arise from the use of limited historical data, an assumed distribution, defined holding periods, set confidence intervals and frequency of calculation. The exposure level at the confidence interval does not convey any information about potential losses which may arise if this level is exceeded. A 95 per cent confidence interval with a 1-day holding period is equivalent to an expected 1 in 20 day loss. The Group recognises these limitations and supplements the use of VaR with a variety of other techniques more suited to the nature of the business activity.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In addition:

- Capital impact and deficit triggers are used in respect of defined benefit pensions which have a material impact on capital resources.
- Profit and loss triggers are used in the trading books in order to ensure that mitigating action is considered if profit and loss becomes volatile.
- Interest rate repricing gaps, earnings sensitivity analysis, and open foreign exchange positions are used for banking book activity, and
- Stress testing and scenario analysis are also used in certain portfolios and at Group level, to simulate the impact of extreme conditions and to understand more fully the interdependence of different parts of the balance sheet.

These measures are reviewed regularly by senior management to inform effective decision making.

Defined benefit pension schemes

Management of the assets is the responsibility of the Trustees of the schemes who are responsible for setting the investment strategy and for agreeing funding requirements with the Group. The difference between assets and liabilities determines whether there is a surplus or deficit. Any deficit must be met by the Group with additional funding agreed with the Trustees as part of a triennial valuation process.

For accounting purposes, a AA corporate bond based discount rate is used to determine present value of liabilities resulting in significant credit spread risk. Assets are marked to market.

Trading portfolios

Based on the 1-day 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2013 and 2012 based on the Group's global trading positions is detailed in table 1.28.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the five risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all trading book positions arising from short term market facing activity. Trading book VaR (1-day 99 per cent) is compared daily against both forecast and actual profit and loss.

The average VaR for 2013 was lower than the average over 2012 due primarily to lower credit spread and interest rate exposure and improvement in market conditions. Trading book VaR assumes no diversification across risk type, instead it is a simple sum of interest rate, foreign exchange, credit spread, and inflation risk.

Table 1.28: **Trading portfolios: VaR 1-day 95 per cent confidence level (audited)**

	Close £m	Average £m	Maximum £m	Minimum £m
At 31 December 2013				
Interest rate risk	3.5	2.9	4.8	2.0
Foreign exchange risk	0.2	0.4	2.0	0.1
Equity risk	–	–	–	–
Credit spread risk	0.8	0.5	1.4	0.3
Inflation risk	0.2	0.3	0.7	0.1
Total VaR	4.7	4.1	6.5	2.7

1-day 99 per cent VaR charts for 2013 for Lloyds Bank, HBOS and Lloyds Banking Group models can be found in the Group's Pillar 3 Disclosures.

	Close £m	Average £m	Maximum £m	Minimum £m
At 31 December 2012				
Interest rate risk	2.8	4.2	7.4	1.9
Foreign exchange risk	0.3	0.4	1.0	–
Equity risk	–	–	–	–
Credit spread risk	0.8	1.9	3.6	0.7
Inflation risk	0.5	0.5	1.3	0.1
Total VaR	4.4	7.0	11.4	4.1

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

Banking activities

Market risk in non-trading books consists of exposure to changes in interest rates including basis risk. This is the potential impact on earnings and value that occurs due to mismatches in the timing of repricing assets and liabilities.

Interest rate risk exposure is monitored monthly using, primarily:

(a) Market value sensitivity: this methodology considers all repricing mismatches (behaviourally adjusted where appropriate) in the current balance sheet and calculates the change in market value that would result from an instantaneous 25, 100 and 200 basis points parallel rise or fall in the yield curve (subject to a floor at zero per cent).

(b) Interest income sensitivity: this measures the impact on future net interest income arising from an instantaneous 25, 100 and 200 basis points parallel rise or fall in all the yield curves over a rolling 12 month basis (subject to a floor at zero per cent). Unlike the market value sensitivities, the interest income sensitivities incorporate additional behavioural assumptions as to how and when individual products would reprice in response to such change.

(c) Value at Risk (VaR): for short dated portfolios and other accrual accounted trading portfolios, where the portfolio turns over more than once within a three month horizon, VaR is used for internal risk management.

(d) Market Value notional limit: this caps the amount of conventional and inflation-linked government bonds held by the Group for liquidity purposes.

The Group has an integrated Asset and Liability Management (ALM) system which supports non traded asset and liability management of the Group. This provides a single consolidated tool to measure and manage interest rate repricing profiles (including behavioural assumptions), perform stress testing and produce forecast outputs. Interest rate gaps are reported by currency and used to calculate the income and value sensitivities (in GBP equivalent). Repricing assumptions and customer reaction to changes in product pricing is a major determinant of the risk profile. The Group is aware that any assumptions based model is open to challenge. However, a full behavioural review is performed annually by Group ALM functions to ensure the assumptions remain appropriate, and is reviewed by Risk Division.

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

Table 1.29 below shows, split by material currency, the Group's market value sensitivities at 31 December 2013 to an instantaneous parallel up and down 25 basis points change to all interest rates.

Table 1.29: **Banking activities: market value sensitivity**

	2013		2012[1]	
	Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m
Sterling	(25.1)	25.6	51.4	(54.0)

US dollar	16.3	(16.5)	14.9	(16.7)
Euro	(0.4)	0.6	14.5	(8.5)
Australian dollar	(0.7)	(0.1)	1.0	(1.0)
Other	(0.3)	0.3	(0.1)	0.1
Total	(10.2)	9.9	81.7	(80.1)

[1] Restated

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio. The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

Table 1.30 below shows the banking book income sensitivity to an instantaneous parallel up and down 25 basis points change to all interest rates.

Table 1.30: **Banking activities: net interest income sensitivity (audited)**

	2013		2012	
	Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m
Client facing activity and associated hedges	48.2	(136.0)	202.0	(209.3)

The market value sensitivity is driven by temporary customer flow positions not yet hedged plus other positions occasionally held within limits, by the Group's wholesale funding desks in order to minimise overall funding and hedging costs. The level of risk is low relative to the size of the total balance sheet.

The fall in net interest income sensitivity reflects further structural hedging against margin compression undertaken in 2013, and a revision of the assumptions as to how variable retail savings would reprice in a rising rate scenario.

Insurance portfolios

Market risks within the Insurance business are measured using a variety of techniques including stress and scenario testing and, where appropriate, stochastic modelling. Current and potential future market risk exposures are assessed and aggregated using a range of stresses and risk measures including 1-in-200 year stresses for Insurance's Individual Capital Assessment (ICA) and alternative stresses for profit before tax and other measures. The effect of changes in key assumptions including sensitivities to the risk-free rate, equity investment volatility, widening of credit spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax and equity are set out in note 37.

MITIGATION

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

Defined benefit pension schemes

The Group takes an active involvement in agreeing risk management and mitigation strategies with the Trustees of the schemes through whom any such activity must be conducted. An interest rate hedging programme is in place to reduce liability risk. The schemes are also reducing equity allocation and investing the proceeds in credit assets as part of a programme to appropriately de-risk the portfolio.

Trading portfolios and banking activities

The Group’s policy is to optimise reward whilst managing its interest rate risk exposures within the risk appetite defined by the Board. For individual banking divisions, simple positional interest rate risk is minimal due to the Group requirement for these businesses to hedge (or match fund) promptly all open positions directly via the Group Corporate Treasury (GCT) function.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

As defined within the scope of the Group IRRBB Policy, all hedgeable interest rate risk in the non-traded book should be transferred to GCT via the Interest Rate Risk Transfer Pricing (ITP) framework. GCT is responsible for managing centralised risk (both traded and non-traded) and does this through natural offsets of matching assets and liabilities, and appropriate hedging activity of the residual exposures, subject to the authorisation and mandate of Group Asset and Liability Committee within the Board Risk Appetite. Derivative desks in Financial Markets will then externalise the hedges to the market. However, certain residual interest rate risks may remain outside the centre due to differences in basis and profile mismatches, largely arising from customer behaviour.

Customer facing divisions incur foreign exchange risk in the course of providing services to their customers. GCT incurs foreign exchange risk through its various debt and capital management programmes. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled within the trading risk appetite and any residual risk is hedged in the market.

Insurance portfolios

Investment holdings are diversified across markets and, within markets, across sectors. Holdings are diversified to minimise specific risk and the relative size of large individual exposures is monitored closely. For assets held outside unit-linked funds, investments are only permitted in countries and markets which are sufficiently regulated and liquid. Where considered appropriate, hedges are in place to reduce exposure to market risk, principally equity and interest rate risk, but also foreign currency.

For annuity 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. Further, in assessing the current value of these future cashflows, it is not always possible to achieve equally resilient levels of matching between the different capital measures that are used to assess regulatory solvency.

MONITORING

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk Division and where appropriate, escalation procedures are in place.

Defined benefit pension schemes

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees (one Group Executive sub-committee and a supporting management committee).

Under this governance structure, the surplus or deficit in the schemes is tracked on a monthly basis along with various single factor and scenario stresses which consider the assets and liabilities holistically. Performance against risk appetite limits and triggers is also tracked regularly including an assessment of the impact on Group capital resources. Hedges in place and asset/liability matching positions are also actively monitored.

Trading portfolios and banking activities

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

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

Insurance portfolios

Ongoing monitoring is in place to track market risks. This includes monitoring the progression of market risk capital against risk appetite limits, as well as the sensitivity of profit before tax to combined market risk stress scenarios and in year market movements. Asset/liability matching positions and hedges in place are actively monitored and if necessary rebalanced to be within certain tolerances. In addition market risk is controlled via approved investment policies and mandates.

OPERATIONAL RISK

DEFINITION

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

The aim of operational risk management is to manage operational risks in line with defined appetites, and to protect both customers and the Group whilst delivering sustainable growth. The Group Operational Risk framework is the method by which operational risks are managed in terms of setting risk appetite, evaluating key exposures, measuring risk, mitigating risk, and monitoring risks on an ongoing basis, as set out below.

RISK APPETITE

The Group's Operational Risk appetite is designed to safeguard the interests of customers, internal and external stakeholders, and shareholders. Appetite is expressed through five high level statements summarised below, each of which are defined with limits and triggers approved by the Board, and are regularly monitored by Executive and Board risk committees:

- **Customer:** The Group builds trust and does not expect its customers to be impacted negatively.
- **Reputation:** The Group manages its external profile effectively. The Group will manage and mitigate any prominent negative nationwide media coverage.
- **Financial loss:** The Group does not expect to experience cumulative fraud or operational losses above a defined level of budgeted Group income.
- **Management time and resources:** The Group does not expect internal events that divert excessive senior management time from running the business or have extensive impact on colleague time and/or morale.
- **Risk culture:** All colleagues are responsible for risk within their individual roles. The Group sets a strong tone from the top and embraces a risk culture across the business which is aligned to its strategy, vision, values and codes of responsibility. The Group encourages an open dialogue and rapid escalation of potential threats and events.

EXPOSURES

The principal operational risks to the Group are:

– IT systems and resilience risk arising from failure to develop, deliver and maintain effective IT solutions;

– Information security risk arising from information leakage, loss or theft;

– External fraud arising from an act of deception or omission;

– Cyber risk arising from malicious attacks on the Group via technology, networks and systems; and

– Risks arising from inadequate customer facing processes, including transactions, processing and information capture.

The risks below also have potential to negatively impact customers and the Group's future results:

– The sale of TSB may result in disruption of senior management's ability to lead and manage the Group effectively. In addition, the Group is committed to providing service for TSB, with potential for customer detriment, plus reputational and financial exposure for the Group in the event of any significant issues in maintaining services.

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

– Systems and procedures in place to comply with increasingly complex and detailed anti-money laundering and anti-terrorism laws and regulations may not always be fully effective in preventing third parties from using the Group as a conduit for money laundering. Should the Group be associated with money laundering, its reputation could suffer and/or it could become subject to fines, sanctions and legal enforcement; any one of which could have a material adverse effect on operating results, financial condition and prospects.

MEASUREMENT

Operational risk is managed within a Board approved framework and risk appetite, as set out above. A variety of measures are used such as: scoring of potential risks, using impact and likelihood, with impact thresholds aligned to the risk appetite statements above; assessment of the effectiveness of controls; monitoring of events and losses by size, business unit and internal risk categories.

In 2013, the highest frequency of events occurred in external fraud (61.96 per cent) and execution, delivery and process management (24.58 per cent). Clients, products and business practices accounted for 39.66 per cent of losses. Execution, delivery and process management accounted for 38.64 per cent of losses. Losses in both categories are driven by legacy issues (excluding PPI).

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

The table overleaf shows high level loss and event trends using Basel II categories.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.31: **Operational risk events by risk category**

	% of total volume		% of total losses	
	2013	2012	2013	2012
Business disruption and system failures	0.92	1.08	0.86	1.46
Clients, products and business practices	11.02	15.27	39.66	58.65
Damage to physical assets	0.81	0.32	0.45	0.24
Employee practices and workplace safety	0.61	0.14	0.36	0.10
Execution, delivery and process management	24.58	24.90	38.64	27.19
External fraud	61.96	58.02	20.01	11.99
Internal fraud	0.10	0.27	0.02	0.37
Total	100.00	100.00	100.00	100.00

MITIGATION

The Group's control environment receives regular review and investment, with reporting on the material risks discussed monthly by senior management. Risks are managed via a range of strategies – avoidance, mitigation, transfer (including insurance), and acceptance, and contingency plans maintained for a range of potential scenarios with a regime of regular disaster recovery exercises, both Group specific and industry wide. Mitigating actions for the principal risks above include:

– The Group completed a strategic review in 2013, focused on IT resilience (the ability of IT systems to resist and/or recover from failure). Actions from the review include implementation of a new Group-wide risk appetite for IT service and availability based on the processes most time-critical to its customers, or to manage the Group. Strategic enhancements and investment are in plan over the next three years to reflect enhanced demands on IT both in terms of customer and regulator expectations.

– The Group has, and will continue to, invest in enhanced protection of customer information, including access to key systems and the security, durability and accessibility of critical records.

– The Group adopts a risk based approach to mitigate the external fraud risks it faces, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Through Group-wide policies and operational control frameworks, the Group has developed a robust fraud operating model with centralised accountability. The Group's fraud awareness programme is a key component of its fraud control environment.

– Significant investment has been made in increasing the Group's cyber defence, for example through the IT Security Improvement Programme, to protect customers and the Group's infrastructure.

– The Group continues to place appropriate and significant focus on improving customer processing by remediating known issues and addressing root cause through its rectification programmes, and seeking to improve the overall servicing environment in key areas through the Simplification programme. In addition, incident management capability has been revised and enhanced to increase speed of response to customer impacting incidents.

– The level and impact of change involved in the sale of TSB is managed via robust change management governance and a consolidated strategic change plan. There are separate governance arrangements in place to oversee the impacts of the divestment on the retained business customers, operations and controls.

– Operational resilience measures and recovery planning defined in the Group's Business Continuity Management policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, economic instability, pandemic planning and operational incidents.

– The Group has adopted policies and procedures to detect and prevent the use of its banking network for money laundering and related activities, and it regularly reviews and assesses these to keep them current and effective. These activities include 'know-your-customer' requirements, training and awareness, transaction monitoring technologies and reporting of suspicions of money laundering to the applicable regulatory authorities.

MONITORING

Monitoring and reporting is undertaken at Board, Group and business area committees, in accordance with delegated limits of authority which are regularly reviewed and refreshed. Business unit risk exposure is aggregated and discussed at the monthly Group Operational Risk Committee, and matters are escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of systems, monthly reports from business areas, and oversight and challenge from the Risk Division; audit; and assurance teams ensures that key risks are regularly presented and debated by an Executive audience.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

FUNDING AND LIQUIDITY RISK

DEFINITION

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

RISK APPETITE

Funding and liquidity risk appetite for the banking business is set, reviewed and approved annually by the Board with the support of the Group Asset and Liability Committee (GALCO). Funding and liquidity risk is managed separately for the banking and Insurance businesses. Risk is reported against appetite through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by GALCO, regularly reviews performance against risk appetite.

EXPOSURE

Liquidity exposure represents the amount of potential stressed outflows in any future period less expected inflows. Liquidity is considered from both an internal and a 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, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite covers a range of metrics considered key to maintaining a strong liquidity and funding position, with regular reporting to GALCO and the Board. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 54 on page F-113 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. Divisional teams form a view of customer behaviour based on quantitative and qualitative analysis and these assumptions are subject to governance via divisional asset and liability committees. This also forms the foundation of the Group's Liquidity Transfer Pricing (LTP) and the liquidity risk stress testing framework on which the Group's liquidity controls are based.

MITIGATION

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through short-term liquidity management and through the life of the funding plan. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. The Group manages its risk appetite and liquidity position as a coverage ratio (proportion of stressed outflows covered by primary liquid assets) rather than by reference to a quantum of liquid assets; this corresponds with the PRA and CRD IV liquidity requirements. 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 having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships with corporate customers and certain wholesale market segments to supplement its retail deposit base. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although mostly repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. Funding concentration by counterparty is not considered significant for the Group. Where concentrations do exist (for example, maturity profile); these are limited by the internal risk appetite and considered manageable.

To assist in managing the balance sheet the Group operates a LTP Policy which:

– Allocates relevant interest expenses from GCT to the Group's banking businesses within the internal management accounts in a manner consistent with the Group Funding and Liquidity Policy;

– Helps drive the correct inputs to customer pricing and supports the overall Group balance sheet strategy; and

– Is consistent with regulatory requirements.

Relevant interest expenses allocated via LTP include term funding spreads incurred over a three month LIBOR benchmark and the cost of funding and holding liquid asset reserves. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits. Such behavioural maturity assumptions are subject to formal governance, reviewed at least annually, and founded on analysis and evidence of actual customer behaviour using historical data gathered over several years.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's banking businesses. In addition to central bank reserves, the Group holds sizeable balances of high grade marketable debt securities as set out in table 1.34 which can be sold to provide, or used to secure, additional cash inflows should the need arise from either market counterparties or central bank facilities (Bank of England, European Central Bank and Federal Reserve).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Liquidity risk within the Insurance business may result from the inability to sell financial assets quickly at their fair values; or from an insurance liability falling due for payment earlier than expected; or from the inability to generate cash inflows as anticipated. The shareholder (Lloyds Banking Group) is exposed to liquidity risk through the shareholder business. This is predominantly the annuity portfolio, where the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. Unit-linked and with-profits funds are normally expected to meet their own liquidity obligations. The shareholder's exposure to liquidity risk is actively managed and monitored within Insurance to ensure that, even under stress conditions, Insurance has sufficient liquidity as required to meet its obligations and remains within approved risk appetite. In addition, liquidity risk is controlled via approved funding and liquidity policies.

MONITORING

Liquidity is actively monitored at Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular GALCO which meets monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent internal oversight.

Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. These are a mixture of quantitative and qualitative measures including daily variation of customer balances, changes in maturity profiles, cash outflows, funding concentration, changes in primary liquidity portfolio, credit default swap (CDS) spreads and changing funding costs.

In addition, the monitoring framework has two other important components:

Firstly, the Group carries out stress testing of its liquidity and potential cash flow mismatch position over both short (up to two weeks) and longer term (up to three months) horizons against a range of scenarios, including those prescribed by the PRA, (the idiosyncratic, market wide and combined stresses) and the Group's own scenarios reflecting possible future liquidity risks. The Group's scenarios cover US market disruption, market counterparty failure, UK sovereign rating downgrade and a Eurozone stress. The key risk driver assumptions applied to the scenarios are:

Liquidity risk driver	Market wide and Group specific stresses
Wholesale funding	Outflows calculated based on contractual maturity of wholesale funding with limited roll over
Marketable asset	Haircut widening and repos assumed not to roll on contractual maturity
	Substantial outflows on customer deposit base

Retail and commercial funding	
Intra-day liquidity	Liquidity required for clearing and payment systems under stressed conditions
Intra group liquidity	Requirements from the stressed position of subsidiaries
Off balance sheet	Stressed cash outflows from commitments granted. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities
Downgrade	Contractual outflows resulting from short and long-term rating downgrades
Franchise viability	Actions that need to be taken to maintain the Group's core business franchise and reputation

The scenarios and the assumptions are reviewed at least annually to gain assurance that they continue to be relevant to the nature of the business. The Group's liquidity risk appetite is calibrated against a number of stressed liquidity metrics. Liquidity stress tests are applied to the Group's funding plan to project possible future stressed positions. The funding plan is also stressed against a range of macroeconomic scenarios, including those prescribed by the PRA under the Pillar 2 'anchor' scenario. The Group also applies its own macroeconomic stress scenarios, including a one in 20 year recession.

– Secondly, the Group maintains a Contingency Funding Plan which is designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency Funding Plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators, prudential and regulatory liquidity risk limits and triggers, stress testing results, event and systemic indicators and market intelligence.

For further information on the Group's 2013 stress testing results refer to page 115.

The planned introduction of the Liquidity Coverage Ratio (LCR – minimum requirement will begin at 60 per cent in January 2015 rising in equal annual steps of 10 per cent to reach 100 per cent in January 2019) and the Net Stable Funding Ratio (NSFR – 100 per cent minimum requirement in January 2018) contained within CRD IV are intended to raise the resilience of banks to potential liquidity shocks and provide the basis for a harmonised approach to liquidity risk management. The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the PRA's Individual Liquidity Adequacy Standards liquidity regime and will satisfy the LCR and NSFR requirements. The Group's LCR and NSFR position is monitored and forecast. The Group notes the recommendation of the Financial Policy Committee on 18 June 2013 that, for UK banks, the minimum LCR requirement should be set at 80 per cent until 1 January 2015, rising thereafter to reach an LCR requirement of 100 per cent on 1 January 2018.

During the year, the individual entities within the Group, and the Group, complied with all of the external regulatory liquidity and funding requirements to which they are subject and expects to meet all future liquidity regulatory requirements as implemented by the PRA.

FUNDING AND LIQUIDITY MANAGEMENT IN 2013

The transformation of the Group funding position has been substantially completed. The continued run down of the asset portfolios outside of the Group's risk appetite and the growth in customer deposits has strengthened the Group's funding position and reduced exposure to wholesale funding. This strong funding position has enabled the Group to undertake a number of funding related actions during the course of the year. In May 2013 the Group repaid in full the remaining €3.5 billion of outstanding Long Term Refinancing Operation (LTRO) funding from the European Central Bank having earlier repaid €10 billion in February 2013. In addition to this, during 2013, the Group repaid other term funding totalling £12.6 billion early.

In 2009 the Group entered into a number of EU State aid related obligations, one of which was reductions in certain parts of its balance sheet by the end of 2014. The Group achieved the asset reduction commitment ahead of the mandated completion date and has received formal confirmation that it has been released from this commitment from the European Commission.

Market conditions continued to improve during 2013 along with investor confidence in the UK economy. The Group has experienced reduced term issuance costs and spreads on outstanding issuance have remained significantly narrower than previous years. As well as improved market conditions, rating changes for the Group were positive. A report from Standard & Poor's published on 3 December 2013 affirmed the Lloyds Bank 'A/A-1' long/short-term rating and revised upwards the stand alone rating from 'bbb' to 'bbb+'. The ratings action was reflective of, in the opinion of Standard & Poor's, a strengthened capital position and stronger prospects for Lloyds Bank's statutory earnings.

The combination of a strong balance sheet and access to a wide range of funding markets, including government schemes, provides the Group with a broad range of options with respect to funding the balance sheet in the future.

GROUP FUNDING SOURCES

Total funded assets reduced by £28.5 billion to £510.2 billion. This reduction enabled the Group to make changes in wholesale funding which reduced by £32.0 billion to £137.6 billion, with the volume with a residual maturity less than one year reducing to £44.2 billion (£50.6 billion at 31 December 2012). The Group's term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) reduced to 68 per cent (70 per cent at 31 December 2012) as expected in line with maturities of wholesale term funding and limited term wholesale issuance in 2013.

The Group loan to deposit ratio has improved to 113 per cent compared with 121 per cent at 31 December 2012, driven by strong deposit growth and a reduction is assets outisde of the Group's risk appetite. Excluding reverse repos and repos, loans and advances to customers reduced by £16.9 billion, customer deposits increased by £15.8 billion, and there was a continued reduction in assets outside of the Group's risk appetite. (31 December 2013: £63.5 billion; 31 December 2012: £98.4 billion).

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Table 1.32: **Group funding position (audited)**

	2013 £bn	2012[1] £bn	Change %
Funding requirement			
Loans and advances to customers[2]	495.2	512.1	(3)
Loans and advances to banks[3]	5.1	12.5	(59)
Debt securities	1.4	5.3	(74)
Reverse repurchase agreements	0.2	–	
Available-for-sale financial assets – secondary[4]	4.4	5.3	(17)
Cash balances[5]	3.9	3.5	11
Funded assets	510.2	538.7	(5)
Other assets[6]	248.6	302.2	(18)
	758.8	840.9	(10)
On balance sheet primary liquidity assets[7]			
Reverse repurchase agreements	0.1	5.8	(98)
Balances at central banks – primary[5]	46.0	76.8	(40)
Available-for-sale financial assets – primary	39.6	26.1	52
Trading and fair value through profit and loss	3.1	(9.4)	
Repurchase agreements	**(0.6)**	(5.9)	(90)
	88.2	93.4	(6)
Total Group assets	847.0	934.3	(9)
Less: Other liabilities[6]	(227.5)	(277.8)	(18)
Funding requirement	619.5	656.5	(6)
Funded by			
Customer deposits[8]	438.3	422.5	4
Wholesale funding[9]	137.6	169.6	(19)
	575.9	592.1	(3)
Repurchase agreements	4.3	21.8	(80)
Total equity	39.3	42.6	(8)
Total funding	619.5	656.5	(6)

1 Restated to reflect the implementation of IAS 19R and IFRS 10.

2 Excludes £0.1 billion (31 December 2012: £5.1 billion) of reverse repurchase agreements.

3 Excludes £20.1 billion (31 December 2012: £19.6 billion) of loans and advances to banks within the Insurance business and £0.2 billion (31 December 2012: £0.7 billion) of reverse repurchase agreements.

4 Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

5 Cash balances and balances at central banks – primary are combined in the Group's balance sheet.

6 Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

7 Primary liquidity assets are PRA eligible liquid assets including UK Gilts, US Treasuries, Euro AAA government debt and unencumbered cash balances held at central banks.

8 Excluding repurchase agreements of £3.0 billion (31 December 2012: £4.4 billion).

9 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

Table 1.33: **Reconciliation of Group funding figure to the balance sheet (audited)**

	Included in funding analysis (above) £bn	Repos £bn	Fair value and other accounting methods £bn	Balance sheet £bn
At 31 December 2013				
Deposits from banks	**12.1**	**1.9**	**–**	**14.0**
Debt securities in issue	**91.6**	**–**	**(4.5)**	**87.1**
Subordinated liabilities	**33.9**	**–**	**(1.6)**	**32.3**
Total wholesale funding	**137.6**	**1.9**		
Customer deposits	**438.3**	**3.0**	**–**	**441.3**
Total	**575.9**	**4.9**		
At 31 December 2012[1]				
Deposits from banks	15.1	23.3	–	38.4
Debt securities in issue	120.4	–	(3.1)	117.3
Subordinated liabilities	34.1	–	–	34.1
Total wholesale funding	169.6	23.3		
Customer deposits	422.5	4.4	–	426.9
Total	592.1	27.7		

[1] Restated to reflect the implementation of IAS 19R and IFRS 10.

Total wholesale funding by type and expected residual maturity is detailed below.

Table 1.34: **Analysis of 2013 total wholsale funding by residual maturity (audited)**

	Less than one month £bn	One to three months £bn	Three to six months £bn	Six to nine months £bn	Nine months to one year £bn	One to two years £bn	Two to five years £bn	More than five years £bn	Total at 31 Dec 2013 £bn	Total at 31 Dec 2012 £bn
Deposits from banks	9.5	0.6	0.3	–	0.7	0.3	0.2	0.5	12.1	15.1
Debt securities in issue:										
Certificates of deposit	1.0	3.4	2.4	1.3	0.9	–	–	–	9.0	10.7
Commercial paper	2.3	2.0	0.4	–	0.1	–	–	–	4.8	7.9
	0.8	0.4	1.8	0.1	2.2	5.7	9.5	8.6	29.1	34.6

Medium-term notes[1]										
Covered bonds	0.9	–	0.7	–	3.0	3.3	8.8	12.7	29.4	38.7
Securitisation	2.8	–	0.9	–	3.3	7.7	4.6	–	19.3	28.5
	7.8	5.8	6.2	1.4	9.5	16.7	22.9	21.3	91.6	120.4
Subordinated liabilities	0.3	0.3	0.6	0.6	0.6	3.3	5.9	22.3	33.9	34.1
Total wholesale funding[2]	17.6	6.7	7.1	2.0	10.8	20.3	29.0	44.1	137.6	169.6

1 Medium-term notes include funding from the National Guarantee Scheme (31 December 2013: £1.4 billion; 31 December 2012: £1.4 billion).

2 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

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Table 1.35: **Total wholesale funding by currency (audited)**

	Sterling £bn	US dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2013	44.4	36.1	48.7	8.4	137.6
At 31 December 2012	54.3	41.6	60.2	13.5	169.6

Table 1.36: **Analysis of 2013 term issuance (audited)**

	Sterling £bn	US dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	–	0.5	–	–	0.5
Medium-term notes	–	0.6	1.3	–	1.9
Private placements[1]	0.1	0.4	1.3	0.1	1.9
Total issuance	0.1	1.5	2.6	0.1	4.3

[1] Private placements include structured bonds and term repurchase agreements (repos).

Term issuance for 2013 totalled £4.3 billion with the majority across medium-term notes and private placements. Utilisation of the UK government's Funding for Lending Scheme (FLS) has further underlined the Group's support to the UK economic recovery, and the Group remains committed to passing the benefits of this low cost funding on to its customers. The Group drew down £3.0 billion in 2012 and £5.0 billion in 2013 under the FLS scheme. A further £2.2 billion was drawn in January 2014, which under FLS rules, counts as funding from the 2013 scheme capacity.

Encumbered assets

The Board monitors and manages total balance sheet encumbrance via a risk appetite metric. During 2013 the Group had term issuance of £0.5 billion from securitisations and no issuance from covered bonds. Maturities have led to a reduction in externally held notes from residential mortgage backed securitisation and covered bond issuance. The table below summarises the assets encumbered through the Group's external issuance transactions.

Table 1.36: **Secured external issuance transactions**

	Notes issued £bn	Assets encumbered[3] £bn
At 31 December 2013		
Securitisations[1]	18.6	31.6
Covered bonds[2]	30.7	49.6
Total	49.3	81.2

At 31 December 2012		
Securitisations[1]	28.0	46.3
Covered bonds[2]	40.7	56.9
Total	68.7	103.2

1 In addition the Group retained internally £38.3 billion (31 December 2012: £58.7 billion) of notes secured with £49.3 billion (31 December 2012: £71.9 billion) of assets.

2 In addition the Group retained internally £7.6 billion (31 December 2012: £26.3 billion) of notes secured with £12.5 billion (31 December 2012: £37.5 billion) of assets.

3 Pro-rated by programme (31 December 2012 number restated on this basis).

Total notes issued externally from secured programmes (asset backed securities and covered bonds) have fallen from £68.7 billion (assets encumbered £103.2 billion, pro rated by programme) at 31 December 2012 to £49.3 billion (assets encumbered £81.2 billion, pro rated by programme). A total of £45.9 billion (31 December 2012: £85.0 billion) of notes issued under securitisation and covered bond programmes have also been retained internally, most of which are held to provide a pool of collateral eligible for use at central bank liquidity facilities. This reduction in retained notes partially reflects the Group's increased use of whole loans as eligible collateral at central banks.

The Group uses secured transactions to manage short-term cash and collateral needs. Further details on repo and collateral pledges are available in note 54: Financial risk management. Internally held notes, encumbered through repo activity or assets pledged, are included in these disclosure amounts. Details on the assets within asset-backed commercial paper (ABCP) conduits are available in note 22: Structured entities.

Liquidity portfolio

At 31 December 2013, the Group had £89.3 billion (2012: £87.6 billion) of highly liquid unencumbered assets in its primary liquidity portfolio which are available to meet cash and collateral outflows and PRA regulatory requirements, as illustrated in the table overleaf. In addition the Group had £105.4 billion (2012: £117.1 billion) of secondary liquidity which is eligible for use in a range of central bank or similar facilities. This liquidity is managed as a single pool in the centre and is under the control of the function charged with managing the liquidity of the Group. It is available for deployment at immediate notice, subject to complying with regulatory requirements, and is a key component of the Group's liquidity management process.

Table 1.37: **Liquidity portfolio**

Primary liquidity	2013 £bn	2012 £bn	Average 2013 £bn	Average 2012 £bn
Central bank cash deposits	46.0	76.8	69.4	78.3
Government bonds	43.3	10.8	28.2	21.1
Total	89.3	87.6	97.6	99.4

Secondary liquidity	**2013 £bn**	2012 £bn	**Average 2013 £bn**	Average 2012 £bn
High-quality ABS/covered bonds[1]	1.4	2.8	2.0	2.1
Credit institution bonds[1]	0.4	3.4	1.2	2.8
Corporate bonds[1]	0.1	0.1	0.1	0.1
Own securities (retained issuance)	22.1	44.9	33.3	50.2
Other securities	4.3	5.0	4.8	8.3
Other[2]	77.1	60.9	75.2	49.8
Total	105.4	117.1	116.6	113.3
Total liquidity	194.7	204.7		

1 Assets rated A- or above.

2 Includes other central bank eligible assets.

Table 1.38: **Liquidity portfolio: currency**

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2013					
Primary liquidity	65.3	13.3	10.5	0.2	89.3
Secondary liquidity	100.4	0.8	4.0	0.2	105.4
Total	165.7	14.1	14.5	0.4	194.7
At 31 December 2012					
Primary liquidity	42.2	7.2	36.5	1.7	87.6
Secondary liquidity	109.2	1.6	4.7	1.6	117.1
Total	151.4	8.8	41.2	3.3	204.7

Primary liquid assets of £89.3 billion represent approximately 4.2 times (3.5 times at 31 December 2012) the Group's money market funding less than one year maturity (excluding derivative collateral margins and settlement accounts) and are approximately 2.0 times (1.7 times at 31 December 2012) all wholesale funding less than one year maturity, and thus provides a substantial buffer in the event of continued market dislocation.

In addition to primary liquidity holdings the Group has significant secondary liquidity holdings providing access to liquidity facilities at a number of central banks which the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions. The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of primary and secondary liquid assets and expects to see some transition from primary to secondary assets over the course of 2014.

The Group notes that the Liquidity Coverage Ratio (LCR) will become the Pillar 1 standard for liquidity in the UK in 2015, and that the PRA has the ability to impose firm specific liquidity requirements. The European Commission is to adopt further legislation by 30 June 2014 to specify the definition, calibration, calculation and phase-in of the LCR for implementation in 2015. The Group expects to meet the new requirements ahead of the implementation dates.

Stress testing results

Internal stress testing results at 31 December 2013 show that the Group has liquidity resources representing 130.9 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intra-day requirements and rating dependent contracts under the Group’s most severe liquidity stress scenario (the three month PRA combined scenario).

The Group’s stress testing assumes that further credit rating downgrades may reduce investor appetite for some of the Group’s liability classes and therefore funding capacity. A hypothetical idiosyncratic two notch downgrade of the Group’s current long-term debt rating and accompanying short-term downgrade implemented instantaneously by all major rating agencies, could result in an outflow of £6.6 billion of cash over a period of up to one year, £3.0 billion of collateral posting related to customer financial contracts and £11.8 billion of collateral posting associated with secured funding. The Group’s internal liquidity risk appetite includes such a stress scenario. The stress scenario modelling demonstrates the Group has available liquidity resources to manage such an event.

contractual cash obligations

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2013.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Enhanced capital notes	–	–	–	8,938	8,938
Long-term debt – dated	1,088	2,071	1,834	11,288	16,281
Debt securities in issue	25,808	13,619	20,292	32,650	92,369
Finance leases	2	2	2	9	15
Operating leases	292	464	464	1,166	2,386
Capital commitments	345	–	–	–	345
Other purchase obligations	1,001	1,244	417	160	2,822
	28,536	17,400	23,009	54,211	123,156

Other purchase obligations include amounts expected to be payable in respect of material contracts entered into by the Lloyds Banking Group, in the ordinary course of business, for the provision of outsourced and other services. The cost of these services will be charged to the income statement as it is incurred. The Lloyds Banking Group also has a constructive obligation to ensure that its defined post-retirement benefit schemes remain adequately funded. The amount and timing of the Lloyds Banking Group's cash contributions to these schemes is uncertain and will be affected by factors such as future investment returns and demographic changes. Lloyds Banking Group expects to make cash contributions of at least £525 million to these schemes in 2014.

At 31 December 2013, Lloyds Banking Group also had £7,093 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2013, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds Bank and HBOS to pay dividends going forward, or for Lloyds Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

Off-balance sheet arrangements

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2013 is included in note 52 to the financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £8,591 million at 31 December 2013 (with £4,233 million expiring within one year; £837 million between one and three years; £2,039 million between three and five years; and £1,482 million over five years).

Lloyds Banking Group's banking businesses are also exposed to liquidity risk through the provision of securitisation facilities to certain corporate customers. At 31 December 2013, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicles, Argento, Cancara and Grampian. These are funded in the global asset-backed commercial paper market. The assets and obligations of these conduits are included in Lloyds Banking Group's consolidated balance sheet. Lloyds Banking Group provides short-term asset-backed commercial paper liquidity support facilities on commercial terms to the issuers of the commercial paper, for use in the event of a market disturbance should they be unable to roll over maturing commercial paper or obtain alternative sources of funding.

Details of securitisations and other special purpose entity arrangements entered into by the Group are provided in notes 21 and 22 to the financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

As indicated on page F-46, the Group's securitisations include a number of synthetic securitisation arrangements. Synthetic securitisations use credit default swaps to transfer the credit risk of the underlying assets to a third party without transferring the funding requirement. As the prices of the underlying assets fall, this creates a credit risk on the third party which typically is not collateralised. The total notional amount of credit default swaps used for synthetic securitisation transactions at 31 December 2013 was £83 million.

Within Lloyds Banking Group's insurance businesses, the principal sources of liquidity are premiums received from policyholders, charges levied upon policyholders, investment income and the proceeds from the sale and maturity of investments. The investment policies followed by Lloyds Banking Group's life assurance companies take account of anticipated cash flow requirements including by matching the cash inflows with projected liabilities where appropriate. Cash deposits and highly liquid government securities are available to provide liquidity to cover any higher than expected cash outflows.

CAPITAL RISK

DEFINITION

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

RISK APPETITE

Capital risk appetite is set by the Board, reflecting the Group's strategic plans, regulatory capital constraints and market expectations. It includes a number of minimum capital ratios in normal and stressed conditions as well as a specific measure for the Insurance business, set by the Insurance Board, taking account of the need to maintain regulatory solvency including appropriate management buffers. The Board and the Group Chief Executive, assisted by the Group Asset and Liability Committee and the Group Risk Committee, regularly review performance against the risk appetite. A key metric is the Group's common equity tier 1 (CET1) capital ratio which the Group currently aims to maintain in excess of 10 per cent.

EXPOSURE

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

MEASUREMENT

The Group measures the amount of capital it holds using the regulatory framework. From 1 January 2014 this included the new Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulatory Authority (PRA) policy statement PS7/13. Prior to this date, and for the purposes of determining the Group's capital resources and requirements at 31 December 2013, these have been based upon the modified Basel II framework as implemented by the PRA.

The regulatory minimum amounts of capital, under Pillar 1 of the Basel framework, are determined as percentages of the aggregate risk-weighted assets calculated in respect of credit risk, counterparty credit risk, operational risk and market risk (Trading Book), which are predominantly calculated using internal models that are prudently calibrated based on internal loss experience. The models are subject to a number of internal controls and external scrutiny from the PRA.

The minimum requirement for total capital is supplemented, under Pillar 2 of the regulatory framework, through the issuance of bank specific Individual Capital Guidance (ICG) which adjusts the Pillar 1 minimum for those risks not covered or not fully covered under Pillar 1. A key input into the PRA's ICG setting process is a bank's own assessment of the amount of capital it needs, a process known as the Internal Capital Adequacy Assessment Process. The Group has been set specific ICG by the PRA and maintains capital at a level which exceeds this requirement. From 1 January 2015, at least 56 per cent of the ICG must be covered by CET1 capital and at least 75 per cent must be covered by tier 1 capital.

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

MITIGATION

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, continues to comply with regulatory requirements and is positioned to meet anticipated future changes to its capital requirements.

The Group is able to accumulate additional capital through profit retention, by raising equity via, for example, a rights issue or debt exchange and by raising tier 1 and tier 2 capital by issuing subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals. If necessary, this can include limiting new business.

Additional measures to manage the Group's capital position include seeking to strike an appropriate balance of capital held within its insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

MONITORING

Capital is actively managed and regulatory ratios are a key factor in the Group's planning processes and stress analyses. Five year forecasts of the Group's capital position, based upon the Group's operating plan, are produced at least annually to inform the Group's capital strategy whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group's actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a Recovery Plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios, including those in stressed scenarios, is undertaken, including submissions to the Group Asset and Liability Committee, the Group Risk Committee, Board Risk Committee and the Board.

The regulatory framework within which the Group operates continues to be enhanced as part of the global banking reforms.

Over the course of 2013 there have been significant regulatory developments in the area of capital and the related management. The principal changes relate to the finalisation of CRD IV and subsequent consultation and finalisation of PRA requirements for their implementation in the UK and the 2013 announcement that major UK banks are expected to meet specific targets on an adjusted basis for CET1 and leverage ratios. The Group notes the final statements from the PRA on the implementation of capital requirements in the UK and will continue to work with the regulator to ensure that the Group continues to meet the regulator's capital expectations. The Group continuously evaluates the efficiency of its capital structure, management of which may result in significant one-off charges or gains, and its capital structure's alignment with the regulatory framework. With the adoption of CRD IV, the Group is considering opportunities to raise new Additional tier 1 securities which would rank senior to ordinary shares, and be automatically convertible into ordinary shares if the Group's common equity tier 1 ratio fell below a specified trigger point.

Beyond CRD IV there have been a number of draft technical standards issued for consultation which relate to both capital and leverage and both Basel and European regulatory bodies continue to develop their thinking on both capital resources and capital requirement measures. Within the UK the PRA have been active in requiring enhanced capital standards and encouraging further disclosure developments and HM Treasury have been consulting on practical aspects of the application of a counter cyclical buffer.

The Group monitors these developments very closely, participating actively in the regulatory consultation processes and analysing the potential financial impacts to ensure that the Group continues to have a strong loss absorption capacity that exceeds the regulatory requirements and the Group's risk appetite and is consistent with market expectations.

CAPITAL MANAGEMENT IN 2013

The Group made significant progress in further strengthening its capital position in 2013 through its strongly capital generative strategy, including capital-efficient profit generation, the release of capital through asset disposals outside of the Group's risk appetite and the successful delivery of management actions.

- Core tier 1 ratio, based on the capital regulations as at 31 December 2013, increased 2.0 percentage points from 12.0 per cent to 14.0 per cent.
- Fully loaded CET1 ratio under the CRD IV rules increased to 10.0 per cent. The adjusted fully loaded CET1 ratio increased to 10.3 per cent.

Capital position at 31 December 2013

The Group's capital position applying prevailing rules as at 31 December 2013 is set out in the following section. Additionally, information about the Group's capital position on a CRD IV basis is set out on page 123.

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Table 1.39: **Capital resources (audited)**

Capital resources	2013 £m	2012[2] £m
Core tier 1		
Shareholders' equity per balance sheet	38,989	43,999
Non-controlling interests per balance sheet	347	685
Regulatory adjustments:		
Regulatory adjustments to non-controlling interests	(315)	(628)
Adjustment for own credit	185	217
Defined benefit pension adjustment	(78)	(1,438)
Unrealised reserve on available-for-sale debt securities	750	(343)
Unrealised reserve on available-for-sale equity investments	(135)	(56)
Cash flow hedging reserve	1,055	(350)
Other items	452	33
	41,250	42,119
Less: deductions from core tier 1		
Goodwill	(2,016)	(2,016)
Intangible assets	(1,799)	(2,091)
50 per cent excess of expected losses over impairment provisions	(373)	(636)
50 per cent of securitisation positions	(71)	(183)
Core tier 1 capital	36,991	37,193
Non-controlling preference shares[1]	1,060	1,568
Preferred securities[1]	3,982	4,039
Less: deductions from tier 1		
50 per cent of material holdings	(3,859)	(46)
Total tier 1 capital	38,174	42,754
Tier 2		
Undated subordinated debt	1,825	1,828
Dated subordinated debt	18,567	19,886
Unrealised gains on available-for-sale equity investments provisions	135	56
Eligible provisions	359	977
Less: deductions from tier 2		
50 per cent excess of expected losses over impairment provisions	(373)	(636)
50 per cent of securitisation positions	(71)	(183)
50 per cent of material holdings	(3,859)	(46)
Total tier 2 capital	16,583	21,882
Supervisory deductions		
Unconsolidated investments – life	–	(10,104)
– general insurance and other	–	(929)
Total supervisory deductions	–	(11,033)
Total capital resources	54,757	53,603

[1] Covered by existing grandfathering provisions.

[2] 31 December 2012 comparatives have not been restated to reflect the implementation of IAS 19R and IFRS 10.

Table 1.41: **Risk-weighted assets and capital ratios**

	2013 £m	2012[1] £m

Risk-weighted assets	263,850	310,299
Core tier 1 capital ratio	14.0%	12.0%
Tier 1 capital ratio	14.5%	13.8%
Total capital ratio	20.8%	17.3%

[1] 31 December 2012 comparatives have not been restated to reflect the implementation of IAS 19R and IFRS 10.

The movements in core tier 1, tier 1, tier 2 and total capital in the period are shown below:

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Table 1.40: **Movements in capital**

	Core tier 1 £m	Tier 1 £m	Tier 2 £m	Supervisory deductions £m	Total Capital £m
At 31 December 2012[1]	37,193	5,561	21,882	(11,033)	53,603
Loss attributable to ordinary shareholders	(838)	–	–	–	(838)
Share issuance	510	–	–	–	510
Pension movements:					
Implementation of IAS 19R[2]	(1,258)	–	–	–	(1,258)
Deduction of pension asset	515	–	–	–	515
Movement through other comprehensive income	(108)	–	–	–	(108)
Goodwill and intangible assets deductions	292	–	–	–	292
Excess of expected losses over impairment provisions	263	–	263	–	526
Change in treatment of material holdings	–	(5,517)	(5,516)	11,033	–
Material holdings deduction	–	1,704	1,703	–	3,407
Eligible provisions	–	–	(618)	–	(618)
Subordinated debt movements:					
Foreign exchange	–	40	98	–	138
New issuances	–	–	–	–	–
Repurchases, redemptions, amortisation and other	–	(605)	(1,420)	–	(2,025)
Other movements	422	–	191	–	613
At 31 December 2013	36,991	1,183	16,583	–	54,757

1 31 December 2012 comparatives have not been restated to reflect the implementation of IAS 19R and IFRS 10.

2 Includes the impact to other comprehensive income and movement in the retirement benefit asset.

Core tier 1 capital resources have decreased by £202 million in the period largely driven by movements relating to defined benefit pension schemes and attributable loss, partially offset by share issuances and reductions in excess expected losses and intangible assets. The movements relating to pension schemes primarily reflect the impact of the adoption of amendments to IAS 19, whereby valuation impacts relating to Group defined benefit schemes flow through other comprehensive income, partially offset by a reduction in the regulatory deduction of the defined benefit pension scheme asset.

Tier 1 and tier 2 capital resources have reduced primarily due to the reallocation of unconsolidated investments in Life and General Insurance businesses, which were previously deducted as supervisory deductions from total capital, to become deductions from tier 1 capital (50 per cent of the total) and tier 2 capital (also 50 per cent).

The material holdings deduction from capital, predominantly relating to the Group’s investment in its Insurance businesses, has reduced by £3,407 million during the period reflecting payment by the Insurance businesses to the banking group of dividends totalling £2,155 million, elements of the Group’s subordinated debt holdings in the Insurance business that have been repaid following the issuance of external subordinated debt in the period and the disposal of the Group’s holding in St. James’s Place.

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Table 1.41: **Risk-weighted assets**

Risk-weighted assets	2013 £m	2012 £m
Divisional analysis of risk-weighted assets:		
Retail	85,677	95,470
Commercial Banking	138,541	165,209
Wealth, Asset Finance and International	25,886	36,167
Group Operations and Central items	13,746	13,453
	263,850	310,299
Risk type analysis of risk-weighted assets:		
Foundation Internal Ratings Based (IRB) approach	82,870	80,612
Retail IRB approach	85,139	91,445
Other IRB approach	9,221	12,396
IRB approach	177,230	184,453
Standardised approach	41,150	73,665
Credit risk	218,380	258,118
Counterparty credit risk	7,794	12,848
Operational risk	26,594	27,939
Market risk	11,082	11,394
Total risk-weighted assets	263,850	310,299

Retail risk-weighted assets reduced by £9.8 billion in the year primarily due to improvements in credit quality due to effective portfolio management and the impact of positive macroeconomic factors including favourable movements in UK house prices.

The reductions of risk-weighted assets of £26.7 billion in Commercial Banking and £10.3 billion in Wealth, Asset Finance and International primarily reflect a further reduction in assets outside of the Group's risk appetite, the move to slotting models for Commercial Real Estate (CRE) businesses and the impact of macroeconomic factors.

The reduction in Standardised approach risk-weighted assets is largely due to the roll-out of new IRB approaches, predominantly the implementation of slotting models in the UK and Ireland, and disposals of assets outside of the Group's risk appetite.

Counterparty credit risk-weighted assets reduced from £12.8 billion to £7.8 billion. Contributing to this reduction are mark-to-market changes, management actions and migration of portfolios to the Foundation IRB approach.

Table 1.42: **Risk-weighted asset movement by key driver**

	£bn	£bn

At 31 December 2012		310.3
Management of the balance sheet	(1.8)	
Disposals	(20.7)	
External economic factors	(15.4)	
Model and methodology changes	3.2	
Regulatory policy changes	(5.4)	
Other	0.4	
Credit risk-weighted asset movement		**(39.7)**
Counterparty credit risk-weighted asset movement		**(5.1)**
Operational risk weighted asset movement		**(1.3)**
Market risk-weighted asset movement		**(0.3)**
At 31 December 2013		**263.9**

The risk-weighted asset movements table provides an analysis of the movement in risk-weighted assets in 2013 and an insight in to the key drivers of the movements in credit risk risk-weighted assets over the course of the year as follows.

– Management of the balance sheet includes risk-weighted asset movements arising from new lending and asset run-off. During 2013 there was a small risk-weighted asset reduction of £1.8 billion in this category.

– Disposals include risk-weighted asset reductions arising from the sale of assets, portfolios and businesses. Disposals reduced risk-weighted assets by £20.7 billion, primarily reflecting disposals of assets outside of the Group's risk appetite in Commercial Banking and Wealth, Asset Finance and International.

– External economic factors captures movements driven by changes in the economic environment. The reduction in risk-weighted assets of £15.4 billion is mainly due to changes in underlying credit quality, favourable house price movements and exposures outside of the Group's risk appetite moving into default under the Foundation IRB approach.

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– Model and methodology changes include the movement in risk-weighted assets arising from new model implementation, model enhancement and changes in credit risk approach applied to certain portfolios. Model and methodology changes increased risk-weighted assets by £3.2 billion.

– Regulatory policy changes represent changes required by regulatory authorities. Substantially all of the £5.4 billion reduction is due to the implementation of slotting models relating to Commercial Real Estate and other exposures in the UK and Ireland.

Within the categories above, risk-weighted asset movements can arise as a result of credit risk exposures becoming adjustments to capital resources, through expected losses, rather than being risk-weighted.

CRD IV

There have been significant developments in the prudential regulatory requirements for European banks during 2013 principally the finalisation of the rules which implement the Basel III regulatory reforms in the European Union (EU). The legislation (CRD IV) implementing these reforms in Europe comprises updated Capital Requirements Regulation (CRR) and Directive (CRD).

CRD IV is enacted in law and applicable in Europe from 1 January 2014. There are however a number of draft regulatory and implementing technical standards that the European Banking Authority (EBA) will implement following further consultation. These standards are intended to provide guidance in interpreting CRD IV text and the Group has not reflected the impact of these in its CRD IV estimates as it does not currently expect them to have a material impact on the capital position outlined below.

The CRD IV rule changes introduce a revised definition of regulatory capital, primarily focussed on Common Equity Tier 1 (CET 1) capital as the predominant form of going concern capital, with greater quantum to be held by banks. There are increased capital deductions and new regulatory adjustments affecting this higher tier of capital. The new rules also introduce revised eligibility requirements for capital instruments and increased risk-weighted assets (RWA) requirements, mainly for counterparty credit risk, and also allows for certain amounts of significant investments and deferred tax assets to be risk weighted.

The CRD IV reforms also include the introduction of a leverage ratio framework designed to reinforce risk based capital requirements with a simple, transparent, non-risk based ‘backstop’ measure. The leverage ratio is defined as tier 1 capital divided by the exposure measure. The Basel Committee will test the proposed 3 per cent minimum requirement for the leverage ratio and have proposed that final calibrations, and any further adjustments to the definition of the leverage ratio, will be completed by 2017, with a view to migrating to a Pillar 1 treatment on

1 January 2018.

The Group's Pillar 3 Report, which is available on the Group's website www.lloydsbankinggroup.com, is required under Basel II and sets out additional information relating to risk and capital management, principally focusing on capital resources and risk-weighted assets under the various regulatory approaches, includes further information on CRD IV.

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Table 1.43: **Capital position on CRD IV basis**

	Fully loaded CRD IV rules £m
At 31 December 2013	
Common equity tier 1 (CET1)	
Shareholders' equity per balance sheet	38,989
Adjustment for insurance entity[1]	(1,917)
Regulatory adjustments:	
Non-controlling interests	–
Unrealised reserves on available-for-sale assets	–
Other adjustments	1,295
	38,367
less: deductions from common equity tier 1	
Goodwill and other intangible assets[1]	(1,979)
Excess of expected losses over impairment provisions	(866)
Securitisation deductions	(141)
Significant investments[1]	(3,185)
Deferred tax assets	(5,155)
Common equity tier 1 capital	27,041
Adjustment in respect of the announced sales of Heidelberger Leben, Scottish Widows Investment Partnership and Sainsbury's Bank	**884**
Adjusted common equity tier 1 capital	27,925
Risk-weighted assets	271,078
Adjustment in respect of the announced sales of Heidelberger Leben, Scottish Widows Investment Partnership and Sainsbury's Bank	**830**
Adjusted risk-weighted assets	271,908
Common equity tier 1 capital ratio	10.0%
Adjusted common equity tier 1 capital ratio	10.3%

1 Removal of post-acquisition reserves impacts for Insurance business as under CRD IV, as implemented by PRA policy statement PS7/13, the deduction for significant investments in the equity of financial sector entities is based on cost of investment where previously this was based on net asset value. The overall impact of this change on the CRD IV ratios is negligible.

Adjusted CRD IV capital information includes the benefits of the announced sales of Heidelberger Leben, Scottish Widows Investment Partnership and Sainsbury's Bank.

The CRD IV and adjusted CRD IV capital information set out in the table above constitutes non-GAAP measures as defined by the United States Securities and Exchange Commission's Regulation G. Management uses this capital information as a measure of its capital adequacy and believes that it provides important information to investors because it uses the basis under which the Group expects to be regulated in the future. The Group's capital and risk-weighted assets measured under regulatory rules prevailing at 31 December 2013 is the comparable measure for Regulation G purposes.

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The table below presents a reconciliation of the Group's reported core tier 1 capital and RWA position at 31 December 2013 to the estimated fully loaded CET1 capital and estimated RWA position based on the Group's interpretation of the final CRD IV regulation supplemented by PRA guidance.

	Risk-weighted assets £m	Capital £m	Capital ratio £m
Under rules prevailing at 31 December 2013			
Reported risk-weighted assets (RWAs)	263,850		
Reported core tier 1 capital		36,991	
Reported core tier 1 ratio			14.0%
Reconciliation to CRD IV basis			
Removal of filters			
– unrealised gains/(losses) on available-for-sale debt securities		(750)	
– unrealised gains/(losses) on available-for-sale equity investments		135	
Excess of expected losses over impairment provisions deducted 100% from CET1		(373)	
Restriction of excess of impairment provisions over expected losses in defaulted portfolios		(349)	
Securitisation positions deducted 100% from CET1		(71)	
Deferred tax assets		(5,155)	
Significant investments in CET1 capital of financial sector entities		(3,185)	
Other CRD IV adjustments, including additional valuation adjustments		(202)	
Credit valuation adjustment volatility	3,190		
Significant investments below threshold, risk-weighted at 250%	6,899		
Deferred tax assets below threshold, net of reversal of amounts risk-weighted under 31 December 2013 rules	(2,894)		
Other CRD IV adjustments	33		
Under CRD IV			
Estimated total risk-weighted assets	271,078		
Estimated CET1 capital under CRD IV		27,041	
Estimated CET1 ratio			10.0%
Reconciliation to CRD (IV) adjusted			
Adjustment in respect of the announced sales of Heidelberger Leben, Scottish Widows Investment Partnership and Sainsbury's Bank	830	884	
Under CRD (IV) adjusted			
Estimated total risk-weighted assets	271,908		
Estimated adjusted CET 1 capital under CRD IV		27,925	
Estimated adjusted CET 1 ratio			10.3%

Capital management initiatives adopted by the Group have already contributed to improving the Group's CET1 ratio during 2012 and 2013. Following these initiatives, the Group's capital ratios are in line with or above its enhanced internal target well in advance of the mandated transition to CRD IV. Activities in 2013 have included the continuing run off and disposal of capital intensive portfolios including UK, Irish and Australian commercial real estate portfolios together with the disposal of a number of investments that do not form part of the Group's ongoing strategy, principal among which was the sale of the Group's holding in St James's Place plc.

Although the effect of the CRD IV rules is shown on a fully loaded basis the CRD IV rules allow for a transition period up to 2019 to phase in the new deductions and regulatory adjustments to CET 1 and up to 2022 for phasing out the eligibility of certain subordinated debt instruments which will not qualify as capital under the new rules. The PRA has however issued final policy guidance on the implementation of CRD IV in the UK in November and December 2013 and has used the discretion granted to it by the European Commission to require a significant acceleration of the transition timetable for deductions and regulatory adjustments impacting at the CET 1 level. In practice there is very limited difference between the CET 1 definition that PRA has required is applied from 1 January 2014 and fully loaded CET 1.

Accordingly, the Group currently manages its capital position to meet an internal target CET1 ratio on a fully loaded basis for year ended 31 December 2013 and beyond. The Group will continue to manage its capital position to ensure that it exceeds current regulatory requirements and expects to meet future regulatory requirements. It will review its target capital ratios on an ongoing basis, reflecting any change in the regulatory environment as they develop.

LIFE INSURANCE BUSINESSES

The business transacted by the life insurance companies within the Group comprises unit-linked business, non-profit business and with-profits business. Several companies transact either unit-linked and/or non-profit business, but Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical) hold the only With-Profit Funds managed by the Group.

BASIS OF DETERMINING REGULATORY CAPITAL OF THE LIFE INSURANCE BUSINESSES

Available capital resources

Available capital resources represent the excess of assets over liabilities calculated in accordance with detailed regulatory rules issued by the PRA.

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. If the market is not active, the Group establishes a fair value by using valuation techniques. 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 PRA 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.

Regulatory capital requirements

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the PRA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows and Clerical Medical, 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 Resilience Capital Requirement). The regulatory capital requirement is deducted from the available capital resources to give statutory excess capital.

For Scottish Widows and Clerical Medical, no Resilience Capital Requirement is required. However, a further test is required in respect of the With-Profit Funds. This involves comparing the statutory basis of assessment with a realistic basis of assessment as described below.

Realistic basis: The PRA requires each life insurance company which contains a With-Profit Fund in excess of £500 million to also carry out a realistic valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word realistic in this context reflects the fact that assumptions are best-estimate as opposed to prudent. This realistic valuation is an assessment of the financial position of a With-Profit Fund calculated under a methodology prescribed by the PRA.

The valuation of with-profits assets in a With-Profit Fund on a realistic basis differs from the valuation on a statutory basis as, in respect of non-profit business written therein, it includes the present value of the anticipated future release of the prudent margins for adverse deviation. In addition, the realistic valuation uses the market value of assets without the limit affecting the statutory basis noted above. The realistic valuation of liabilities differs from the statutory basis in including an allowance for future bonuses whilst the value of options and guarantees are assessed using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). In calculating the realistic liabilities, the model also 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 in the section entitled Options and guarantees on page 129.

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 (the Risk Capital Margin). In circumstances where the realistic excess capital position is less than the statutory excess capital, the company is required to hold additional capital to cover the shortfall. Any additional capital requirement under this test is referred to as the With-Profits Insurance Capital Component.

The determination of realistic liabilities of the With-Profit Funds includes the value of internal transfers expected to be made from each With-Profit Fund to the Non-Profit Fund held within the same life insurance entity. These internal transfers may include charges on policies where the associated costs are borne by the Non-Profit Fund.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Capital statement

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are based on management's current expectations pending completion of the annual financial returns to the PRA.

Table 1.44: **Capital resources (audited)**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	UK Life Shareholder Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2013 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds	**–**	**–**	**–**	**2,362**	**4**	**2,366**
Held within the long-term funds	**–**	**–**	**6,139**	**–**	**181**	**6,320**
Total shareholders' funds	**–**	**–**	**6,139**	**2,362**	**185**	**8,686**
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	**336**	**55**	**–**	**–**	**–**	**391**
Value of in-force business	**–**	**–**	**(4,117)**	**–**	**(80)**	**(4,197)**
Other differences between IFRS and regulatory valuation of assets and liabilities	**–**	**–**	**(430)**	**(2,659)**	**(23)**	**(3,112)**
Estimated share of realistic liabilities consistent with the PRA reporting treatment	**(389)**	**(55)**	**–**	**–**	**–**	**(444)**
Qualifying loan capital	**–**	**–**	**–**	**2,611**	**–**	**2,611**
Support arrangement assets	**210**	**–**	**(210)**	**–**	**–**	**–**
Available capital resources	**157**	**–**	**1,382**	**2,314**	**82**	**3,935**
At 31 December 2012 (statutory basis)						
Shareholders' funds:						
Held outside the long-term funds			6	1,791	562	2,359
Held within the long-term funds	–	–	6,259	–	225	6,484
Total shareholders' funds	–	–	6,265	1,791	787	8,843
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	205	62	–	–	–	267
Value of in-force business	–	–	(5,056)	–	(718)	(5,774)
Other differences between IFRS and regulatory valuation of assets and liabilities	–	–	101	(175)	152	78
Estimated share of realistic liabilities consistent with the PRA reporting treatment	(305)	(62)	–	–	–	(367)

Qualifying loan capital	–	–	–	2,238	–	2,238
Support arrangement assets	190	–	(190)	–	–	–
Available capital resources	90	–	1,120	3,854	221	5,285

Available capital resources for With-Profit Funds are presented in the table on a realistic basis as this is more onerous than on a regulatory basis.

FORMAL INTRA-GROUP CAPITAL ARRANGEMENTS

Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

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Constraints over available capital resources

Scottish Widows

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-Profits 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. The requirements of the Scheme sit alongside Scottish Widows' published Principles and Practices of Financial Management of With-Profit business.

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. Under the Scheme 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 PRA permission to include the value of the Support Account or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets (subject to the Non-Participating Fund being able to cover this amount by its surplus admissible assets) in assessing the realistic value of assets available to the With-Profit Fund. At 31 December 2013 the estimated value of surplus admissible assets in the Non-Participating Fund was £1,902 million (2012: £1,430 million) and the estimated value of the Support Account was £nil (2012: £nil). However, at 31 December 2013, the excess of realistic liabilities of with-profits business written before demutualisation over the relevant assets was £54 million (2012: £62 million) which, in accordance with the PRA's permission, has been used to assess the estimated value of realistic assets available to the With-Profit Fund (and has therefore reduced the value of the Non-Participating Fund's surplus admissible assets by that amount).

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 2013, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £6,784 million (2012: £5,647 million) and the estimated combined value of the Support Account and Further Support Account was £2,070 million (2012: £2,171 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 2013 is £156 million (2012: £128 million). Scottish Widows has obtained from the PRA 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.

Clerical Medical

The surplus held in the Clerical Medical With-Profit Fund can only be applied to meet the requirements of the fund itself or distributed according to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses on traditional with-profits business. The use of capital within the fund is also subject to the terms of the Scheme of Demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. In extreme circumstances capital within the Clerical Medical Non-Profit Fund may be made available to support the With-Profit Fund.

Other life insurance businesses

Except as described above capital held in UK Non-Profit Funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK, including Germany and Ireland. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

Movements in regulatory capital

The movements in the Group's available capital resources in the life business can be analysed as follows:

Table 1.45: **Movements in available capital resources**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Fund £m	UK Life Shareholder Fund £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2012	90	–	1,120	3,854	221	5,285
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	2	6	101	–	11	120
Dividends and capital transactions	–	–	(394)	(1,280)	(23)	(1,697)
Change in support arrangements	20	–	(20)	–	–	–
New business and other factors	45	(6)	732	(240)	60	591
Disposal of business	–	–	(157)	(20)	(187)	(364)
At 31 December 2013	157	–	1,382	2,314	82	3,935

With-Profit Funds

Available capital in the Scottish Widows With-Profit Fund has increased from £90 million at 31 December 2012 to an estimated £157 million at 31 December 2013 mainly due to a decrease in the liabilities of the non-transferred business (caused by model changes and positive investment returns). Available capital in the Clerical Medical With-Profit Fund is estimated to be zero at 31 December 2013 (no change from 31 December 2012). This is because the fund is in the process of distributing the free estate and all surplus will ultimately be distributed to policyholders.

UK Non-Profit Funds

Available capital in the UK Non-Profit Funds has increased from £1,120 million at 31 December 2012 to an estimated £1,382 million at 31 December 2013. This is mainly due to income on existing business offset by the impact of writing new business, positive investment returns, one-off transfers and an increase in provisions.

UK Life Shareholder Funds

Available capital in the UK Life Shareholder Funds has decreased from £3,854 million at 31 December 2012 to an estimated £2,314 million at 31 December 2013. The decrease mainly reflects the funding used to pay the dividend from Scottish Widows Group to Lloyds Bank.

Overseas life business

Available capital has decreased during 2013 due to a dividend payment which was partially offset by profits emerging on new and in force business.

Analysis of policyholder liabilities reported in the balance sheet in respect of the Group's life insurance business is as follows. With-Profit Fund liabilities are valued in accordance with FRS 27.

Table 1.46: **Analysis of policyholder liabilities**

	Scottish Widows With-Profit Fund £m	Clerical Medical With-Profit Fund £m	UK Non-Profit Funds £m	Overseas Life Business £m	Total Life Business £m
At 31 December 2013					
With-Profit Fund liabilities	**13,539**	**7,427**	**–**	**–**	**20,966**
Unit-linked business (excluding that accounted for as non-participating investment contracts)	**–**	**–**	**45,310**	**4,064**	**49,374**
Other life insurance business	**–**	**–**	**11,702**	**–**	**11,702**
Insurance and participating investment contract liabilities	**13,539**	**7,427**	**57,012**	**4,064**	**82,042**
Non-participating investment contract liabilities	**–**	**–**	**26,722**	**868**	**27,590**
Total policyholder liabilities	**13,539**	**7,427**	**83,734**	**4,932**	**109,632**
At 31 December 2012					
With-Profit Fund liabilities	13,779	8,248	2	–	22,029
Unit-linked business (excluding that accounted for as non-participating investment contracts)	–	–	38,756	8,429	47,185
Other life insurance business	–	–	12,923	2	12,925
Insurance and participating investment contract liabilities	13,779	8,248	51,681	8,431	82,139
Non-participating investment contract liabilities	–	–	49,929	4,443	54,372
Total policyholder liabilities	13,779	8,248	101,610	12,874	136,511

CAPITAL SENSITIVITIES

Shareholders’ funds

Shareholders’ funds outside the long-term business fund are invested in readily tradable assets (e.g. equities and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the liquidity risk appetite of the Insurance business.

With-Profit Funds

The with-profits realistic liabilities and the available capital for the With-Profit Funds 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. Various hedging strategies are used to manage these exposures.

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 Funds is partly mitigated by the actions that can be taken by management.

Other long-term funds

Outside the With-Profit Funds, 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). Assumptions relating to future expenses are also significant with increases in the expected level of future costs leading to increases in the value of the liabilities and consequently leading to a reduction in available capital. Reinsurance arrangements are in place to reduce the Group’s exposure to deteriorating mortality rates in respect of non-annuity life insurance contracts such that assured life mortality is a less significant assumption. For Clerical Medical, assumptions relating to the provision in relation to German insurance business litigation are also significant.

Assets held in excess of those backing reserves are invested in readily tradable assets (e.g. equities and fixed interest securities), cash and a range of less liquid fixed interest instruments, at levels consistent with the risk appetite of the Insurance business.

OPTIONS AND GUARANTEES

The Group has sold insurance products that contain options and guarantees, both within the With-Profit Funds and in other funds.

Options and guarantees within the With-Profit Funds

The most significant options and guarantees provided from within the With-Profit Funds 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 in Scottish Widows 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 2013 of £2.2 billion (2012: £2.1 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 PRA, the liabilities of both the Clerical Medical and Scottish Widows With-Profit Funds 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 spot yields derived from swap yield curves.

– 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, at 31 December 2013, the 10 year equity-implied at-the-money assumption was set at 22.1 per cent (2012: 26.3 per cent).

The assumption for property volatility was 15 per cent (2012: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 17 per cent (2012: 18 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 Funds

A number of typical guarantees are provided outside the With-Profit Funds such as guaranteed payments on death (e.g. term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, 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 £63 million (2012: £56 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 approximately £1 million. If yields were 0.5 per cent lower than assumed, the liability would increase by approximately £9 million.

REGULATORY RISK

DEFINITION

Regulatory risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action due to failing to comply with applicable laws, regulations, codes of conduct or legal obligations.

RISK APPETITE

The Group has zero risk appetite for material regulatory breaches. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes which apply to the Group and its activities.

EXPOSURES

The Group periodically experiences material regulatory breaches outside its risk appetite. Regulatory exposure is also driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group. This is particularly the case currently: the industry still continues to witness increased levels of government and regulatory intervention in the banking sector with an increasing number of regulatory rules from both the UK and overseas affecting the Group's operations. It is clear that regulatory challenges remain, including the area of conduct where the Group accepted the findings of the FCA investigation into its historic Bancassurance incentive schemes, and agreed to pay a fine of £28 million in 2013. The Group has made significant changes to its incentive schemes since the period relating to the fine.

MEASUREMENT

Regulatory risks are measured against a set of risk appetite metrics, with appropriate thresholds, which have been approved by the Board and which are regularly reviewed and monitored. Metrics include assessments of control and material regulatory rule breaches.

MITIGATION

Mitigation is undertaken across the Group and comprises the following key components:

- Risks are assessed by the business and controls put in place to mitigate them;
- Enhanced regulatory reporting;
- Regulatory horizon scanning;
- Oversight and assurance of the regulatory risks within the business;
- Quality assurance theme reviews to assess compliance with rules, regulations and policies;
- Continued investment in the Group's IT systems is enabling the Group to meet its regulatory commitments;
- Senior business leaders monitor the progress of these assessments and mitigations;
- Material risks and issues are escalated to Group-level bodies which challenge the business on its management of risks and issues; and
- Mandated policies and processes require minimum control frameworks, management information and standards to be implemented.

MONITORING

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Compliance and Conduct Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory sections in the Group's consolidated risk reporting.

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INSURANCE RISK

DEFINITION

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

RISK APPETITE

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the Group's risk preferences. Insurance risk appetite in the Insurance business is set by the Insurance Board and includes maximum earnings exposures to longevity and persistency risk in defined stresses. Insurance risk appetite for longevity in the defined benefit pension schemes is set by the Board using two key metrics: a one year increase to life expectancy and a combined market and longevity stress.

EXPOSURES

The major sources of insurance risk within the Group are the Insurance business and the Group's defined benefit pension schemes. The nature of Insurance business involves the accepting of insurance risks which relate primarily to mortality, longevity, morbidity, persistency and expenses for the life and pension business, and property and unemployment for the general insurance business. The prime insurance risk of the Group's defined benefit pension schemes is related to longevity. As with any business, the Group is exposed to a number of insurance events, some of which are covered by bespoke corporate insurance policies.

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 on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance's Individual Capital Assessment (Group defined benefit pension schemes utilise 1-in-20 year stresses) and other supporting measures where appropriate, including those set out in notes 36 and 37 to the financial statements.

MITIGATION

A key element of the control framework is the consideration of insurance risk by an appropriate combination of high level committees and Boards. For the Insurance business the ultimate control body is the Insurance Board but significant risks from Insurance and the defined benefit pensions schemes are reviewed by the Group Executive and Group Risk Committees and/or Board. Governance of the Group's defined benefit pension schemes also includes two specialist pension committees (one Group Executive sub committee and a supporting management committee).

Insurance risk is mitigated through pooling and through diversification across large numbers of individuals, geographical areas, and different types of risk exposure. A number of processes are used to control insurance risk including: underwriting (the process to ensure that new insurance proposals are properly assessed); pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products); claims management; product design and management; policy wording; reinsurance and cost controls and efficiencies.

In addition, exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

The most significant insurance risks within the Insurance business are longevity risk, persistency risk and expenses. The merits of longevity risk transfer and hedging solutions are regularly reviewed. It is not possible to hedge persistency risk. 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 potential losses 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 the Group's chosen reinsurers. The most significant insurance risk in the defined benefit pension schemes is longevity risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

The Group's exposure to accumulations of risk and events (including possible catastrophes) is mitigated by insurance arrangements spread over different insurers. Detailed analysis, including that of the potential losses under various catastrophe scenarios, supports the choice of insurance arrangements.

MONITORING

Ongoing monitoring is in place to track the progression of insurance risks. In respect of the Insurance business this involves monitoring relevant experiences against expectations (for example claims experience, persistency experience, expenses and non-disclosure at the point of sale) as well as tracking the progression of insurance risk capital against limits and the sensitivity of profit before tax to the most significant insurance risks persistency and longevity. The effectiveness of controls put in place to manage insurance risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken. Progress against risk appetite metrics in respect of longevity risk in the Group's defined benefit pension schemes is regularly reported and reviewed by the relevant committees.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PEOPLE RISK

DEFINITION

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/or value.

RISK APPETITE

The Group’s people risk appetite and corresponding measures are reviewed and approved annually by the Board to enable the Group to lead responsibly and proficiently, manage people resource effectively, support and develop colleague talent, and meet legal and regulatory obligations related to its people.

To achieve this, the Group has developed and implemented policies and processes that provide a framework where the Group’s businesses and colleagues can operate in accordance with the laws, regulations and voluntary codes that apply to the Group and its activities.

EXPOSURES

The Group’s management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. Over the coming year the Group anticipates the following key people risk exposures:

- Retention of colleague talent within key populations in the context of a more active employment market;
- The Group’s reward scheme compliance and talent attraction may be impacted by regulatory changes to remuneration governance and the Approved Persons regime; and
- Colleague engagement may be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct.

MEASUREMENT

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group. In addition to risk appetite measures, people risks and controls are monitored across individual Divisions and business units. Divisional metrics are calibrated against the Group's risk appetite and monitored on a monthly basis via the Group's risk reporting structure.

MITIGATION

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Strengthening the risk and customer focused culture amongst colleagues by developing and delivering initiatives that reinforce behaviours to generate the best possible long-term outcomes for customers and colleagues;
- Embedding the Group's Codes of Personal and Business Responsibility across the Group;
- Reviewing and developing incentives to ensure they promote colleagues behaviours that meet customer needs and regulatory expectations;
- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Maintaining focus on people risk management across the Group; and
- Ensuring compliance with legal and regulatory requirements related to Approved Persons and the Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities.

MONITORING

People risks from across the Group are reported through the first line of defence. Key people risks are then escalated to the relevant operational or regulatory oversight committees. Key people risks are assessed in the context of the Group's wider risk profile, and tracked to remediation.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FINANCIAL REPORTING RISK

DEFINITION

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate and timely information.

RISK APPETITE

The risk appetite is set by the Board and reviewed on an annual basis or more frequently. It includes complying with statutory and regulatory reporting requirements and compliance with tax legislation in the jurisdictions in which the Group operates.

EXPOSURE

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support market disclosures.

MEASUREMENT

Financial reporting risk is measured by the adequacy of and compliance with a number of key controls. Identification of potential financial reporting risk also forms a part of the Group's Operational Risk management framework.

MITIGATION

The Group maintains a system of internal controls, which is designed to:

– ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;

– enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements; and

– ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the British Bankers' Association Code for Financial Reporting Disclosure.

MONITORING

Financial reporting risk is actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

– annual assessments of (1) the effectiveness of internal controls over financial reporting; and (2) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act;

– annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a Disclosure Committee which assists the Group Chief Executive and Group Finance Director in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 176 to 177.

GOVERNANCE RISK

DEFINITION

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

RISK APPETITE

Governance risk appetite is defined and embedded through the Group's Governance Principle and Policy which are reviewed and approved by the Board on an annual basis. The Group has governance arrangements that support the effective long-term operation of the business, maximise shareholder value and meet regulatory and social expectations.

EXPOSURE

The internal governance arrangements of major financial institutions continue to be subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation within the UK and overseas with which it must comply. Risk governance and risk culture are mutually reinforcing.

MEASUREMENT

The Group's governance arrangements are assessed against new or proposed legislation and regulation and best practice among peer organisations in order to identify any areas of enhancement required.

MITIGATION

The Group's Risk Management Framework establishes robust arrangements for risk governance, in particular by:

- defining individual and collective accountabilities for risk management, risk oversight and risk assurance through a Three Lines of Defence model which supports the discharge of responsibilities to customers, shareholders and regulators;
- outlining governance arrangements which articulate the enterprise-wide approach to risk management; and
- supporting a consistent approach to Group-wide behaviour and risk decision-making through a Group Policy Framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, boundaries and risk appetite measures which can be controlled, enforced and monitored.

The Ethics and Responsible Business Policy and supporting Codes of Personal Responsibility and Business Responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the Codes in all aspects of their roles.

Driving adherence to the Group's Risk Management framework goes 'hand in glove' with its approach to risk culture which is embedded in the Group's approach to recruitment, selection, training, performance management and reward.

MONITORING

A review of the Group's Risk Management Framework, which includes the status of the Group's Principles and Policy Framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings are reported to the Group Risk Committee, Board Risk Committee and the Board.

In addition, in 2013 the Group undertook a review of the findings of the Barclays Salz Review to ensure the Salz recommendations were factored into the Group's current approach to governance and ongoing initiatives. A further review will be undertaken in 2014.

For further information on Corporate Governance see pages 164 to 185.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Investment portfolio, maturities, deposits, short-term borrowings

Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables

The following table sets out the book values and valuations of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

	2013 Book value £m	2013 Valuation £m	2012 Book value [1] £m	2012 Valuation [1] £m	2011 Book value £m	2011 Valuation £m
Trading securities and other financial assets at fair value through profit or loss						
US treasury and US government agencies	922	922	1,097	1,097	1,506	1,506
Other government securities	19,767	19,767	20,248	20,248	21,861	21,861
Other public sector securities	2,197	2,197	1,056	1,056	1,183	1,183
Bank and building society certificates of deposit	1,491	1,491	3,394	3,394	3,248	3,248
Mortgage-backed securities	798	798	925	925	711	711
Other asset-backed securities	927	927	1,913	1,913	1,986	1,986
Corporate and other debt securities	20,620	20,620	27,559	27,559	21,858	21,858
Treasury bills and other bills	115	115	430	430	299	299
Equity shares	66,403	66,403	89,447	89,447	75,737	75,737
	113,240	113,240	146,069	146,069	128,389	128,389
Available-for-sale financial assets						
US treasury and US government agencies	6,594	6,594	7,355	7,355	6,206	6,206
Other government securities	31,696	31,696	18,200	18,200	19,030	19,030
Other public sector securities	–	–	–	–	27	27
Bank and building society certificates of deposit	208	208	188	188	366	366
Mortgage-backed securities	1,263	1,263	1,524	1,524	1,803	1,803
Other asset-backed securities	915	915	760	760	1,064	1,064
Corporate and other debt securities	1,855	1,855	1,848	1,848	5,245	5,245
Treasury bills and other bills	875	875	971	971	1,727	1,727
Equity shares	570	570	528	528	1,938	1,938
	43,976	43,976	31,374	31,374	37,406	37,406
Held-to-maturity investments						
US treasury and US government agencies	–	–	–	–	1,562	1,562
Other government securities	–	–	–	–	6,536	6,582
	–	–	–	–	8,098	8,144
Debt securities classified as loans and receivables						

Mortgage-backed securities	333	285	3,927	3,095	7,179	5,739
Other asset-backed securities	740	668	1,150	964	5,030	4,781
Corporate and other debt securities	407	298	402	329	537	433
	1,480	1,251	5,479	4,388	12,746	10,953
Allowance for impairment losses	(125)	–	(206)	–	(276)	–
	1,355	1,251	5,273	4,388	12,470	10,953

[1] Restated – see note 1 on page F-11.

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Maturities and weighted average yields of interest-bearing securities

The weighted average yield for each range of maturities is calculated by dividing the annualised interest income prevailing at 31 December 2013 by the book value of securities held at that date.

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
Trading securities and other financial assets at fair value through profit or loss								
US treasury and US government agencies	82	1.8	484	1.9	181	1.3	175	3.9
Other government securities	1,707	2.3	3,053	3.0	3,170	3.0	11,837	3.1
Other public sector securities	42	3.6	199	4.8	308	6.8	1,648	5.8
Bank and building society certificates of deposit	1,491	0.9	–	–	–	–	–	–
Mortgage-backed securities	–	–	3	0.0	19	4.7	776	4.7
Other asset-backed securities	10	2.0	102	4.4	159	1.8	656	5.8
Corporate and other debt securities	1,760	5.7	3,629	4.5	4,045	4.8	11,186	5.2
Treasury bills and other bills	115	1.3	–	–	–	–	–	–
	5,207		7,470		7,882		26,278	
Available-for-sale financial assets								
US treasury and US government agencies	–	–	1,341	0.4	3,443	2.8	1,810	6.5
Other government securities	–	–	1,478	2.4	14,144	3.6	16,074	4.2
Bank and building society certificates of deposit	208	0.1	–	–	–	–	–	–
Mortgage-backed securities	220	1.8	664	1.7	33	0.9	346	0.7
Other asset-backed securities	–	–	245	0.6	189	0.7	481	0.8
Corporate and other debt securities	36	0.0	1,137	1.8	682	3.6	–	–
Treasury bills and other bills	875	1.6	–	–	–	–	–	–
	1,339		4,865		18,491		18,711	
Debt securities classified as loans and receivables								
Mortgage-backed securities	43	0.1	–	–	30	1.9	260	0.4
Other asset-backed securities	–	–	–	–	520	1.1	220	2.2
Corporate and other debt securities	179	0.9	162	5.8	–	–	66	2.9
	222		162		550		546	

The Group's investment holdings at 31 December 2013 include £35,520 million due from the UK government and its agencies and £7,517 million due from the US government and its agencies.

MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AT 31 DECEMBER 2013

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis at 31 December 2013. Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

All amounts are before deduction of impairment allowances. Demand loans are included in the 'maturing in one year or less' category.

	Maturing in one year or less £m	Maturing after one but within five years £m	Maturing after five years £m	Total £m
Loans and advances to banks	22,734	2,171	460	25,365
Loans and advances to customers:				
Mortgages	6,488	28,232	300,891	335,611
Other personal lending	16,565	6,050	615	23,230
Property companies	14,268	12,445	17,564	44,277
Financial, business and other services	16,346	18,927	9,534	44,807
Transport, distribution and hotels	9,018	7,363	5,913	22,294
Manufacturing	3,691	2,862	1,097	7,650
Other	9,141	11,397	8,840	29,378
Total loans	98,251	89,447	344,914	532,612
Of which:				
Fixed interest rate	14,826	18,659	94,240	127,725
Variable interest rate	83,425	70,788	250,674	404,887

DEPOSITS

The following tables show the details of the Group's average customer deposits in each of the past three years.

	2013 Average balance £m	2013 Average rate %	2012 Average balance £m	2012 Average rate %	2011 Average balance £m	2011 Average rate %
Non-interest bearing demand deposits	35,994	–	30,039	–	31,519	–
Interest-bearing demand deposits	75,704	0.55	73,092	0.49	71,527	0.50
Savings deposits	266,122	1.93	269,489	2.13	247,062	2.03
Time deposits	57,292	1.02	51,239	1.02	46,829	1.50
Total average deposits	435,112	1.41	423,859	1.57	396,937	1.53

Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013. The analysis of the Group's average customer deposits for 2012 and 2011 between domestic and foreign offices is as follows:

2012	Domestic Average balance £m	Domestic Average rate %	Foreign Average balance £m	Foreign Average rate %	Total Average balance £m	Total Average rate %
Non-interest bearing demand deposits	28,989	–	1,050	–	30,039	–
Interest-bearing demand deposits	72,138	0.49	954	0.42	73,092	0.49
Savings deposits	249,968	2.11	19,521	2.41	269,489	2.13
Time deposits	48,725	0.97	2,514	2.11	51,239	1.02
Total deposits	399,820	1.53	24,039	2.19	423,859	1.57

2011	Domestic Average balance £m	Domestic Average rate %	Foreign Average balance £m	Foreign Average rate %	Total Average balance £m	Total Average rate %
Non-interest bearing demand deposits	30,606	–	913	–	31,519	–
Interest-bearing demand deposits	70,579	0.50	948	0.11	71,527	0.50
Savings deposits	236,518	2.01	10,544	2.54	247,062	2.03
Time deposits	43,665	1.48	3,164	1.80	46,829	1.50
Total deposits	381,368	1.51	15,569	2.09	396,937	1.53

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits at 31 December 2013 individually in excess of US $100,000 (or equivalent in another currency) by time remaining to maturity. Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

	3 months or less £m	Over 3 months but within 6 months £m	Over 6 months but within 12 months £m	Over 12 months £m	Total £m
Certificates of deposit	4,460	2,398	1,983	25	8,866
Time deposits	6,752	6,985	7,522	6,506	27,765
Total	11,212	9,383	9,505	6,531	36,631

SHORT-TERM BORROWINGS

Short-term borrowings are included within the balance sheet captions 'Deposits by banks', 'Customer accounts' and 'Debt securities in issue' and are not identified separately on the balance sheet. The short-term borrowings of the Group consist of overdrafts from banks, securities sold under agreements to repurchase, notes issued as part of lending securitisations, certificates of deposit issued, commercial paper and promissory notes issued and other marketable paper. Securities sold under agreements to repurchase, certificates of deposit issued, commercial paper, securitisation notes and covered bonds are the only significant short-term borrowings of the Group.

The following tables give details of these significant short-term borrowings of the Group for each of the past three years.

	2013 £m	2012 £m	2011 £m
Liabilities in respect of securities sold under repurchase agreements			
Balance at the year end	**4,852**	27,801	22,385

Average balance for the year	**6,515**	16,702	24,108
Maximum balance during the year	**27,801**	27,801	35,162
Average interest rate during the year	**1.2%**	1.5%	1.4%
Interest rate at the year end	**0.6%**	1.0%	0.9%
Certificates of deposit issued			
Balance at the year end	**8,866**	11,087	27,994
Average balance for the year	**13,145**	19,493	46,203
Maximum balance during the year	**14,343**	30,662	52,966
Average interest rate during the year	**0.9%**	1.3%	1.1%
Interest rate at the year end	**0.6%**	1.1%	1.2%
Commercial paper			
Balance at the year end	**5,035**	7,897	18,091
Average balance for the year	**10,878**	10,905	29,182
Maximum balance during the year	**18,313**	11,301	35,209
Average interest rate during the year	**0.5%**	0.6%	0.6%
Interest rate at the year end	**0.5%**	0.4%	0.6%
Securitisation notes			
Balance at the year end	**18,613**	28,059	37,412
Average balance for the year	**22,246**	30,349	35,378
Maximum balance during the year	**28,059**	33,986	40,742
Average interest rate during the year	**2.4%**	2.9%	2.9%
Interest rate at the year end	**2.0%**	2.0%	2.3%
Covered bonds			
Balance at the year end	**30,667**	40,673	38,196
Average balance for the year	**37,138**	41,181	37,283
Maximum balance during the year	**40,673**	42,341	40,033
Average interest rate during the year	**3.7%**	4.5%	4.7%
Interest rate at the year end	**4.2%**	4.0%	3.6%

MANAGEMENT AND EMPLOYEES

DIRECTORS AND SENIOR MANAGEMENT

The Group is led by the Board comprising executive and non-executive directors with wide experience. The appointment of directors is considered by the Nomination and Governance Committee and approved by the Board. Following the provisions in the articles of association, directors must stand for election by the shareholders at the first annual general meeting following their appointment and must retire, and may stand for re-election by the shareholders, at each annual general meeting thereafter. Independent non-executive directors are appointed for three-year renewable terms, which may, in accordance with the articles of association, be terminated without notice or payment of compensation.

The Board meets regularly. In 2013, a total of ten Board meetings were held, eight of which were scheduled at the start of the year.

The roles of the Chairman, the Group Chief Executive and the Board and its governance arrangements, including the schedule of matters specifically reserved to the Board for decision, are reviewed annually. The matters reserved to the Board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group's budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisation structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company's main professional advisers and their fees; and the appointment of senior executives within the organisation and related succession planning.

According to the articles of association, the business and affairs of the Company are managed by the Directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the Group's expense, where they judge it necessary to discharge their duties as directors.

The Chairman has a private discussion at least once a year with each Director on a wide range of issues affecting the Group, including any matters which the Directors, individually, wish to raise.

There is an induction programme for all directors, which is tailored to their specific requirements having regard to their specific role on the Board and their skills and experience to date. Major shareholders are also offered the opportunity to meet new non-executive directors.

The directors and senior management of Lloyds Banking Group plc are:

NON-EXECUTIVE DIRECTORS

SIR WINFRIED BISCHOFF

Chairman (retiring on 3 April 2014)

Chairman of the Nomination & Governance Committee. Member of the Remuneration Committee and the Risk Committee.

Sir Winfried joined the Board in September 2009. He has substantial experience of leading complex international boards in the UK and the US. His background spans a range of sectors, including banking and capital markets, finance and government regulation and public policy. Sir Winfried is a highly respected leader with the proven experience and judgement who has led the Board of Lloyds Banking Group during a period of significant progress over the past four years. Sir Winfried has a BA in Commerce from the University of the Witwatersrand, a Doctorate in Science, Honoris Causa, from City University and was made a Johnson Honorary Fellow of the University of Oxford. He is a Non-Executive Director of Eli Lilly and Company and The McGraw Hill Companies Inc. He is Chairman of the Advisory Council of TheCityUK, a Member of the Akbank International Advisory Board and from 1 May 2014, will be Chairman of the Financial Reporting Council. Sir Winfried was appointed Chairman of Citigroup Europe in 2000. He became the acting Chief Executive Officer of Citigroup Inc. in 2007 and was subsequently appointed as Chairman in the same year until his retirement in February 2009. Prior to this, he was the Group Chief Executive and then Chairman of Schroders.

LORD BLACKWELL

Chairman (from 3 April 2014) and Independent Director

Chairman of Scottish Widows Group. Member of the Audit Committee, the Risk Committee and the Nomination & Governance Committee.

Lord Blackwell joined the Board in June 2012. He has extensive insurance, banking, regulatory and public policy experience gained from senior positions in a wide range of industries. Lord Blackwell's deep financial services knowledge and experience, leadership qualities and credibility with key stakeholders made him the unanimous choice of the Board to succeed Sir Winfried as Chairman of Lloyds Banking Group. Lord Blackwell has an MA in Natural Sciences from the University of Cambridge, and a Ph.D in Finance and Economics and an MBA from the University of Pennsylvania. He is the Chairman of Interserve plc. He is a Non-Executive Director of Ofcom (until the end of March 2014) and Halma plc. Lord Blackwell is a former Senior Independent Director of Standard Life and chaired their UK Life and Pensions Board. He was a Non-Executive Director of Dixons Group and SEGRO, a member of the Board of the Centre for Policy Studies and a Non-Executive Member of the Office of Fair Trading. He was a partner of McKinsey & Co. and a Director of Group Development at NatWest Group. From 1995 to 1997, Lord Blackwell was Head of the Prime Minister's Policy Unit and was appointed a Life Peer in 1997.

DAVID ROBERTS

Deputy Chairman and Independent Director

Chairman of the Risk Committee. Member of the Audit Committee, the Remuneration Committee and the Nomination & Governance Committee.

David Roberts joined the Board in March 2010. He has many years of experience at board and executive management level in retail and commercial banking in the UK and internationally. As Chair of the Risk Committee, he has a deep understanding of risk management, underpinned by recent, in-depth knowledge of all aspects of banking operations. David's valuable contributions to the deliberations of the Board and Committee meetings, combined with natural leadership qualities, make him an effective Deputy Chairman. David has a Diploma in Marketing from the Chartered Institute of Marketing, a degree in Mathematics & Applications from Birmingham University and an MBA from the University of Reading. David is a member of the Strategy Board of Henley Business School. He joined Barclays in 1983 and held various senior management positions culminating in Executive Director, member of the Group Executive Committee and Chief Executive, International Retail and Commercial Banking, a position which he held until December 2006. He is a former Non-Executive Director of BAA and Absa Group and was Chairman and Chief Executive of BAWAG P.S.K. AG.

CAROLYN FAIRBAIRN

Independent Director

Member of the Audit Committee and the Remuneration Committee

Carolyn Fairbairn joined the Board in June 2012. She has extensive digital and on-line, government and regulatory experience gained across a range of sectors including media and financial services. With her broad experience and strong analytical mind, Carolyn plays an active part in reviewing the strategy of the Board and contributing to the debate at Board and Committee meetings. Carolyn has a BA in Economics from the University of Cambridge, an MA in International Relations from the University of Pennsylvania and an MBA from INSEAD. Carolyn is a Non-Executive Director of The Vitec Group and is the Chairman of its Remuneration Committee. She is a trustee of Marie Curie and a Non-Executive Director of the Competition and Markets Authority and the UK Statistics Authority. Carolyn was a Non-Executive Director of the Financial Services Authority and chaired their Risk Committee, a Director of Group Development and Strategy at ITV plc and Director of Strategy and a member of the Executive Board at the BBC. She is a former partner of McKinsey & Co. and was a policy adviser in the Prime Minister's Policy Unit. Carolyn began her career as an Economist at the World Bank.

ANITA FREW

Independent Director

Member of the Audit Committee, the Risk Committee and the Nomination & Governance Committee

Anita Frew joined the Board in December 2010. She has extensive board, financial and general management experience across a range of sectors, including banking, asset management, manufacturing and utilities. Her breadth of experience and strong leadership qualities make her an effective Non-Executive Director. Anita is the Chairman of the

Responsible Business Committee. She has a BA (Hons) in Business from the University of Strathclyde and a MRes in Humanities and Philosophy from the University of London. Anita is the Chairman of Victrex plc, having previously been its Senior Independent Director, and is a Senior Independent Director of Aberdeen Asset Management and IMI. Anita was an Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group and a Non-Executive Director of Northumbrian Water. She has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland.

DYFRIG JOHN, CBE

Independent Director

Member of the Audit Committee and the Risk Committee

Dyfrig John joined the Board on 1 January 2014. He spent his career in banking, principally at HSBC where he worked for 37 years. During that time he held a number of senior management and Board positions in the UK and overseas including Chief Executive Officer of HSBC Bank PLC. He has the knowledge and experience to provide valuable insight and contribute effectively as a Non-Executive Director and Member of the Audit Committee and Risk Committee. Dyfrig has a Sloan Fellowship from the London Business School. He is also a fellow of the Chartered Institute of Bankers. Dyfrig is the Chairman of Principality Building Society and will step down from that position on 17 April 2014. He is a Member of the Welsh Rugby Union's Audit Committee. Dyfrig was a Director of HSBC Bank PLC from 2003 to 2009, Chief Executive Officer from 2006 to 2009 and Deputy Chairman from 2008 to 2009. Prior to joining the board of HSBC Bank PLC, he held a number of senior roles including Group Managing Director and member of the Group Management Board. Until recently he was a Board member of the Wales Millennium Centre.

NICK LUFF

Independent Director

Chairman of the Audit Committee. Member of the Risk Committee

Nick Luff joined the Board on 5 March 2013. He is a chartered accountant and has significant financial experience in the UK listed environment having served in a number of senior finance positions within a range of sectors. His background and experience enables him to fulfil the role of Audit Committee Chair and, for SEC purposes, the role of Audit Committee Financial Expert. Nick is a Mathematics graduate from the University of Oxford. Nick is currently the Group Finance Director of Centrica. He will step down from the Centrica Board before the end of 2014 to take up a new position as Chief Financial Officer of Reed Elsevier. Nick was previously Finance Director of The Peninsular & Oriental Steam Navigation Company and Chief Financial Officer of P&O Princess Cruises plc. Until December 2010, he served as a Non-Executive Director and was the Audit Committee Chair of QinetiQ Group. Nick started his career with KPMG where he qualified as a chartered accountant in 1991.

ANTHONY WATSON, CBE

Senior Independent Director

Chairman of the Remuneration Committee. Member of the Audit Committee, the Risk Committee and the Nomination & Governance Committee

Tony Watson joined the Board in April 2009. He is Senior Independent Director and Chair of the Remuneration Committee. He maintains close dialogue with shareholders with the aim of aligning executive reward with shareholder interests. With over 40 years of experience in the investment management industry and related sectors, he is well placed to carry out these roles. Tony is a Barrister at Law. He has a BSc (Hons) in Economics from the Queen's University Belfast, a Diploma in Security Analysis from the New York Institute of Finance and was called to the Bar of England and Wales. He is a Non-Executive Director of Vodafone Group, Senior Independent Director of Hammerson and Witan Investment Trust, Chairman of the Lincoln's Inn Investment Committee and a member of the Norges Bank Investment Management Corporate Governance Advisory Board. Former Chief Executive of Hermes Pensions Management and formerly Chairman of the Asian Infrastructure Fund, MEPC and of the Strategic Investment Board (Northern Ireland). Former Member of the Financial Reporting Council and the Marks & Spencer Pension Trustees.

MANAGEMENT AND EMPLOYEES

SARA WELLER

Independent Director

Member of the Remuneration Committee and the Risk Committee

Sara Weller joined the Board in February 2012. With a background in retail and associated sectors, including financial services, Sara brings a broad perspective to the Board. She is a strong advocate of customers and of the application of new technology, both of which directly support Lloyds Banking Group's strategy. Sara has considerable experience of boards at both executive and non-executive level. She has an MA in Chemistry from Oxford University. Sara is a Non-Executive Director of United Utilities Group and Chair of their Remuneration Committee. Sara is the former Managing Director of Argos. She held various senior positions at J Sainsbury including Deputy Managing Director and served on its Board between January 2002 and May 2004. She was a Non-Executive Director of Mitchells & Butler and also held senior management roles for Abbey National and Mars Confectionery.

EXECUTIVE DIRECTORS

ANTÓNIO HORTA-OSÓRIO

Executive Director and Group Chief Executive

António Horta-Osório joined the Board in January 2011. He brings extensive experience in, and understanding of, both retail and commercial banking. This has been built over a period of more than 25 years, working both internationally as well as in the UK. António's drive, enthusiasm and commitment to customers, along with his proven ability to build and lead strong management teams, brings significant value to all stakeholders of Lloyds Banking Group. António has a Degree in Management & Business Administration from the Universidade Católica Portuguesa, an MBA from INSEAD and has completed the Advanced Management Program at Harvard Business School. António is a Non-Executive Director of Fundação Champalimaud and Sociedade Francisco Manuel dos Santos in Portugal and is a Governor of the London Business School. António joined Grupo Santander in 1993, having previously worked for Goldman Sachs and for Citibank, and held various senior management positions culminating in becoming Executive Vice President of Grupo Santander and a member of its Management Committee. In November 2004, he was appointed as a Non-Executive Director of Santander UK and, from August 2006 until November 2010, served as its Chief Executive. António is also a former Non-Executive Director of the Court of the Bank of England.

GEORGE CULMER

Executive Director and Chief Financial Officer

George Culmer joined the Board in May 2012. He is a chartered accountant and has deep operational and financial expertise including strategic and financial planning and control. He has worked in financial services in the UK and overseas for over 20 years. With a strong background in insurance and shareholder advocacy, his skills and experience enhance the Board and strengthen further the senior management team. George is a chartered accountant and has a History degree from the University of Cambridge. George was an Executive Director and Chief Financial Officer of RSA Insurance Group. He is also the former Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations. George previously held various senior management positions at Prudential.

JUAN COLOMBÁS

Executive Director and Chief Risk Officer

Juan Colombás joined the Board on 29 November 2013. He has significant banking and risk management experience, having spent 28 years working in these fields both internationally and in the UK. He has served as the Group's Chief Risk Officer and as a member of the Group Executive Committee since January 2011. Juan is responsible for developing the Group's risk framework, recommending its risk appetite and ensuring that all risks generated by the business are measured, reviewed and monitored on an ongoing basis. Juan has a BSc in Industrial Chemical Engineering from the Universidad Politécnica de Madrid, a Financial Management degree from ICADE School of Business and Economics and an MBA from the Institute de Empresa Business School. He is a Member of the International Financial Risk Institute Executive Committee. Juan was previously the Chief Risk Officer of Santander's UK business. Prior to this position, he held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group.

EMPLOYEES

As at 31 December 2013, the Group employed 88,977 people (on a full-time equivalent basis), compared with 92,788 at 31 December 2012 and 98,538 at 31 December 2011. At 31 December 2013, 87,701 employees were located in the UK, 762 in continental Europe, 327 in the Americas, and 187 in the rest of the world. At the same date, 40,052 people were employed in Retail, 7,453 in Commercial Banking, 6,799 in Wealth, Asset Finance and International, 2,242 in Insurance, 20,315 in Group Operations, and 12,116 in other functions.

The Group is committed to providing employment practices and policies which recognise the diversity of its workforce. The Group will not unfairly discriminate in its recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief.

To support the Group in its aim, it belongs to a number of major UK employment equality campaign groups, including the Business Disability Forum, The Age and Employment Network, Stonewall and Race for Opportunity. The Group's involvement with these organisations enables it to identify and implement best practice for its staff. The Group has a range of programmes to support colleagues who become disabled or acquire a long-term health condition. These include a workplace adjustment programme to provide physical equipment or changes to the way a job is done. The Group also runs residential Personal and Career Development Programmes to help colleagues deal positively with the impact of a disability and the colleague disability network, Access, provides peer support.

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 Group. Further details are given in *Compensation*.

The Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. The Group has established a full suite of communication channels, including an extensive face-to-face briefing programme which allows it to update its employees on its performance and any financial issues throughout the year.

The Group has a code of business conduct which applies to all employees. The code as amended from time to time is available to the public on the Company's website at www.lloydsbankinggroup.com in About Us/Corporate Governance.

MEETINGS WITH SHAREHOLDERS

In order to develop an understanding of the views of major shareholders, the Board is kept advised of the views of major shareholders by means of regular updates at Board and Committee meetings. The Board also receives reports on market and investor sentiment and shareholder analysis.

Investor Relations has primary responsibility for managing day-to-day communications with institutional investors. Supported by the Group Chief Executive, Group Finance Director and other members of the senior management team, they achieve this through a combination of briefings to analysts and institutional investors (both at results briefings and throughout the year), as well as individual discussions with institutional investors. A review of the Group's investor interaction was undertaken in 2013 which provided positive feedback on its approach.

All shareholders are encouraged to attend and participate in the Group's Annual General Meeting.

COMPENSATION

DIRECTORS' REMUNERATION POLICY

The Group's policy is intended to ensure that its remuneration proposition is both cost effective and enables it to attract and retain executives of the highest calibre. The Group's objective is to align individual reward with the Group's performance, the interests of its shareholders and a prudent approach to risk management. In this way, the Group balances the requirements of its major stakeholders: its customers, shareholders, employees, and regulators.

The policy is based on principles which are applicable to all employees within the Group and in particular the principle that the reward package should support the delivery of the Group's strategic goal to be the 'Best Bank for Customers'. It embeds a performance-driven and meritocratic culture, encourages effective risk disciplines and is in line with relevant regulations and codes of best practice. There is no significant difference between the policy for Executive Directors and that for employees. If a significant difference for any individual were proposed, this would be subject to approval by the Remuneration Committee (within regulatory requirements).

The policy set out below will formally apply, subject to shareholder approval, from the date of the Annual General Meeting in 2014. It is currently intended that approval of the remuneration policy will be sought at three year intervals unless amendments to the policy are required in which case further shareholder approval will be required.

Consideration of shareholders' and employees' views

The Group is committed to regular dialogue with stakeholders. During the year, the Remuneration Committee has consulted extensively with UK Financial Investments (UKFI), and a number of other shareholders and key stakeholders, such as the Group's main regulation, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

Formal consultation on the remuneration of Executive Directors is not undertaken with employees. However, surveys are undertaken semi-annually on employee engagement and discussion on the Group's remuneration approach takes place with union representatives during the annual pay review cycle and on relevant employee reward matters.

Remuneration policy table for Executive Directors

Base salary	
Purpose and link to strategy	Base salary reflects the role of the individual taking account of responsibilities and experience, and pay in the Group as a whole. It helps to recruit and retain Directors and forms the basis of a competitive remuneration package.
Operation	Base salaries are typically reviewed annually with any increases normally taking effect from 1 January. When determining and reviewing base salary levels, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Pay for comparable roles in comparable publicly listed financial services groups, of a similar size. The Committee also takes into account base salary increases for employees throughout the Group. Base salaries as at January 2014 are detailed below in the Implementation Report on page 152. As disclosed in previous reports, since his appointment, the Group Chief Executive (GCE) has a reference salary of £1.22 million which is used to calculate certain elements of long-term remuneration and the pension allowance.
Maximum potential	The Committee will make no increase which it believes is inconsistent with the two parameters above. Increases will normally be in line with the increase awarded to the overall employee population. However, a greater salary increase may be appropriate in certain circumstances, such as a new appointment made on a salary below a market competitive level, where phased increases are planned, or where there has been an increase in the responsibilities of an individual.
Performance measures	N/A
Fixed Share Award	
Purpose and link to strategy	To ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.
Operation	The Fixed Share Award will be delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award.
Maximum potential	The maximum award is 100 per cent of base salary. The actual awards for the year are stated in the annual remuneration report.
Performance measures	N/A

Pension

Purpose and link to strategy	The Group's pension policy aims to support Executive Directors in building long-term retirement savings. Executive Directors are entitled to participate in the Group's defined contribution scheme with company contributions set as a percentage of salary.
Operation	An individual may elect to receive some or all of their pension contribution as a cash allowance.
Maximum potential	The maximum allowance for the GCE is 50 per cent of reference salary less any flexible benefit allowance. The maximum allowance for other Executive Directors is 25 per cent of base salary.
Performance measures	N/A

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Benefits	
Purpose and link to strategy	To provide suitable benefits as part of a competitive package.
Operation	Benefits may include those currently provided and disclosed in the annual remuneration report. Core benefits include a company car or car allowance, private medical insurance, life assurance and other benefits that may be selected through the Group's flexible benefits plan. Additional benefits may be provided to individuals in certain circumstances such as relocation. This may include benefits such as accommodation, relocation, and travel. The Committee retains the right to provide additional benefits depending on individual circumstances. When determining and reviewing the level of benefits provided, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Benefits for comparable roles in comparable publicly listed financial services groups of a similar size.
Maximum potential	The Committee will make no increase in the benefits currently provided which it believes is inconsistent with the two parameters above. The Group's flexible benefits allowance is capped at 4 per cent of base salary.
Performance measures	N/A
All-employee plans	
Purpose and link to strategy	Executive Directors are eligible to participate in HMRC approved all-employee schemes which encourage share ownership.
Operation	Executive Directors may participate in these plans in line with HMRC guidelines currently prevailing (where relevant), on the same basis as other eligible employees.
Maximum potential	Participation levels may be increased up to HMRC limits as amended from time to time. With effect from April 2014, the monthly savings limits for SAYE is £500. The maximum value of shares that may be purchased under SIP in any year is £1,800 with a two for one match (although currently a one for one match is operated) and the maximum value of free shares that may be awarded in any year is £3,600.
	N/A, following HMRC rules.

Performance measures	
Annual bonus	
Purpose and link to strategy	Incentivise and reward the achievement of the Group’s annual financial and strategic targets.
	Measures and targets are set annually and awards are determined by the Committee after the year end based on performance against the targets set. The annual bonus may be delivered partly in cash and partly deferred into cash, shares, notes or other debt instruments including contingent convertible bonds. Deferral levels are set at the time of award and in compliance with regulatory requirements (which currently require that at least 60 per cent of variable pay is deferred and at least 50 per cent of variable pay is paid in shares or other instruments). Deferred awards normally vest after three years and the Committee may adjust awards in the event of any variation of share capital, demerger, special dividend or distribution or amend the terms of the plan in accordance with the plan rules.
Operation	At the time of the release, Executive Directors receive an amount (in cash or shares) equal to the interest that would have accrued on the deferred component, if deferral is made in notes or debt instruments, or dividends paid or payable if deferred in shares, between the date of grant and the vesting of the award on the number of shares which have vested.
	The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance. The Committee may reduce the level of deferred award (including to zero), apply additional conditions to the vesting, or delay the vesting of deferred awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting.
Maximum potential	The maximum annual bonus opportunities are 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors.

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	Measures and targets are set annually by the Committee in line with the Group's strategic business plan and further details are set out in the annual remuneration report for the relevant year.
Performance measures	At least 50 per cent of the awards are weighted towards financial measures, with the balance on strategic objectives. For example, for 2014, the measures will include Economic Profit and Underlying Profit as well as specific strategic objectives including risk, customer and employee measures. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance is not met for financial measures and the individual is rated Developing performer' or below. The expected value of the bonus is 30 per cent of maximum opportunity.
	The Committee retains the right to change the measures and weighting of those measures, including following feedback from regulators, shareholders and/or other stakeholders. The Committee is, however, committed to providing transparency in its decision-making in respect of bonus awards and will disclose historic target and measure information together with information relating to how the Group has performed against those targets in the annual remuneration report for the relevant year unless this information is deemed to be commercially sensitive.
Long-term incentive plan	
Purpose and link to strategy	Incentivise and reward the achievement of the Group's longer-term objectives, to align executive interests with those of shareholders and to retain key individuals.
Operation	Awards are made in the form of conditional shares or options. Award levels are set at the time of grant and in compliance with regulatory requirements, and may be subject to a discount in determining total variable remuneration under the rules set by the European Banking Authority (EBA).
	Vesting will be subject to the achievement of performance conditions measured over a period of three years, or such longer period, as determined by the Committee.
	On vesting, Executive Directors receive an amount (in cash or shares) equal to the dividends which would have been paid during the vesting period on shares vesting.
	The Committee retains full discretion to amend the payout levels should the award not reflect business and/or individual performance. The Committee may reduce (including to zero) the level of the award, apply additional conditions to the vesting, or delay the vesting of awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting. Executive Directors are required to hold the shares which vest for a further

	two years.
Maximum potential	The maximum annual award for Executive Directors will normally be 300 per cent of salary excluding dividend equivalents (this being the reference salary in the case of the GCE). Under the plan rules, awards can be made up to 400 per cent of salary in exceptional circumstances excluding dividend equivalents.
Performance measures	Measures and targets are set by the Committee annually and are set out in the Implementation Report each year. At least 60 per cent of awards are weighted towards typical market (e.g. Total Shareholder Return (TSR)) and/or financial measures (e.g. Economic Profit), with the balance on strategic measures. For example for 2014, the measures and respective weighting will be Economic Profit (30 per cent); absolute TSR (30 per cent); strategic measures (40 per cent) split into: cost:income ratio (10 per cent), customer satisfaction (10 per cent), net promoter score (10 per cent), SME lending (5 per cent), and share of first time buyer market (5 per cent) 25 per cent will vest for threshold performance and 50 per cent for on-target performance. The measures are chosen to support the ‘Best Bank for Customers’ strategy and to align management and shareholder interests. Targets are set by the Committee to be stretching within the context of the strategic business plan. Measures are selected to balance profitability, achievement of strategic goals and to ensure the incentive does not encourage inappropriate risk taking. Measures and targets are set annually by the Committee and limited details can therefore be provided in the remuneration policy. Further details on the metrics in place for the awards made in 2013, and those on which the 2014 awards will be based, are provided in the Implementation Report. For future awards, the Committee will disclose in the annual remuneration report for the relevant year historic measure and target information, together with how the Group has performed against those targets, unless this information is deemed to be commercially sensitive.
Shareholding guidelines	Executive Directors are required to build up a holding of a value of 200 per cent of base salary and fixed share award for the GCE and 150 per cent for other Executive Directors. Details of holding are shown in the Implementation Report.

Discretion in relation to annual bonus and long-term incentive plans

The Committee retains discretion with regards to the operation and administration of these plans, including :

- the timing and size of awards, subject to policy maximums;
- adjustments required in certain circumstances (e.g. rights issues, corporate restructuring events and special dividends);
- adjustment of targets if events occur which cause it to determine that the conditions are no longer appropriate;
- amending the plan rules in accordance with their terms.

Legacy awards and restrictions on payments

The Committee reserves the right to make any remuneration payments/awards and any payments/awards for loss of office, notwithstanding that they are not in line with the policy set out above where the terms of the payment/award were agreed (i) before the policy came into effect or (ii) at a time when the relevant individual was not a Director of the Group and, in the opinion of the Committee, the payment/award was not in consideration for the individual becoming a Director of the Group. Such payments/awards are set out in the Implementation Report for the relevant year. They include payments in relation to deferred bonus awards and long-term incentive awards granted in 2012 and 2013.

Illustration of application of remuneration policy

The charts below illustrate possible remuneration outcomes under the following three scenarios:

1. The maximum that may be paid, assuming full bonus payout and full vesting under the long-term plan.
2. The expected value of remuneration for performance midway between threshold and maximum, assuming 30 per cent of maximum annual bonus opportunity and 50 per cent vesting under the long-term incentive plan.
3. The minimum that may be paid, where only the fixed element is paid (salary, benefits, pension and the fixed share award).

No share price growth has been assumed and dividends have not been included. The amounts are based on salaries as at 1 January 2014 and assume fixed share awards and bonuses and long-term incentive grants which reflect the implementation of the policy in 2014 as set out below. They also assume long-term incentive grants of 300 per cent of salary, which is normally the maximum award.

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Approach to recruitment and appointment to the Board

In determining appropriate remuneration arrangements on hiring a new Executive Director, the Committee will take into account all relevant factors. This may include the experience and calibre of the individual, local market practice, the existing remuneration arrangements for other executives and the business circumstances. The Committee will seek to ensure that arrangements are in the best interests of both the Group and its shareholders and will seek not to pay more than is necessary.

The Committee may make awards on hiring an external candidate to 'buy-out' remuneration arrangements forfeited on leaving a previous employer. In doing so the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares) and the timeframe of awards. Any such award made will be made in accordance with the PRA's Remuneration Code and made on a comparable basis to those forfeited.

The package will normally be aligned with the remuneration policy as described in the table above. However the Committee retains the discretion to make appropriate remuneration decisions outside the standard policy to facilitate the recruitment of an individual of the calibre required and in exceptional cases.

This may, for example, include the following circumstances:

– An interim recruit, appointed to fill an Executive Director role on a short-term basis.

– Exceptional circumstances requiring the Chairman to take on an executive function on a short-term basis.

– An Executive Director recruited at a time in the year when it would be inappropriate to provide a bonus or LTIP award for that year, for example, where there may be insufficient time to assess performance. In this situation the Committee may feel it appropriate to transfer the quantum in respect of the months employed during the year to the subsequent year so that reward is provided on a fair basis.

– An Executive Director recruited from a business or location where benefits are provided that do not fall into the definition of 'variable remuneration forfeited' but where the Committee considers it reasonable to buy-out these benefits.

– Transitional arrangements for overseas hires, which might include relocation expenses and accommodation.

Any discretion is however limited to the maximum level of variable remuneration (excluding buy-out awards) that may be awarded to new Executive Directors which is equal to 200 per cent of fixed remuneration including any discount permitted by the European Banking Authority for long-term incentive awards. In making any such remuneration decisions, the Committee will apply appropriate performance measures in line with those applied to other Executive Directors.

Service agreements

The service contracts of all current Executive Directors are terminable on 12 months' notice from the Group and six months' notice from the individual. The Chairman also has a service agreement. His engagement may be terminated on six months' notice by either the Group or the individual.

	Notice to be given by the Group	Date of service agreement
Sir Winfried Bischoff	6 months	27 July 2009
António Horta-Osório	12 months	3 November 2010
George Culmer	12 months	16 May 2012
Juan Colombás	12 months	30 November 2010

Under his contract (dated 3 November 2010), the GCE is entitled to an amount equivalent to base salary and pension allowance as a payment in lieu of notice if notice to terminate is given by the Group. If notice to terminate is given by the GCE, he is entitled to an amount equivalent to base salary if the Group chooses to make a payment in lieu of notice. Such payments in lieu will be made in monthly instalments subject to mitigation. He is also entitled to six months' notice from the Group in the event of his long-term incapacity. As part of a buyout of a pension forfeited on joining from Santander, the GCE is also entitled to the provision of an unfunded unapproved retirement benefit scheme (UURBS), subject to performance conditions as described further in the annual remuneration report. In all other respects, the terms of the GCE's contract in relation to payments for loss of office match those set out below for new directors.

Under terms agreed when joining the Group, Juan Colombás is entitled, as described further in the remuneration report, to a conditional lump sum benefit, payable either (i) on reaching normal retirement age unless he voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death, as described further in the annual remuneration report.

The service contracts and letters of appointments are available for inspection at the Company's registered office.

Notice periods

Newly appointed Executive Directors will be employed on contracts that include the following provisions:

– The individual will be required to give six months' notice if they wish to leave and the Group will give 12 months' notice other than for material misconduct or neglect or other circumstances where the individual may be summarily dismissed by written notice. In exceptional circumstances, new joiners will be offered a longer notice period (typically reducing to 12 months within two years of joining).

– In the event of long-term incapacity, if the Executive Director does not perform their duties for a period of at least 26 weeks (in aggregate over a 12 month period), the Group shall be entitled to terminate the executive's employment by giving three months' notice.

– At any time after notice to terminate is given by either the Group or the Executive Director, the Group may require the Executive Director to take leave for some or all of the notice period.

– At any time, at its absolute discretion, the Group may elect to terminate the individual's employment by paying to the Executive Director, in lieu of the notice period, an amount equivalent to base salary, subject to mitigation as described more fully in the termination payments section of this report, below.

Termination payments

It is the Group's policy that where compensation on termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured. Where it is appropriate to make a bonus payment to the individual, this should relate to the period of actual service, rather than the full notice period. Any bonus will be determined on the basis of performance as for all continuing employees

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and will remain subject to performance adjustment (malus). Generally, on termination of employment, bonus awards, long-term incentive awards and other rights to payments will lapse except where termination falls within one of the reasons set out below. In the event of redundancy, the individual may receive a payment in line with statutory entitlements at that time. If an Executive Director is dismissed for gross misconduct, the Executive Director will receive normal contractual entitlements until the date of termination and all deferred bonus awards and long-term incentive awards will lapse.

	Base salary	Fixed Share Award	Pension, benefits and other fixed remuneration
Resignation	In the case of resignation to take up new employment, paid until date of termination (including any period of leave required by the Group). In the case of resignation for other reasons, base salary will be paid in monthly instalments for the notice period (or any balance of it), offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the fact that the Executive Director has left early.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Redundancy or termination by mutual agreement	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the fact that the Executive Director has left early unless, in the case of mutual agreement, the Committee determines that exceptional circumstances apply in which case shares may be released on termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Retirement/ill health, injury, permanent disability/death	Paid until date of retirement/death. For ill health, injury, permanent disability, paid for the applicable notice period (including any period of leave required by the Group).	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the fact that the Executive Director has left early except for death where shares are released on termination, or unless, in the case of permanent disability, the Committee determines that exceptional circumstances apply in which case shares may be released on	Paid until date of death/retirement (subject to individual benefit scheme rules). For ill health, injury, permanent disability, paid for the notice period including any period of leave required by the Group (subject to individual benefit scheme rules).

		termination.	
Change of control or merger	N/A	Unless the Committee decides otherwise, awards will be released on the date of the corporate event and the number of shares subject to the award in the current year will be reduced to reflect the fact that the Executive Director has left early unless the Committee determines that awards will be exchanged for awards over shares in the acquiring company or such other company as the Committee determines.	N/A
Other reason where the Committee determines that the executive should be treated as a good leaver	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the fact that the Executive Director has left early.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).

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	Annual bonus[1]	Long-term incentive[2]	Chairman and non-executive directors fees[3]
Resignation	Forfeited, including unvested deferred elements (2010 deferred bonus not subject to forfeiture but continues to be subject to performance adjustment) unless the Committee determines otherwise in exceptional circumstances.	Unvested award lapses on date of leaving (or on notice of leaving) unless the Committee determines otherwise in exceptional circumstances.	Paid until date of leaving Board.
Redundancy or Termination by mutual agreement	Accrued up until date of termination (current year). Deferred bonus paid in line with normal timeframes and subject to performance adjustment. The Committee may allow awards to vest early if it considers it appropriate.	Pro-rated award (for months worked in performance period) released at end of period, subject to performance objectives being met. The Committee may allow awards to vest early if it considers it appropriate.	Paid until date of leaving Board.
Retirement/ill health/injury permanent disability	Accrued up until date of termination (current year). Deferred bonus paid in line with normal timeframes and subject to performance adjustment. The Committee may allow awards to vest early if it considers it appropriate.	Pro-rated award (for months worked in performance period) released at end of period, subject to performance objectives being met. The Committee may allow awards to vest early if it considers it appropriate.	Paid until date of leaving Board.
Death	Accrued up until date of termination (current year). Deferred bonus paid on death in cash, unless the Committee determines otherwise.	Pro-rated award (for months worked) released to Estate as soon as practicable after date of death. Performance conditions will not apply.	Paid until date of leaving Board.
Change in control[2]	Accrued up until date of termination (current year). Deferred bonus vests to the extent determined by the Committee.	Pro-rated award (for months worked in performance period) released on date of change in control, subject to performance objectives being met at the time of the transaction. Instead of vesting, awards may be exchanged for equivalent awards over the shares or acquiring company or another company.	Paid until date of leaving Board.
Other reason where the Committee determines that the executive should be treated as a good leaver	Accrued up until date of termination (current year). Deferred bonus paid in line with normal timeframes and subject to performance adjustment. The Committee may allow awards to vest early if it considers it	Pro-rated award (for months worked in performance period) released at end of period, subject to performance objectives being met. The Committee may allow awards to vest early if it considers it appropriate.	Paid until date of leaving Board.

appropriate.

1 If any annual bonus is to be paid to the Executive Director for the current year, this will be determined on the basis of performance for the period of actual service, rather than the full notice period (and so excluding any period of leave required by the Group).

2 Reference to change of control or merger includes a compromise or arrangement under section 899 of the Companies Act 2006 or equivalent Fixed share awards may also be released/exchanged in the event of a resolution for the voluntary winding up of the Company; a demerger, delisting, distribution (other than an ordinary dividend) or other transaction, which, in the opinion of the Committee, might affect the current or future value of any award; or a reverse takeover, merger by way of a dual listed company or other significant corporate event, as determined by the Committee. In the event of a demerger, special dividend or other transaction which would in the Committee's opinion affect the value of awards, the Committee may allow a long term incentive award to vest to the extent relevant performance conditions are met to that date and if the Committee so determined, on a time pro rated basis to reflect the number of months of the performance period worked.

3 The Chairman is entitled to six months notice.

On termination, the Executive Director will be entitled to payment for any accrued but untaken holiday calculated by reference to base salary and fixed share award.

The cost of legal, tax or other advice incurred by an Executive Director in connection with the termination of their employment and/or the cost of support in seeking alternative employment may be met up to a maximum of £100,000.

Additional payments may be made where required to settle legal disputes, or as consideration for new or amended post-employment restrictions.

Where an Executive Director is in receipt of expatriate or relocation expenses at the time of termination (as at the date of the AGM no current Executive Directors are in receipt of such expenses), the cost of actual expenses incurred may continue to be reimbursed for up to 12 months after termination or, at the Group's discretion, a one-off payment may be made to cover the costs of premature cancellation. The cost of repatriation may also be covered.

COMPENSATION

Chairman and Non-Executive Directors

The table below sets out the remuneration policy that will apply, subject to shareholder approval, to Non-Executive Directors (NEDs) from the date of the Annual General Meeting in 2014.

Chairman and Non-Executive Director fees	
Purpose and link to strategy	To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.
Operation	The Committee is responsible for evaluating and making recommendations to the Board with regards to the Chairman's fees. The Chairman does not participate in these discussions. The GCE and the Chairman are responsible for evaluating and making recommendations to the Board in relation to the fees of the NEDs. When determining fee levels, the following are considered: – The individual's skills and experience. – Comparable fees at FTSE companies of a similar size to Lloyds Banking Group, including the major UK banks. The Chairman receives an all inclusive fee, which is reviewed periodically plus benefits including life assurance, car allowance, medical insurance and transportation. The Committee retains the right to provide additional benefits depending on individual circumstances. NEDs are paid a basic fee plus additional fees for the chairmanship/membership of committees and/or membership of Group companies/boards/non-board level committees. Additional fees are also paid to the senior independent director and to the deputy chairman to reflect additional responsibilities. 2014 fee levels are stated in the Implementation Report. Any increases normally take effect from 1 January of a given year. When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies. – Pay for comparable roles in comparable publicly listed financial services groups, of a similar size. Fees and benefits as at January 2014 are detailed below in the Implementation Report on page 153.

	The Chairman and the NEDs are not entitled to receive any payment for loss of office (other than in the case of the Chairman fees for the six months notice period) and are not entitled to participate in the Group's bonus, share plan or pension arrangements. NEDs are reimbursed for expenses and any tax arising from these expenses. Where appropriate, the Group will also meet the costs and any tax arising from travel for business purposes.
Maximum potential	The Committee will make no increase in fees or benefits currently provided which it believes is inconsistent with the two parameters above.
Performance metrics	None

Letters of appointment

The Group's policy is for independent NEDs to have letters of appointment, not service agreements. Non-Executive appointments may be terminated, in accordance with the Articles of Association, at any time.

	Date of letter of appointment
David Roberts	February 2010
Lord Blackwell	May 2012
Carolyn Fairbairn	February 2012
Anita Frew	November 2010
Dyfrig John	October 2013
Nick Luff	February 2013
Anthony Watson	February 2009
Sara Weller	January 2012

The service contracts and letters of appointments are available for inspection at the Company's registered office.

COMPENSATION

DIRECTORS' REMUNERATION IMPLEMENTATION REPORT

Consideration of matters relating to directors' remuneration

The members of the Committee during 2013 were:

- Anthony Watson (chairman)
- Sir Winfried Bischoff
- Carolyn Fairbairn
- David Roberts (also chairman of the Board Risk Committee)
- Timothy Ryan (until 18/04/13)
- Sara Weller

During 2013, the Committee met 10 times and considered the following principal matters:

- Review of remuneration arrangements for senior executives
- Determination of the appropriate remuneration packages for a number of senior new hires
- Determination of bonus pools based on Group performance and adjustment for risk
- Performance conditions for the Long-Term Incentive Plan
- Bonus and salary awards for Executive Directors and key senior managers
- Approval of remuneration and terms of service that fall within the Committee's terms of reference, including new hires
- Feedback from the Committee Chairman on his meetings with the PRA and shareholders

Committee members are thanked for their commitment during the last year and attendance at meetings.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. During the year, Deloitte LLP advised the Committee. Deloitte was appointed following a competitive tendering process. Deloitte has voluntarily signed up to the Remuneration Consultants' Code of Conduct. The Committee has evaluated Deloitte during 2013 and has judged its advice as objective and independent.

During 2013, Deloitte provided information on behalf of the Committee for the testing of Total Shareholder Return (TSR) performance conditions for the Group's long-term incentive plans (calculated by reference to both dividends and growth in share price). In addition, Deloitte LLP provided management with advice on taxation and other consulting services, and assurance services. Deloitte's fees for 2013 amounted to £324,300.

António Horta-Osório (Group Chief Executive), Rupert McNeil (Group HR Director) and Paul Hucknall (HR Director, Performance & Reward) provided guidance to the Committee (other than for their own remuneration). Juan Colombás (Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk and financial matters.

STATEMENT OF VOTING AT GENERAL MEETING

The proposals on the remuneration offered to the Company's Executive Directors in 2013 were detailed within the Directors' Remuneration Report for 2012 and were voted on at the 2013 Annual General Meeting. The shareholder votes submitted at the meeting, either directly, by mail or by proxy, were as follows:

	Votes cast (number of shares – millions)	Percentage of votes cast
Votes in favour	46,949	95.91%
Votes against	2,003	4.09%
Abstentions	4,052	–

As mentioned in the Chairman's statement, the Group is committed to an ongoing dialogue with our shareholders. Shareholders have different views, notably on incentive scheme design and, whilst the Group takes all comments into consideration, there will inevitably be some diverging views, notably on the structure of such schemes and on the choice of performance measures.

The Committee believes that the proposed structure of the Group's remuneration is appropriate, given the regulatory requirements. The Group has consulted extensively with its major shareholders but it also welcomes feedback from all of its shareholders on its remuneration arrangements and on this report.

One particular element of feedback from proxy voting agencies was that they were looking for more information on the determination of the bonus payments. The Group has provided greater detail in this year's report.

COMPENSATION

IMPLEMENTATION OF THE POLICY IN 2014

As mentioned in the Chairman's statement and remuneration policy above, the Group is required to comply with the Prudential Regulation Authority's (PRA) Remuneration Code (the 'Code'), as amended on 1 January 2014 to implement the fourth amendment of the Capital Requirements Directive ('CRD IV'). Under the Code, the Group and certain employees who have a material impact on the Group's risk profile ('Code Staff') including executive directors, are subject to certain rules regarding the provision of remuneration.

This has led the Committee to carry out a fundamental review of the remuneration structure for Directors and other Code Staff. It is proposed to operate the Group's policy in the following way in 2014:

Base salary	Salaries for Executive Directors effective from 1 January 2014 are as follows: Group Chief Executive (GCE): £1,061,000 Chief Financial Officer (CFO): £720,000 Chief Risk Officer (CRO): £710,000 The salary for the CRO has been increased to £710,000 with effect from 1 January 2014 to reflect his additional responsibilities as a member of the Board.
Fixed Share Award	As stated in the Chairman's letter, the Group has introduced an additional element in the package in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The actual levels of award set for 2014 are as follows (which will be released in shares over a five year period): GCE: £900,000 CFO: £504,000 CRO: £497,000
Pension	In line with the remuneration policy, Executive Directors are entitled to a cash allowance in lieu of pension contributions. The level of allowances has not been increased for 2014. GCE: 50 per cent of reference salary less flexible benefit allowance. CFO: 25 per cent of base salary.

	CRO: 25 per cent of base salary. The GCE is also entitled to the provision of an unfunded unapproved retirement benefit scheme (UURBS), subject to performance conditions, as described futher in the annual remuneration report.
Benefits	For 2014, the benefits provided to Executive Directors include a car allowance, transportation, private medical insurance, life assurance and other benefits selected through the flexible benefit allowance which is capped at 4 per cent of base salary. The CRO also received benefits in respect of relocation.
All employee plans	Executive Directors are eligible to participate in the Sharesave and Sharematch scheme on the same basis as other employees.
Annual bonus	
Opportunity	The maximum annual bonus opportunity is 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors which represents a significant reduction from last year's levels. All assessment of performance are ultimately subject to the Committee's judgement, but no award will be made if the threshold performance for the financial measures is not met and the individual is rated "developing performer" or below. The expected value of the bonus is 30 per cent of the maximum opportunity.
Performance measures and targets	For 2014 the annual bonus will be based on: – Financial measures (underlying profit and economic profit) – 50 per cent – Balanced scorecard (BSC) objectives comprising five categories (finance, building the business, customer, risk and people) – 50 per cent The Committee considers the targets that apply to these measures to be commercially sensitive but will provide information on the level of payout relative to the performance achieved in next year's annual remuneration report. The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance determining the final BSC rating.
Long-term incentive plan	
Opportunity	The maximum annual long-term incentive award for Executive Directors is 300 per cent of salary. Awards in 2014 will be made as follows: GCE: 300 per cent of reference salary CFO: 275 per cent of base salary CRO: 275 per cent of base salary

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COMPENSATION

Performance measures and targets

During 2013, the Committee consulted widely with various shareholders on appropriate performance measures and, in particular, on how management can be incentivised through the long-term incentive plan to successfully deliver the Group's overall strategic objective of delivering long-term sustainable returns to shareholders. Based on the feedback, the awards made in 2014 will vest based on Lloyds Banking Group's performance against the following key measures:

– Economic Profit (30 per cent)

– Absolute Total Shareholder Return (30 per cent)

– Strategic Measures (40 per cent)

The Group believes these measures capture risk management and profit growth and appropriately align management and shareholder interests.

The following table provides a breakdown of these measures and the targets applicable.

Category	Measure	Basis of payout range	Metric	Weighting
Financial	Economic Profit	Set relative to 2016 targets	Threshold: £2,154m Maximum: £3,231m	30%
	Absolute TSR	Growth in share price including dividends over 3 year period	Threshold: 8% pa Maximum: 16% pa	30%
	Cost:Income ratio	Set relative to 2016 targets	Threshold: 48.9% Maximum: 46.5%	10%
Customer	Customer satisfaction (Total FCA reportable complaints per 1,000 accounts)[a]	Set relative to 2016 targets	Threshold: 1.15 Maximum: 1.05	10%
	Net promoter score	Major Group average ranking over 2016	Threshold: 3rd Maximum: 1st	10%
Helping Britain Prosper	SME lending	Set relative to targets for SME lending growth over 3 year period	Threshold: 14% Maximum: 18%	5%
	Share of first-time buyer market	Set relative to targets for market share over 3 year period	Threshold: 20% Maximum: 25%	5%

[a] Measure excludes PPI complaints, but includes Banking, Home Finance, General Insurance, Life, Pensions and Investment complaints.

CHAIRMAN AND NON-EXECUTIVE DIRECTOR FEES IN 2014

The annual fee for the Chairman is unchanged at £700,000.

The annual Non-Executive Director fees were reviewed in 2013 and increased as listed below with effect from 1 July 2013: