Lloyds Banking Group plc
Form 20-F
March 16, 2012

As filed with the Securities and Exchange Commission on 16 March 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

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

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2011

OR

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

OR

o 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)

Harry Baines, Group Secretary
Tel +44 (0) 207 356 1400, Fax +44 (0) 207 356 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
4.875% Senior Notes due 2016	The New York Stock Exchange
6.375% Senior Notes due 2021	The New York Stock Exchange
Floating Rate Notes due 2014	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 2011 was:

Ordinary shares, nominal value 10 pence each	68,726,627,112
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	1,917,280
Preference shares, nominal value 25 euro cents each	173,350

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

Yes x No o

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 o No x

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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 x No o

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 o No o

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 x Accelerated filer o Non-Accelerated filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements including in this filing:

U.S. GAAP o International Financial Reporting Standards as issued by the International Accounting Standards Board x Other o

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 o Item 18 o

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 o No x

TABLE OF CONTENTS

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 TSB Bank are to 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 Services Authority or FSA are to the United Kingdom (the UK) Financial Services Authority.

On 16 January 2009 the Company acquired 100 per cent of the ordinary share capital of HBOS plc and changed the Company s name to Lloyds Banking Group plc. Accordingly, where this annual report provides information for dates prior to 16 January 2009, unless otherwise indicated, such information relates to the Lloyds Banking Group prior to the acquisition of HBOS plc. References to HBOS or the HBOS Group are to HBOS plc and its subsidiary and associated undertakings.

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 e are to the lawful currency of the member states of the European Union 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 2011, which was $1.5537 = £1.00. The Noon

Buying Rate on 31 December 2011 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 personal and corporate customers. At 31 December 2011, total Lloyds Banking Group assets were £970,546 million and Lloyds Banking Group had some 98,538 employees (on a full-time equivalent basis). Lloyds Banking Group plc s market capitalisation at that date was some £17,825 million. The Group reported a loss before tax for the 12 months to 31 December 2011 of £342 million, and the capital ratios as at that date were 15.6 per cent for total capital, 12.5 per cent for tier 1 capital and 10.8 per cent for core tier 1 capital.

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

	2011	2010	2009
	£m	£m	£m
Net interest income	**12,698**	12,546	9,026
Other income	**14,114**	31,498	36,745
Total income	**26,812**	44,044	45,771
Insurance claims	**(6,041)**	(19,088)	(22,493)
Total income, net of insurance claims	**20,771**	24,956	23,278
Operating expenses	**(13,050)**	(16,470)	(15,984)
Trading surplus	**7,721**	8,486	7,294
Impairment	**(8,094)**	(10,952)	(16,673)
Share of results of joint ventures and associates	**31**	(88)	(752)
Gain on acquisition			11,173
Loss on disposal of businesses		(365)	
(Loss) profit before tax	**(342)**	(2,919)	1,042

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

The Group has five primary operating divisions, which constitute the Group s reporting segments: Retail, Wholesale, Commercial, Wealth and International, and Insurance. Retail provides banking, mortgages and other financial services to personal customers in the UK. Wholesale provides banking and related services for major UK and multinational corporates and financial institutions, with a turnover in excess of £15 million. Commercial services the needs of small and medium-size enterprises and community organisations with a turnover of up to £15 million. Wealth and International provides private banking and asset management in the UK and overseas and operates the Group s international business. Insurance offers life assurance, pensions and investment products in the UK and Europe and provides general insurance to personal customers in the UK.

The acquisition of HBOS plc on 16 January 2009 had a significant effect on the comparability of the Group s financial position and results with prior periods. Profit before tax is analysed further on pages 18 to 29 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group s segments, on pages 32 to 51 on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described on page 32. 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 a combined businesses basis, which the Group Executive Committee feel best represents the underlying performance of the Group. These combined businesses segmental results for 2011, 2010 and 2009 are therefore presented in compliance with IFRS 8 but the aggregated total of the combined businesses segmental profits and losses before tax constitutes a non-GAAP measure and a reconciliation of this aggregated total to the Group s statutory profit before tax is therefore provided on page 33. The following table shows the results of Lloyds Banking Group s Retail, Wholesale, Commercial, Wealth and International, and Insurance segments and Group Operations and Central items in the last three fiscal years, and their aggregation.

	2011	2010	2009
	£m	£m	£m
Retail	**3,636**	3,986	955
Wholesale	**828**	2,514	(4,682)
Commercial	**499**	291	(200)
Wealth and International	**(3,936)**	(4,950)	(2,433)
Insurance	**1,422**	1,326	1,203
Group Operations and Central items:			

Group Operations	**(56)**	(52)	(143)
Central items	**292**	(903)	(1,000)
	236	(955)	(1,143)
Profit (loss) before tax Combined businesses basis	**2,685**	2,212	(6,300)

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.

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.

	2011	2010	2009	2008[1]	2007[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**20,771**	24,956	23,278	9,868	10,696
Operating expenses	**(13,050)**	(16,470)	(15,984)	(6,100)	(5,568)
Trading surplus	**7,721**	8,486	7,294	3,768	5,128
Impairment losses	**(8,094)**	(10,952)	(16,673)	(3,012)	(1,796)
Gain on acquisition			11,173		
(Loss) profit before tax	**(342)**	(2,919)	1,042	760	3,999
(Loss) profit for the year	**(378)**	(2,594)	2,953	798	3,320
(Loss) profit for the year attributable to equity shareholders	**(451)**	(2,656)	2,827	772	3,288
Total dividend for the year[2]				648	2,026
Balance sheet data at 31 December (£m)					
Share capital	**6,881**	6,815	10,472	1,513	1,432
Shareholders equity	**45,920**	43,725	43,278	9,393	12,141
Customer deposits	**413,906**	393,633	406,741	170,938	156,555
Subordinated liabilities	**35,089**	36,232	34,727	17,256	11,958
Loans and advances to customers	**565,638**	592,597	626,969	240,344	209,814
Total assets	**970,546**	992,438	1,027,255	436,033	353,346
Share information					
Basic earnings per ordinary share[3]	**(0.7)p**	(4.0)p	7.5p	6.7p	28.9p
Diluted earnings per ordinary share[3]	**(0.7)p**	(4.0)p	7.5p	6.6p	28.7p
Net asset value per ordinary share	**67p**	64p	68p	155p	212p
Total dividend per ordinary share[2]				11.4p	35.9p
Equivalent cents per share[2,4]				20.3c	71.0c
Market price per ordinary share (year end)	**25.9p**	65.7p	50.7p	126.0p	472.0p
Number of shareholders (thousands)	**2,770**	2,798	2,834	824	814
Number of ordinary shares in issue (millions)[5]	**68,727**	68,074	63,775	5,973	5,648
Financial ratios (%)[6]					
Dividend payout ratio				83.9	61.6
Post-tax return on average shareholders equity	**(1.0)**	(5.8)	8.8	7.0	28.1
Post-tax return on average assets	**(0.04)**	(0.26)	0.28	0.21	0.94
Average shareholders equity to average assets	**4.5**	4.6	3.1	2.9	3.3
Cost:income ratio[7]	**62.8**	66.0	68.7	61.8	52.1
Capital ratios (%)[8,9]					
Total capital	**15.6**	14.5	12.4	11.1	11.0
Tier 1 capital	**12.5**	11.0	9.6	7.9	8.1
Core tier 1 capital	**10.8**	9.6	8.1	5.5	7.4

1 Restated in 2009 for IFRS 2 (Revised).

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 Earnings per share calculations for 2008 and earlier years have also been restated for the impact of the bonus element of the share issues in 2009.

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

5 This figure excludes the limited voting ordinary shares owned by the Lloyds TSB Foundations.

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

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

[8] Capital ratios are in accordance with Basel II requirements other than the ratios for 2007 which reflect Basel I.

[9] Capital ratios for 2008 and 2009 were restated in 2010 to reflect a prior year adjustment to available-for-sale revaluation reserves.

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:

	2012 February	**2012 January**	**2011 December**	**2011 November**	**2011 October**	**2011 September**
US dollars per pound sterling:						
High	**1.60**	**1.58**	**1.57**	**1.61**	**1.61**	**1.62**
Low	**1.57**	**1.53**	**1.54**	**1.55**	**1.54**	**1.54**

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:

	2011	**2010**	**2009**	**2008**	**2007**
US dollars per pound sterling:					
Average	**1.61**	1.54	1.57	1.84	2.01

On 9 March 2012, the latest practicable date, the US dollar Noon Buying Rate was $1.5677 = £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, this transaction also positioned Lloyds TSB Group as one of the leading suppliers of long-term savings and protection products in the UK.

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 further issues of ordinary shares, the UK Government s holding has been reduced to approximately 40.1 per cent at 9 March 2012.

STRATEGY OF LLOYDS BANKING GROUP

The Group is a well diversified UK financial services group providing a wide range of banking and financial services to personal, commercial and corporate customers. The main focus of the Group remains the financial services markets in the UK and the Group has leading positions in many of the markets in which it participates, a comprehensive distribution capability, well recognised brands and a large customer base.

The Group s corporate strategy is built around becoming the best bank for individual, commercial and corporate customers across the UK and creating value by investing in areas that make a real difference to these customers. Customer leadership driven by superior customer insight, tailored products, better service and relationship focus is the overriding priority. There are a number of other key elements to the strategy announced in June 2011, including simplifying the business, improving its agility and efficiency, whilst focusing on core markets which offer strong returns and attractive growth, maintaining a prudent approach to risk and further strengthening the Group s balance sheet.

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

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 its core customer strategy.

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.

BUSINESS

SIMPLIFY THE GROUP TO IMPROVE AGILITY AND EFFICIENCY

The HBOS integration programme was substantially completed in 2011, delivering a single IT platform and a run-rate of £2 billion per annum in cost synergies and other operating efficiencies. The Group is now targeting a further £1.7 billion of cost savings in 2014 through a series of simplification initiatives.

Savings will be released 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 the legal structures.

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 customers, becoming the best through the cycle partner for its business customers and maintaining Bancassurance as a core element of this proposition.

STRENGTHEN THE GROUP S BALANCE SHEET AND LIQUIDITY POSITION

The Group aims to continue to strengthen its balance sheet and liquidity position through:

- Targeting a core tier 1 capital ratio prudently in excess of 10 per cent
- Exceeding regulatory liquidity requirements
- Maintaining a stable funding base
- Improving the Group s loan to deposit ratio to 130 per cent or below by end 2014, although it now expects to attain this in 2012.

SUMMARY

The Group is looking to create a simpler, more agile, efficient and responsive organisation with a real focus on operating sustainably and responsibly. Whilst focusing on core markets, which offer strong returns and attractive growth, the Group will 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.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

The Group is organised into five segments: Retail; Wholesale; Commercial; Wealth and International; and Insurance; see note 4 to the consolidated financial statements.

Further information on the Group s segments is set out on pages 32 to 51.

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*.

BUSINESS

ENVIRONMENTAL MATTERS

ENVIRONMENTAL RESPONSIBILITY

In 2011, the Group introduced a set of market leading long-term environmental targets under its Environmental Action programme to significantly reduce its environmental footprint. The Group aims to reduce paper, water and business travel by 20 per cent; ensure that less than 20 per cent of waste is sent to landfill; and reduce energy use by 30 per cent by 2020. The Group publishes a standalone, data-driven Climate and Environment Report on an annual basis which details progress it has made against its targets, and this is available from the Lloyds Banking Group website. Last year, the Group achieved the Carbon Trust Standard for its entire UK operations, which recognises its robust approach to measuring, managing and reducing its carbon emissions. The Group also reduced its use of energy by 1 per cent, its use of water by 3 per cent and paper use by 7 per cent in 2011 compared with 2010. Its overall carbon footprint reduced by 1 per cent in 2011 compared with 2010.

Over the last year the Group has been the UK s most active provider of finance to renewable energy projects, having lent over £413 million across 13 renewable energy projects in the UK, Germany and the US. The Group s approach to environmental risk management is covered on pages 123 and 124.

The Group is also encouraging businesses that bank with it to take action to address climate change. The Group has trained over 650 staff on its Business & Environment programme, to enable them to guide and support its customers in recognising environmental risks and seizing the opportunities. The Group is the only major UK bank to provide this kind of support to its business customers.

The Group recognises that its influence extends well beyond the size of its organisation. Its asset management business, Scottish Widows Investment Partnership (SWIP), has over £136 billion invested around the world and is committed to using its influence to encourage best practice in corporate governance and management of sustainability risks. SWIP has also launched a new sustainability strategy across its entire £8 billion property portfolio, including a target to reduce its energy consumption by 10 per cent by 2012 compared with 2009.

CO_2 Emissions (tonnes)

	2011	2010
Total UK CO_2 emissions	**421,568**	425,996
Scope 1 emissions	**52,179**	60,302
Scope 2 emissions	**321,698**	324,007
Scope 3 emissions	**42,691**	41,687

The Group has improved the accuracy of energy data for the 2010 reporting years, replacing estimates with actual data. The Group has also changed its method for reporting car travel data in 2011 and have applied this method to historical data.

TRACKING PROGRESS

Independent consultants verify the Group s performance every year. The Group also measures its performance against its peers through external benchmarks. In 2011, the Group was re-selected for the Dow Jones Sustainability Index. The Group was also ranked top UK bank in the FTSE4Good Index and was re-selected for the Carbon Disclosure Leadership Index. The Group has a Platinum ranking in Business in the Community s Corporate Responsibility Index and was awarded Business in the Community s CommunityMark, the national standard that publicly recognises excellence in community investment.

PROPERTIES

As at 31 December 2011, Lloyds Banking Group occupied 3,144 properties in the UK. Of these, 898 were held as freeholds and 2,246 as long-term leaseholds. 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 423 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, 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.

INTERCHANGE FEES

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard set a uniform Multilateral Interchange Fee (MIF) in respect of cross-border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the MIF be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the General Court). Lloyds TSB Bank plc and Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard s position that the arrangements for the charging of the MIF are compatible with European Union competition laws. The UK Government has also intervened in the General Court appeal supporting the European Commission position. An oral hearing took place on 8 July 2011 and the judgement is expected on 24 May 2012. MasterCard has reached an understanding with the European Commission on a new methodology for calculating intra-European Economic Area MIF on an interim basis pending the outcome of the appeal.

Meanwhile, the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by visa for the levying of the MIF in respect of cross-border payment transactions also infringe European Union competition laws. In this regard visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by

BUSINESS

MasterCard. The UK s Office of Fair Trading has also commenced similar investigations relating to the MIF in respect of domestic transactions in relation to both the MasterCard and visa payment schemes. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

PAYMENT PROTECTION INSURANCE

There has been extensive scrutiny of the Payment Protection Insurance (PPI) market in recent years.

In October 2010, the UK Competition Commission confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. The Competition Commission consulted on the wording of a draft Order to implement its findings from October 2010, and published the final Order on 24 March 2011 which became effective on 6 April 2011. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products to its customers in July 2010.

On 29 September 2009 the FSA announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. Lloyds Banking Group agreed in principle that it would undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. That review now forms part of the ongoing PPI work referred to below.

On 1 July 2008, the Financial Ombudsman Service (FOS) referred concerns regarding the handling of PPI complaints to the Financial Services Authority (FSA) as an issue of wider implication. On 29 September 2009 and 9 March 2010, the FSA issued consultation papers on PPI complaints handling. The FSA published its Policy Statement on 10 August 2010, setting out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress, as well as a requirement for firms to reassess historically rejected complaints which had to be implemented by 1 December 2010.

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008.

The Judicial Review hearing was held in late January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. On 9 May 2011, the BBA confirmed that the banks and the BBA did not intend to appeal the judgment.

After publication of the judgment, the Group entered into discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group has conducted of compliance with applicable sales standards, which is continuing, the Group concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group made a provision in its financial statements for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses. During 2011, the Group made redress payments of £1,045 million to customers. However, there are still a number of uncertainties as to the eventual costs from any such contact and/or redress given the inherent difficulties of assessing the impact of the detailed implementation of the Policy Statement for all PPI complaints, uncertainties around the ultimate emergence period for complaints, the availability of supporting evidence and the activities of claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs.

INTERBANK OFFERED RATE SETTING INVESTIGATIONS

Several government agencies in the UK, US and overseas, including the US Commodity Futures Trading Commission, the US SEC, the US Department of Justice and the FSA, as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates. The Group, and/or its subsidiaries, were (at the relevant time) and remain members of various panels that submit data to these bodies in a number of jurisdictions. The Group has received requests from some government agencies for information and is co-operating with their investigations. In addition the Group has been named in private purported class action suits in the US with regard to the setting of London interbank offered rates (LIBOR). It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and lawsuits on the Group.

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. CMIG has won the majority of decisions to date, although a small number of regional district and appeal courts have found against CMIG on specific grounds. CMIG s strategy includes defending claims robustly and appealing against adverse judgments. The ultimate financial effect, which could be significant, will only be known once all relevant claims have been resolved. However, consistent with this strategy, and having regard to the costs involved in managing these claims, and the inherent risks of litigation, the Group has recognised a provision of £175 million. Management believes this represents the most appropriate estimate of the financial impact, based upon a series of assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs.

SHAREHOLDER COMPLAINTS

The Group and two former members of the Group s Board of Directors have been named as defendants in a purported securities class action pending in the United States District Court for the Southern District of New York. The complaint, dated 23 November 2011, asserts 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. No quantum is specified.

In addition, a UK-based shareholder action group has threatened multi-claimant claims on a similar basis against the Group and two former directors in the UK. No claim has yet been issued.

The Group considers that the claims are without merit and will defend them vigorously. The claims have not been quantified and it is not possible to estimate the ultimate financial impact on the Group at this early stage.

EMPLOYEE DISPUTES

The Group is aware that a union representing a number of the Group s employees is seeking to challenge the cap on pensionable pay introduced by the Group in 2011 on the grounds that it is unlawful. This challenge is at a very early stage. The Group will resist the challenge should it be pursued.

BUSINESS

The Group also faces a number of other threats of legal action from employees in relation to terms of employment including pay and bonuses. The Group considers that the complaints are without merit and, should proceedings be issued, they will be vigorously defended.

It is not possible to estimate the ultimate financial impact on the Group at this stage.

FSA INVESTIGATION INTO BANK OF SCOTLAND

In 2009 the FSA commenced a supervisory review into HBOS. The supervisory review was superseded when the FSA commenced an enforcement investigation into Bank of Scotland plc in relation to its Corporate Division between 2006 and 2008. These proceedings have now concluded. The FSA published its Final Notice on 9 March 2012. No financial penalty has been imposed on the Group or Bank of Scotland plc.

REGULATORY MATTERS

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters including complaints handling, packaged bank accounts, savings accounts, product terms and conditions, interest only mortgages, sales processes and remuneration schemes. The Group is keen to ensure that any regulatory concerns are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

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 (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges 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 to assess properly 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 matter to have a material adverse effect on its financial position.

COMPETITIVE ENVIRONMENT

The Group provides financial services to personal and corporate 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 wholesale banking markets and with bancassurance, life assurance and general insurance companies in the UK insurance market.

In the competitive open market in which the Group operates there is an increasing range of products and services available to customers and with the current public scrutiny of banks the expectations and demands of customers continue to increase.

See *Risk Factors Competition Related Risks The Independent Commission on Banking and the UK Treasury Select Committee have reviewed competition in the UK retail banking industry. The potential impact of the recommendations is inherently uncertain and could have a material adverse effect on the interests of the Group* and *Business and Economic Risks The Group s businesses are conducted in highly competitive environments and the Group s financial performance depends upon management s ability to respond effectively to competitive pressures*.

BUSINESS

RECENT DEVELOPMENTS

PAYMENT OF ACCUMULATED INTEREST ON UPPER TIER TWO HYBRID CAPITAL SECURITIES ISSUED BY LLOYDS BANKING GROUP COMPANIES

The Group made the following announcement on 19 January 2012

Since 31 January 2010, the Group has been prohibited under the terms of an agreement with the European Commission from paying discretionary coupons and dividends on hybrid capital securities issued by the Company and certain of its subsidiaries. This prohibition ends on 31 January 2012.

The Group now confirms that it intends to pay on the upper tier two securities set out below which have cumulative deferrable coupon terms the relevant amount of Arrears of Interest (as defined therein).

ISIN	ISSUER	SECURITY
XS0083932144	Bank of Scotland plc	7.375% Subordinated Undated Instruments
GB0000395102	Bank of Scotland plc	8.750% Perpetual Subordinated Bonds
GB0000395094	Bank of Scotland plc	12.00% Perpetual Subordinated Bonds
GB0005242879	Bank of Scotland plc	9.375% Perpetual Subordinated Bonds
GB0000765403	Bank of Scotland plc	Undated Floating Rate Primary Capital Notes
XS0046690961	Bank of Scotland plc	8.625% Perpetual Subordinated Notes
XS0059171230	Bank of Scotland plc	10.25% Subordinated Undated Instruments
GB0000394915	Bank of Scotland plc	13.625% Perpetual Subordinated Bonds
XS0063730203	Bank of Scotland plc	Subordinated Undated Instruments due 2016
XS0188201536	HBOS plc	4.875% Undated Subordinated Fixed to Floating Rate Instruments
XS0188201619	HBOS plc	Floating Rate Undated Subordinated Instruments
US4041A3AF96 / US4041A2AG96	HBOS plc	5.375% Undated Fixed to Floating Rate Subordinated Notes
XS0177955381	HBOS plc	5.125% Undated Subordinated Fixed to Floating Rate Notes
XS0205326290	HBOS plc	5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes
XS0145407507	Lloyds Banking Group plc	6.00% Undated Subordinated Guaranteed Bonds
GB0005224307	Lloyds TSB Bank plc	Primary Capital Undated Floating Rate Notes (Series 1)
XS0099508698	Lloyds TSB Bank plc	4.648% Undated Subordinated Step-up Notes
XS0099507534	Lloyds TSB Bank plc	6.50% Undated Subordinated Step-up Notes
XS0099507963	Lloyds TSB Bank plc	6.50% Undated Subordinated Step-up Notes
XS0079927850	Lloyds TSB Bank plc	8% Undated Subordinated Step-up Notes
GB0005232391	Lloyds TSB Bank plc	Primary Capital Undated Floating Rate Notes (Series 3)
GB0005205751	Lloyds TSB Bank plc	Primary Capital Undated Floating Rate Notes (Series 2)
XS0169667119	Lloyds TSB Bank plc	5.125% Upper Tier 2 Callable Perpetual Subordinated Notes
XS0056390007	Lloyds TSB Bank plc	5.57% Undated Subordinated Step Up Coupon Notes 2015

Such amounts will be calculated in accordance with the terms of such securities and will be paid on 9 February 2012 subject to, and in accordance with, the terms of those securities.

LLOYDS BANKING GROUP ANNOUNCES CHANGES TO ITS GROUP BOARD AND THE MANAGEMENT TEAM

The Group made the following announcement on 1 February 2012

Lloyds Banking Group has today announced changes to its Group Board and the management team.

The changes to the Board and the senior management organisational structure mean that there will be five business lines reporting directly to the Group Chief Executive as follows:

Alison Brittain will undertake the newly created role of Group Director of Retail with responsibility for our multi channel and multi brand strategy including Lloyds TSB, the Bank of Scotland and Halifax, retail products and marketing, as well as telephony and digital banking.

Antonio Lorenzo, Group Director of Strategy and Wealth and International, will also undertake responsibility for Asset Finance which had formerly been a part of the Wholesale business.

Truett Tate, Group Executive Director for Wholesale has decided to retire from the Group during February and will not seek re-election at the Group s Annual General Meeting in May. As a result of Truett s departure Andrew Géczy, CEO of Wholesale Banking and Markets, will report on an interim basis to Group Chief Executive, António Horta-Osório.

The Group has begun a search internally and externally for a permanent Director of the Group s Wholesale Division.

John Maltby remains as Director of Commercial continuing with his responsibility for our SME businesses.

Toby Strauss role also remains unchanged as Director of the Group s Insurance division.

Further to the centralisation of all control functions as part of the Group Strategic Review in 2011 there will now be five control and support functions as follows:

Risk led by our Chief Risk Officer Juan Colombas.

BUSINESS

Finance led by our Group Finance Director, George Culmer when he joins the Group.

Operations led by our Director of Group Operations, Mark Fisher.

Corporate Affairs led by our Group Corporate Affairs Director, Matt Young.

Group Corporate Functions Human Resources, Legal and Secretariat and Group Audit will now report to a newly-created position of Group Corporate Functions Director. The Group Corporate Functions Director will be a member of the Group Executive Committee and the Group is currently recruiting for the role.

LLOYDS BANKING GROUP: CHANGES TO BOARD

The Group made the following announcement on 1 February 2012

Lloyds Banking Group is pleased to announce the appointment of Sara Weller as a non-executive director. Ms Weller will join the Board with effect from 1 February 2012 and will serve as a member of the Remuneration and the Risk Committees.

Sir Julian Horn-Smith has informed the Group of his intention to retire from the Board at the Annual General Meeting in May 2012 and will therefore not stand for re-election as a Director.

Truett Tate, Executive Director for Wholesale, has decided to retire from the Group at the Annual General Meeting in May 2012 and will therefore not seek re-election.

LLOYDS BANKING GROUP PLC RESIGNATION OF DIRECTOR

The Group made the following announcement on 6 February 2012

Further to the Group s announcement on 1 February 2012, Truett Tate, Executive Director, Wholesale, has resigned from the Board of Lloyds Banking Group plc with immediate effect.

LLOYDS BANKING GROUP PLC MANAGEMENT CHANGE

The Group made the following announcement on 24 February 2012

Further to the Group s announcement on 19 September 2011, Tim Tookey, Group Finance Director, will stand down from the Board of Lloyds Banking Group at close of business today, 24 February 2012.

LLOYDS BANKING GROUP ANNOUNCES BOARD CHANGES

The Group made the following announcement on 27 February 2012

The Board of Lloyds Banking Group plc announces that Glen Moreno, its Deputy Chairman and Senior Independent Director, intends not to seek re-election at the Annual General Meeting on 17 May 2012 and will retire from the Board on that date.

The Board has decided to appoint Anthony Watson, Chairman of the Remuneration Committee, as its Senior Independent Director and David Roberts, Chairman of the Risk Committee, as Deputy Chairman both with effect from 17 May 2012.

LLOYDS BANKING GROUP PLC MANAGEMENT CHANGE

The Group made the following announcement on 1 March 2012

Lloyds Banking Group plc announces that George Culmer will be appointed as Group Finance Director of Lloyds Banking Group with effect from 16 May 2012.

George Culmer has been Chief Financial Officer of RSA Insurance Group plc since May 2004.

Biographical details of George Culmer

Between 2004 and 2012, George was a director and Chief Financial Officer of RSA Insurance Group plc. His previous roles included Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations. Prior to that he held various senior management positions at Prudential. George began his career at Coopers & Lybrand in London and New Zealand and read History at Cambridge. Age 49.

Key compensation notes

Compensation arrangements include an annual salary of £720,000 and a discretionary annual bonus up to a maximum of 200 per cent of salary. It is intended to award a long term performance-based share incentive of up to 225 per cent of salary for 2012 which will only vest in full in three years if stretching performance targets are exceeded. Mr Culmer will receive an allowance to fund personal pension arrangements amounting to 25 per cent of his salary.

Mr Culmer has deferred awards and a cash bonus from RSA Insurance Group plc, which he forfeits as a result of leaving RSA Insurance Group plc. He will therefore be partially compensated in respect of these by receiving shares in Lloyds Banking Group worth £1.9 million which will vest in 2013 and 2014. The extent to which Mr Culmer will receive future awards depends on the performance of Lloyds Banking Group in the short, medium and longer term against stretching performance measures.

LLOYDS BANKING GROUP PLC (GROUP) NOTIFICATION OF TRANSACTIONS BY PERSONS DISCHARGING MANAGERIAL RESPONSIBILITIES IN ORDINARY SHARES OF THE GROUP OF 10P EACH (SHARES)

The Group made the following announcement on 9 March 2012

The following announcement sets out details of awards made today, 9 March 2012, under the Group s share plans to the Group Chief Executive and members of the Group Executive Committee.

Deferred bonus awards for 2011 performance

Conditional awards of shares were made today in respect of bonus awards for 2011 performance. Part of the 2011 bonus awards will be made in June 2012 based on the prevailing share price. These shares will be notified at that time. Awards vesting over the period September 2012 to

BUSINESS

September 2015 are based on a share price of 34.786 pence and are detailed below. Bonus awards are subject to performance adjustment in full or in part if the performance that generated the award is found not to be sustainable.

Name	Maximum number of shares awarded
A Brittain	2,414,764
J Colombás	1,782,326
M Fisher	2,069,798
A Lorenzo	1,782,326
J Maltby	728,741
D Nicholson	436,957
A Risley	577,818
T Strauss	451,330
M Young	929,971

Long term incentive plan   2012 awards

Conditional share awards were made today under the Group s Long Term Incentive Plan as detailed below. The shares under the awards will only vest in 2015 subject to the satisfaction of stretching performance conditions over a three year period. The awards are based on a share price of 34.786 pence.

Name	Maximum number of shares awarded
A Horta-Osório	9,644,684
A Brittain	4,527,683
J Colombás	4,146,064
M Fisher	4,876,961
A Lorenzo	4,243,086
J Maltby	2,910,653
D Nicholson	2,587,247
A Risley	2,587,247
T Strauss	3,395,762
M Young	2,587,247

Emoluments of the eight highest paid senior executives

The following table sets out the Emoluments of the eight highest paid senior executives in respect of the 2011 performance year. The disclosure is made on the same basis as the five highest paid senior executives for the 2010 performance year, as shown in the Annual Report and Accounts 2010.

	Employee							
	8	7	6	5	4	3	2	1
Fixed	£000	£000	£000	£000	£000	£000	£000	£000
Cash based	342	480	310	233	754	941	956	500
Total fixed	342	480	310	233	754	941	956	500
Variable[1]								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	0	0	0	0	0	0	0	0
Upfront shares[2]	20	0	0	332	0	205	320	0
Deferred shares	478	498	793	1,048	898	773	773	1,998
Long term incentive plan[3]	270	144	199	473	509	433	443	150
Total variable pay	770	644	994	1,855	1,409	1,413	1,538	2,150
Pension cost[4]	85	120	44	58	189	160	164	125
Total remuneration	1,197	1,244	1,348	2,146	2,352	2,514	2,658	2,775

1 Variable pay in respect of performance year 2011.

2 Award to compensate for loss of variable remuneration from previous employer which vested in 2011.

3 LTIP values shown are on an expected value basis.

4 Pension cost based on an average pension cost of 25 per cent of salary.

LLOYDS BANKING GROUP PLC (GROUP) - NOTIFICATION OF TRANSACTIONS BY PERSONS DISCHARGING MANAGERIAL RESPONSIBILITIES IN ORDINARY SHARES OF THE GROUP OF 10P EACH (SHARES)

The Group made the following announcement on 15 March 2012

The Group announces that today, following the successful delivery of the integration programme, the 2009 LTIP Integration Awards vested for the individuals listed in the table below. They have received the number of Shares as set out by their name, after the appropriate number of Shares had been withheld to cover tax and national insurance contributions. The Shares were acquired for nil consideration.

Name	**Shares**
M Fisher	748,008
J Maltby	480,862
D Nicholson	400,717
A Risley	400,718

The Group further announces that today Mr Fisher exercised an option over 1,984,093 Shares under the Lloyds Banking Group plc Executive Share Plan 2003. The Shares were acquired for nil consideration.

Mr Fisher sold 2,482,101 Shares today at 35.6711 pence per Share, inclusive of the appropriate number of Shares to cover tax and national insurance contributions due on the exercise of his option. Following the above transactions, Mr Fisher’s shareholding in the Group increased by 250,000 Shares bringing his total shareholding to 519,738 Shares.

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 consolidated financial statements.

TABLE OF CONTENTS

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OVERVIEW AND TREND INFORMATION

The external macro economic and regulatory environment in which the Group operates remains uncertain but the Group has endeavoured to outline below some of the key regulatory, economic and social factors impacting its markets.

REGULATION

The quantum of regulatory change remains high and the regulatory environment remains challenging but the Group is starting to see greater clarity in a number of areas. There are however a number of different issues that are likely to have a fundamental impact on the business going forward including the recommendations arising from the Independent Commission on Banking, future capital and liquidity requirements, and the changes to the UK banking supervisory structure:

- Stringent UK capital and liquidity standards
- More focus on consumer protection and transparency
- Recovery and resolution mechanisms and Retail ring-fencing
- Independent Commission on Banking final recommendations

Independent Commission on Banking (ICB)

In 2010 the UK Government appointed an ICB to review possible structural measures to reform the banking system and promote stability and competition. The ICB published its final report on 12 September 2011 putting forward proposals that would require ring-fencing some of the retail and SME activities of banks from their investment banking activities and additional capital requirements beyond those required under Basel III.

On 19 December 2011 the Chancellor delivered the UK Government s first formal response to the ICB s Final Report of 12 September. The response endorsed many of the key recommendations contained in the ICB s Final Report, including the ring-fencing of commercial and retail operations, higher capital requirements and a 7-day current account switching service. Importantly for the Group, the Government also supported the principle of a flexible ring fence, which allows banks to choose where to place some (but not all) services.

While the Group welcomes the increased clarity provided by the Government s initial response, significant uncertainty remains over key elements of the reforms, including what activities could be allowed inside the ring-fenced bank , the extent of depositor preference of other creditors and measures that could see some categories of wholesale funding bailed-in in the instance of resolution.

The Government has announced that it will be producing a formal White Paper in the spring and the Group would anticipate that this paper will provide additional clarity, while still leaving some issues open to consultation. The Group continues to work to assess the impact that the reforms may have on its business and continues to play a constructive role in the debate with the Government and other stakeholders.

Capital Requirements Directive IV

Evolving capital and liquidity requirements continue to be a priority for the Group. Separate to the capital recommendations laid out by the ICB, the Basel Committee on Banking Supervision has put forward proposals for a reform package which changes regulatory capital and liquidity standards, the definition of capital , introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2013 and 2018 and the fourth round of changes to the European Capital Requirements Directive IV is currently in draft form and progressing through the European legal framework towards finalisation.

UK Banking Supervisory Structure

The recent ongoing difficulties in global financial markets have prompted a review and alteration to the banking supervisory structure in the UK. In April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) and Prudential

Regulatory Authority (PRA) in 2012. Until this time the responsibility for regulating and supervising the activities of the Lloyds Banking Group and its subsidiaries will remain with the FSA. However, the reorganisation could lead to changes in how the Group is regulated and supervised on a day-to-day basis. In addition, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE ECONOMY

The global economy was split in 2011 between relatively strong growth in emerging markets, and economies struggling to recover from recession in much of the Western world. Indeed, the extent of the UK economic recovery has now fallen behind even the weak recovery after the late 1970 s recession.

The stark difference is due to the high levels of indebtedness that many developed economies accumulated prior to 2008, which are holding back economic growth through deleveraging of initially the private sector, but now governments too. In the Eurozone, countries with particularly high government debt or deficit levels have lost market confidence as they struggled to achieve the necessary fiscal tightening to bring their public finances onto a sustainable trajectory without damaging economic growth prospects too severely. Ireland, Portugal and Greece have received further IMF and EU financial support in return for accepting even more stringent austerity programmes, and at the time of writing it looks likely that private creditors will suffer effective haircuts of significantly more than 50 per cent on their Greek debt. Italy and Spain have also tightened public budgets further, and given their much greater size this is dragging down Eurozone economic growth more significantly. In the US, public finance concerns are less immediate, but the unsustainable long term trajectory of debt on current policies has led to political stalemate, raising the risk of sudden fiscal tightening as previous loosening measures expire, and in turn hurting businesses and consumers confidence. Global growth was also hampered in 2011 by natural disasters, including the floods in Australia and Thailand and the earthquake and tsunami in Japan, the latter causing significant disruption to global manufacturing supply chains.

First estimates suggest the UK economy grew by 0.9 per cent in 2011, well below the long term average of 2.3 per cent. The economy is currently estimated to have shrunk slightly in the final quarter of the year as consumers and businesses confidence fell, the result of relatively high inflation reducing consumers spending power, a faster than expected reduction in public sector employment, and the worsening outlook for the Eurozone which caused companies to postpone investment spending and recruitment. Unemployment rose from 7.7 per cent in the first quarter of 2011 to 8.4 per cent by December. Company failures in England and Wales rose from a low point of 3,973 in the final quarter of 2010 to 4,260 by the fourth quarter of 2011, although the failure rate remained steady over that period at just 0.7 per cent of companies, close to its pre-recession trough. Property prices were broadly flat through the year, however house prices on average fell marginally by 2 per cent in the year to December 2011, and commercial property prices rose on average by just 1 per cent.

Based on data for the first three quarters of 2011, the Irish economy appears to have grown in 2011 for the first time since 2007, and the unemployment rate appears to be stabilising. Strict austerity measures in recent years targeted at improving international competitiveness are beginning to pay off falling domestic demand is now being more than offset by increasing net exports. Property markets remain very weak, however; house prices fell by over 16 per cent in 2011 and CRE prices by 11 per cent. Despite the large fall in prices already, an overhang of vacant property continues to weigh on market prices.

Future economic developments in the UK and Ireland are highly contingent on how successful political leaders are at stemming the Eurozone crisis, to what extent the private sector can offset shrinking of the public sector, and how the implementation of new regulation on banks impacts their ability to supply credit whilst meeting tighter capital and liquidity criteria. The recent weakening in the Eurozone economy and the balance of risks make double-dip recession there in 2012 the most likely scenario indeed this is now the consensus view (Chart 2).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The current consensus view for 2012 UK GDP growth is not yet that weak, at 0.4 per cent. The low level of imbalances in the economy relative to the 2008 position suggest that weak growth should not deteriorate into significant recession provided the Eurozone moves quickly towards a solution to the sovereign debt crisis. Bank Rate is likely to stay at or close to current low levels for some time, and property prices are expected to be broadly stable. Unemployment is likely to rise further, however, as estimates of public sector job cuts have increased. The current consensus view for 2012 Irish GDP growth is broadly flat, and the unemployment rate there is expected to be stable. Property prices are expected to fall further, but by less than in 2011.

However, whilst a definitive solution to the Eurozone crisis remains lacking there continues to be a risk that ongoing uncertainty around the Eurozone economic outlook, the survival of the Euro currency and the availability of credit could cause a significant recession in the UK and Ireland. Such a scenario would likely result in higher UK corporate failures, a second leg of falling property prices, albeit by less than during the 2008-9 recession, and rising commercial tenant defaults. Irish property prices would also fall by more than currently expected. In turn, this would have a negative impact on the Group s income, funding costs and impairment charges.

THE IMPACT ON THE GROUP S MARKETS

The weak economic recovery has kept growth in the Group s markets subdued. With the economy expected to grow very slowly in 2012, the Group s central expectation is that growth in its markets will remain weak in 2012.

For the market as a whole, net new mortgage lending has amounted to just 0.7 per cent of outstanding balances during 2011, very similar to 2010. Consumers made net repayments of unsecured debt (excluding student loans) of around 2 per cent of outstanding balances for the third consecutive year in 2011. Household deposits rose by 2.6 per cent in 2011 similar to the rate of increase in the previous two years but well down from the 8-9 per cent growth per year pre-recession.

Similarly, companies have been focussed on paying down existing debt, for the third successive year in 2011. Non-financial companies made net repayments of 3.7 per cent of sterling lending from banks and building societies in 2011, after repayments of 3.5 per cent in 2010 and 2.2 per cent in 2009. Company deposits with UK banks rose by 1.1 per cent in 2011, slower than the 1.8 per cent rise in 2010 and the 4.5 per cent increase in 2009. Although companies have held back investment spending and prioritised cashflow, much of this has fed into lower borrowing rather than higher deposits.

In Ireland, continued falls in house prices, despite the already steep reductions prior to 2011, have kept impairments high and the Group expects property prices to remain subdued.

The Group expects that another weak year for the UK economy in 2012 will be accompanied by weak customer deposit growth and a continued period of declining demand for borrowing, particularly from companies. The continuation of low interest rates, and the substantial adjustments that many companies and households have already made to their indebtedness, is likely to minimise any deterioration in arrears. The Group s central expectation of broadly flat property prices in the UK in 2012 is consistent with the subdued market expected.

CUSTOMER DRIVERS, INCLUDING COMPETITION

- Want simplicity and transparency
- Demand a quality, multi-channel customer service experience
- Growing demand for advice to plan/save for retirement
- Increasingly demand better value for their money

In the competitive open market in which the Group operates there is an increasing range of products and services available to customers, and with the current public scrutiny of banks the expectations and demands of customers continue to increase.

Access to convenient branches remains important for many customers but demand for a quality multi-channel banking proposition is now more prevalent and the provision of effective telephone, digital and mobile channels is increasingly important. 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 environment many customers are demanding 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. Customers are demanding basic banking services to be delivered well but there is also an increasing demand for advice in more complex areas such as help in planning and saving for retirement. Product innovation is also important for some whereas longstanding relationships remain important for others.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

As highlighted above, there are some clear customer trends emerging but the Group recognises that every customer, whether they be retail or corporate, has their own personal needs and has to be treated individually. It is clear that different customer segments have different demands and the opportunity exists to differentiate service for varied segments but fundamentally the customer has a choice and will select the provider that can most effectively service their personal needs.

The financial services market remains competitive. The Group is seeing a number of new entrants including virgin Money and Metro Bank looking to make inroads into the market and the disposal of the verde branches along with the improved switching process will further enhance competition.

The Group s strategy, as outlined on pages 4 and 5, reflects the 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 changing needs of every customer.

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 consolidated financial statements.

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group s IFRS reporting are discussed in note 58 to the consolidated financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS 2011, 2010 AND 2009

SUMMARY

	2011 £m	2010 £m	2009 £m
Net interest income	**12,698**	12,546	9,026
Other income	**14,114**	31,498	36,745
Total income	**26,812**	44,044	45,771
Insurance claims	**(6,041)**	(19,088)	(22,493)
Total income, net of insurance claims	**20,771**	24,956	23,278
Operating expenses	**(13,050)**	(16,470)	(15,984)
Trading surplus	**7,721**	8,486	7,294
Impairment	**(8,094)**	(10,952)	(16,673)
Share of results of joint ventures and associates	**31**	(88)	(752)
Gain on acquisition			11,173
Loss on disposal of businesses		(365)	
(Loss) profit before tax	**(342)**	(2,919)	1,042
Taxation	**(36)**	325	1,911
(Loss) profit for the year	**(378)**	(2,594)	2,953
Profit attributable to non-controlling interests	**73**	62	126
(Loss) profit attributable to equity shareholders	**(451)**	(2,656)	2,827
(Loss) profit for the year	**(378)**	(2,594)	2,953

2011 COMPARED WITH 2010

For the year ended 31 December 2011, the Group recorded a loss before tax of £342 million compared with a loss before tax in 2010 of £2,919 million, which had been driven by the £3,200 million payment protection insurance provision (see page 27) although this had been partly offset by a pension curtailment gain in the same year of £910 million.

Total income decreased by £17,232 million to £26,812 million in 2011 compared with £44,044 million in 2010, comprising a £17,384 million reduction in other income only marginally offset by an increase of £152 million in net interest income.

Net interest income was £12,698 million in 2011; an increase of £152 million, or 1 per cent compared to £12,546 million in 2010. There was a credit of £696 million in 2011 arising from liability management gains (see page 21) and a benefit of £1,117 million from a reduction in the amounts payable to unitholders in those Open-Ended Investment Companies included in the consolidated results of the Group. However, net interest income in the Group s banking businesses fell as a result of both a reduction in average interest earning banking assets in the year and a reduction in the net interest margin. The decline in the net interest margin reflected higher wholesale funding costs, higher deposit rates and the effect of refinancing a significant amount of government and central bank facilities, partially offset by an improvement in customer margins and funding mix.

Other income was £17,384 million, or 55 per cent, lower at £14,114 million in 2011 compared to £31,498 million in 2010. Fee and commission income was £57 million, or 1 per cent, lower at £4,935 million compared to £4,992 million in 2010. Fee and commission expense decreased by £291 million or 17 per cent to £1,391 million compared with £1,682 million in 2010. Net trading income decreased by £16,092 million to a deficit of £368 million in 2011 compared to a surplus of £15,724 million in 2010; this decrease included a reduction of £14,267 million in gains on policyholder investments held within the insurance business, offset by a similar decrease in the related claims expense, see below. Insurance premium income was largely unchanged at £8,170 million in 2011 compared with £8,148 million in 2010; an increase of £22 million. During 2011 the Group exchanged certain existing subordinated debt securities for new securities; these exchanges resulted in a gain on extinguishment of the existing securities of £599 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs; this gain was £176 million, or 42 per cent higher than the liability management gains recognised in 2010. Excluding the liability management gains, other operating income was £1,724 million, or 44 per cent, lower at £2,169 million in 2011 compared to £3,893 million in 2010; this largely reflected an adverse variance of £1,411 million in the income arising from the movement in value of in-force insurance business.

Insurance claims expense was £13,047 million or 68 per cent, lower at £6,041 million in 2011 compared to £19,088 million in 2010. The insurance claims expense in respect of life and pensions business was £12,851 million, or 69 per cent lower at £5,698 million in 2011 compared to £18,549 million in 2010; this decrease in claims was matched by a similar reduction in net trading income, reflecting the performance of policyholder investments. Insurance claims in respect of general insurance business were £196 million, or 36 per cent, lower at £343 million compared to £539 million in 2010.

Operating expenses decreased by £3,420 million, or 21 per cent to £13,050 million in 2011 compared with £16,470 million in 2010; the main reasons for the reduction being the £3,200 million payment protection insurance provision and the £500 million customer goodwill payments provision, raised in 2010, partly offset by a pension curtailment gain of £910 million in the same year. Staff costs were £544 million, or 10 per cent higher at £6,166 million in 2011 compared with £5,622 million in 2010. However, excluding the pension curtailment gain in 2010, staff costs were £366 million, or 6 per cent lower at £6,166 million compared with £6,532 million in 2010. Premises and equipment costs were £126 million, or 11 per cent, lower at £1,051 million compared with £1,177 million in 2010. Other expenses, excluding the payment protection insurance provision from 2010, were £244 million, or 6 per cent lower, at £3,593 million in 2011 compared with £3,837 million in 2010. The decrease reflected the £500 million customer goodwill payments provision made in 2010, partly offset by the UK bank levy of £189 million and provision in relation to German insurance business litigation in 2011. Depreciation and amortisation costs were £257 million, or 11 per cent lower at £2,175 million in 2011 compared to £2,432 million in 2010. In 2011 there was a charge of £65 million in relation to the impairment of tangible fixed assets which was £137 million, or 68 per cent lower than the charge of £202 million in 2010.

Impairment losses decreased by £2,858 million, or 26 per cent, to £8,094 million in 2011 compared with £10,952 million in 2010. Impairment losses in respect of loans and advances to customers were £2,707 million, or 25 per cent, lower at £8,020 million compared with £10,727 million in 2010. The lower charges were

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

principally due to the continued application of the Group s prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK property prices, partly offset by weakening UK economic growth and rising unemployment. In Retail there was a higher secured impairment charge, with the increase on 2010 largely reflecting a less certain outlook for house prices, together with a decrease in the unsecured impairment charge, reflecting continued improving new business quality and portfolio trends as a result of the Group s risk appetite, with a focus on lending to existing customers. In Wholesale there was a decrease in the impairment charge, primarily driven by lower impairment from the corporate real estate and real estate related asset portfolios partly offset by higher impairment on leveraged acquisition finance exposures. The continued low interest rate environment helped to maintain defaults at a reduced level. In Commercial, the impairment charge decreased, reflecting the benefits of the low interest rate environment, which has helped maintain defaults at a lower level. In Wealth and International, impairment charges were also lower. The reduction predominantly reflects lower impairment charges in the Irish portfolio where the rate of impaired loan migration has slowed.

There was no impairment charge in respect of loans and advances to banks in 2011, whereas in 2010 there had been a credit of £13 million following releases in respect of a small number of specific exposures. The impairment charge in respect of debt securities classified as loans and receivables was £8 million, or 14 per cent, lower at £49 million in 2011 compared to £57 million in 2010 and the impairment charge in respect of available-for-sale financial assets was £26 million, or 25 per cent, lower at £80 million in 2011 compared to £106 million in 2010. There was a release of £55 million in respect of other credit provisions in 2011, as a number of commitments have now been drawn down; in 2010 a charge of £75 million resulted from a small number of specific new cases.

The Group s share of results of joint ventures and associates was a gain of £31 million in 2011 compared with a net loss of £88 million in 2010.

In 2011, the Group recorded a tax charge of £36 million compared to a tax credit of £325 million in 2010. The tax charge of £36 million in 2011 arose on a loss before tax of £342 million, reflecting the effect on deferred tax of the reduction in the UK corporation tax rate to 26 per cent with effect from 1 April 2011 and to 25 per cent with effect from 1 April 2012, offset by the net impact of certain tax losses where no deferred tax has been recognised and the recognition of other tax losses that had not previously been recognised.

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 progress on reducing holdings of assets outside of its risk appetite, resulting in a reduction in such assets of £53 billion to £141 billion, against a commitment to decrease these assets to less than £90 billion by the end of 2014. There was a further strengthening of the funding position, with £35 billion of term wholesale funding raised, around £10 billion more than initially targeted. The Group s new pricing management of savings products and its multi-brand strategy have resulted in customer deposit growth (excluding balances arising from repurchase agreements) of 6 per cent, above market growth. The Group had a particularly strong performance from the Halifax challenger brand as a result of innovative products launched in the year. Deposit growth, progress in funding and the asset reductions facilitated further pay-down of government and central bank facilities from £97 billion at the 2010 year end to £24 billion at the end of 2011 (with nothing outstanding under the UK Special Liquidity Scheme).

The Group s credit market exposures primarily relate to asset-backed security exposures held in the Wholesale division; on the balance sheet these exposures are classified as loans and receivables, available-for-sale financial assets or trading and other financial assets at fair value through profit or loss depending on the nature of the investment. A detailed analysis of these asset-backed security exposures is provided in note 56 to the consolidated financial statements. The Wholesale division s total exposure to asset-backed securities has decreased by £19,443 million from £34,724 million at 31 December 2010 to £15,281 million at 31 December 2011 as these investment holdings continue to reduce.

As at 31 December 2011, the Group s capital ratios had increased with a total capital ratio on a Basel II basis of 15.6 per cent (compared to 14.5 per cent at 31 December 2010); a tier 1 capital ratio of 12.5 per cent (compared to 11.0 per cent at 31 December 2010) and a core tier 1 ratio of 10.8 per cent (compared to 9.6 per cent at 31 December 2010). During 2011 risk-weighted assets had decreased by £54,031 million to £352,341 million at 31 December 2011 compared with £406,372 million at 31 December 2010; this decrease reflected risk-weighted asset reductions across all divisions driven by balance sheet reductions, lower lending balances and stronger management of risk, including a £6,017 million reduction in the Retail division and a £32,398 million reduction in the Wholesale division.

2010 COMPARED WITH 2009

The Group recorded a loss before tax of £2,919 million in 2010 compared to a profit of £1,042 million in 2009 as a result of the £3,200 million payment protection insurance provision (see page 27). The results in 2010 also included a pension curtailment gain of £910 million, largely offset by a customer goodwill payments provision of £500 million (see page 27) and a loss on disposal of businesses of £365 million. The profit in 2009 had included a negative goodwill credit of £11,173 million in relation to the acquisition of HBOS plc by the Group and a fee of £2,500 million paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme. There were significant post-acquisition impairment losses in respect of the HBOS portfolios in both 2009 and 2010.

Total income decreased by £1,727 million, or 4 per cent, to £44,044 million in 2010 compared to £45,771 million in 2009; with a £3,520 million, or 39 per cent, increase in the Group s net interest income only partly offsetting a £5,247million, or 14 per cent, decrease in other income.

Net interest income was £3,520 million, or 39 per cent, higher at £12,546 million in 2010 compared to £9,026 million in 2009. Net interest income was increased as the benefit of higher asset pricing more than offset the impact of lower deposit margins. The Group s net interest margin increased by 61 basis points to 1.69 per cent in 2010 compared to 1.08 per cent in 2009 with increases in Retail, where margins improved as a result of improved asset pricing and decreases in the LIBOR to base rate spread, in Wholesale, again as a result of higher asset pricing to reflect customer risk, and in Commercial. There was, however, a reduced margin in Wealth and International as a result of lower base rates, a very competitive deposit environment and the impact of impaired lending balances.

Other income was £5,247 million, or 14 per cent, lower at £31,498 million in 2010 compared to £36,745 million in 2009. Fee and commission income was £264 million, or 6 per cent, higher at £4,992 million in 2010 compared to £4,728 million in 2009. Fee and commission expense was £165 million, or 11 per cent, higher at £1,682 million in 2010 compared to £1,517 million in 2009. Net trading income was £3,374 million lower at £15,724 million in 2010 compared to £19,098 million in 2009; this included a reduction of £2,551 million in gains on policyholder investments held in the Group s insurance businesses (although this was largely offset by a decrease in the related claims expense, see below) as a result of relative market conditions over 2010, compared to 2009; in addition, a loss of £620 million, which was £193 million, or 45 per cent, higher than the loss of £427 million in 2009, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009. During 2010 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liabilities of £423 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs; this was £1,075 million, or 72 per cent, lower than the gains of £1,498 million realised on similar transactions in 2009.

Insurance claims were £3,405 million lower at an expense of £19,088 million in 2010 compared to £22,493 million in 2009. The insurance claims expense in respect of life and pensions business was £3,310 million, or 15 per cent, lower at £18,549 million in 2010 compared to £21,859 million in

2009 as a result of the relative returns on policyholder investments in the long-term insurance business; this movement in claims was broadly matched by a decrease in net trading income reflecting the gains on those policyholder investments. Insurance claims in respect of general insurance business were £95 million, or 15 per cent, lower at £539 million in 2010 compared to £634 million in 2009, this was due primarily to lower payment protection insurance claims related to unemployment.

Operating expenses increased by £486 million, or 3 per cent, to £16,470 million in 2010 compared to £15,984 million in 2009, this increase principally reflected the £3,200 million payment protection insurance provision in 2010, more than offsetting the impact of the non-repetition of the £2,500 million fee paid to the UK Government in 2009 as part of the agreement for the Group not to enter into the Government Asset Protection Scheme. A pension curtailment gain of £910 million in 2010 was offset by a £557 million increase in integration costs and a £500 million customer goodwill payments provision. Staff costs were £1,053 million, or 16 per cent, lower at £5,622 million in 2010 compared to £6,675 million in 2009. Excluding the pension curtailment gain of £910 million in 2010, staff costs were £143 million, or 2 per cent, lower at £6,532 million in 2010 compared to £6,675 million in 2009, as decreased salary costs, reflecting head count reductions, and lower levels of staff restructuring costs were partly offset by increases in other staff costs (reflecting greater use of agency staff in relation to the integration programme). Premises and equipment costs were £21 million, or 2 per cent, higher at £1,177 million in 2010 compared to £1,156 million in 2009. Other expenses, including the payment protection insurance provision, were £4,184 million higher at £7,037 million in 2010 compared to £2,853 million in 2009. This increase reflected the £3,200 million payment protection insurance provision and the £500 million customer goodwill payments provision, both in 2010, and increased communication costs and professional fees in relation to the ongoing integration of the Lloyds TSB and HBOS businesses. Depreciation and amortisation costs were £128 million lower at £2,432 million in 2010 compared to £2,560 million in 2009. In 2010 there was a charge of £202 million in respect of the impairment of tangible fixed assets; and in 2009 there was a charge of £240 million in respect of the impairment of goodwill attributable to the Group s asset finance business.

Impairment losses decreased by £5,721 million, or 34 per cent, to £10,952 million in 2010 compared to £16,673 million in 2009. Impairment losses in respect of loans and advances to customers were £5,056 million, or 32 per cent, lower at £10,727 million in 2010 compared to £15,783 million in 2009. This reflected improved credit experience in the Retail, Wholesale and Commercial divisions as a result of the improving economic environment in the UK and the US; partly offset by increased charges in the International business, especially in Ireland and Australia. The Group s through the cycle credit policies and procedures, which focus on the development of enduring client relationships, had resulted in higher quality new business being originated across the UK and very little new origination took place outside the UK. The Group s level of impairment is being managed in the current challenging economic environment by the Wholesale business support units, also covering Commercial and Retail collection and recovery units. The business support model has been expanded from Wholesale across Wealth and International division, with a central team established to manage the Group s business support activity globally. The Group had also strengthened resources within Retail collections and recoveries to enable more timely engagement with customers experiencing difficulties to drive more effective customer outcomes.

The Group s share of results of joint ventures and associates was a net loss of £88 million in 2010 compared to a net loss of £752 million in 2009; partly due to reduced losses in the joint venture vehicles and partly reflecting the fact that many of the investments are now substantially written-off.

On 16 January 2009, the Group had acquired 100 per cent of the ordinary share capital of HBOS plc. As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill was recognised as a Gain on acquisition in the income statement for the year ended 31 December 2009. There was no such credit in 2010.

In 2010, the Group incurred a loss on disposal of businesses of £365 million (2009: nil). During 2009, the Group had acquired an oil drilling rig construction business through a previous lending relationship and, in the second half of 2010, the Group reached agreement to dispose of its interests in the two wholly-owned subsidiary companies through which this business operates.

In 2010, the Group recorded a tax credit of £325 million compared to a tax credit of £1,911 million in 2009. The tax credit of £325 million in 2010 arose on a loss before tax of £2,919 million, an effective tax rate of 11 per cent compared to the standard UK corporation tax rate of 28 per cent. This lower rate reflected losses where no deferred tax was recognised together with the impact of the tax charge attributable to UK life insurance policyholders and the Group s interests in Open Ended Investment Companies (OEICs), which is required to be included within the income tax charge, and a charge resulting from the change in the UK corporation tax rate being largely offset by overseas tax rate differences and other adjustments.

Total assets were £34,817 million lower at £992,438 million at 31 December 2010 compared to £1,027,255 million at 31 December 2009; loans and advances to customers were £34,372 million, or 5 per cent, lower at £592,597 million at 31 December 2010 compared to £626,969 million at 31 December 2009; and customer deposits were £13,108 million, or 3 per cent, lower at £393,633 million at 31 December 2010 compared to £406,741 million at 31 December 2009; total assets had reduced as the Group continued its strategy to reduce assets associated with non-relationship lending and investments, including business which is outside the Group s current risk appetite. The reduction in total assets was substantially driven by reductions in portfolios of lending which are outside of the Group s risk appetite across the three banking divisions, continued customer deleveraging and de-risking and subdued demand in lending markets.

The Wholesale division s total exposure to asset-backed securities decreased by £8,139 million from £42,863 million at 31 December 2009 to £34,724 million at 31 December 2010 as these investments continued to run-off.

Mortgage-backed security exposures were £2,562 million lower at £15,656 million at 31 December 2010 compared to £18,218 million at 31 December 2009. Exposures to Alt-A US residential mortgage-backed securities were £267 million lower at £3,700 million at 31 December 2010 compared to £3,967 million at 31 December 2009; there is no exposure to sub-prime US residential mortgage-backed securities.

Exposures where reliance is placed on monoline insurers were limited to a total of £254 million at 31 December 2010 (31 December 2009: £444 million); all of the exposure at 31 December 2010 was rated AA.

At the end of December 2010, the Group s capital ratios had increased with a total capital ratio on a Basel II basis of 14.5 per cent (compared to 12.4 per cent at 31 December 2009), a tier 1 ratio of 11.0 per cent (compared to 9.6 per cent at 31 December 2009) and a core tier 1 ratio of 9.6 per cent (compared to 8.1 per cent at 31 December 2009). During 2010, risk-weighted assets had decreased by £86,935 million to £406,372 million at 31 December 2010 compared to £493,307 million at 31 December 2009; this decrease reflected balance sheet reductions across all banking divisions, a revised assessment of the Retail division s secured lending risk-weighted assets following improvements in the economic outlook and changes introduced as a result of continuing the process of integrating the Lloyds TSB and HBOS regulatory capital approaches which had impacted particularly on the Wholesale division.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2011	2010[1]	2009[1]
Net interest income £m	**12,698**	12,546	9,026
Average interest-earning assets £m	**736,032**	741,883	833,503
Average rates:			
Gross yield on interest-earning assets%	**3.58**	3.95	3.39
Interest spread%	**1.62**	1.64	1.05
Net interest margin%	**1.73**	1.69	1.08

1 During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

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.

2011 COMPARED WITH 2010

Net interest income was £12,698 million in 2011; an increase of £152 million, or 1 per cent compared to £12,546 million in 2010. There was a credit of £696 million in 2011 arising from liability management gains (see below) and a benefit of £1,117 million from a reduction in the amounts payable to unitholders in those Open-Ended Investment Companies included in the consolidated results of the Group. However, there were decreases within the Retail division, as a result of higher wholesale funding costs which were not matched by average customer rates, and previous de-risking of the lending portfolio resulting in reduced secured lending balances; and in the Wholesale division reflecting lower interest-earning asset balances and higher funding costs partly offset by improved margins on deposit products.

Average interest-earning assets were £5,851 million, or 1 per cent, lower at £736,032 million in 2011 compared to £741,883 million in 2010. This reduction reflected the 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 £10,963 million, or 3 per cent, lower at £362,145 million in 2011 compared to £373,108 million in 2010. Average personal mortgage balances were £7,235 million, or 2 per cent, lower at £335,496 million in 2011 compared with £342,731 million in 2010; Retail s new mortgage lending continued to be focused on home purchase with 70 per cent of lending being for house purchase rather than re-mortgaging. Average other personal lending balances were £3,728 million, or 12 per cent, lower at £26,649 million in 2011 compared with £30,377 million in 2010 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 £5,112 million, or 1 per cent, higher at £373,887 million in 2011 compared to £368,775 million in 2010. Relationship lending and similar average interest-earning assets in Wholesale were £24,787 million, or 16 per cent, lower at £130,209 million in 2011 compared to £154,996 million in 2010, as demand for new corporate lending and refinancing of existing facilities was more than offset by maturities, reflecting a continued trend of subdued corporate demand for lending and customer deleveraging. Balances in Wealth and International were £4,959 million, or 7 per cent, lower at £63,279 million in 2011 compared to £68,238 million in 2010. Average interest-earning assets in Commercial were £241 million, or 1 per cent, higher at £29,753 million in 2011 compared to £29,512 million in 2010. The remainder of the Group s average interest-earning assets, which include certain non-relationship and treasury-related balances in the Wholesale division and the bank deposits held in the insurance business, were £34,617 million, or 30 per cent, higher at £150,646 million in 2011 compared to £116,029 million in 2010.

The Group s net interest margin increased by 4 basis points to 1.73 per cent in 2011 compared to 1.69 per cent in 2010. However, net interest income in 2011 included £696 million in relation to the revision in the carrying values of certain debt securities. During December 2011, the Group completed the exchange of certain subordinated debt securities issued by Lloyds TSB Bank plc and HBOS plc for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call before 31 December 2012. As part of the exchange, the Group announced that all decisions to exercise calls on those original securities that remained outstanding following the exchange offer would be made with reference to the prevailing regulatory, economic and market conditions at the time. These securities will not, therefore, be called at their first available call date which will lead to coupons continuing to be paid until possibly the final redemption date of the securities. Consequently, the Group is required to adjust the carrying amount of these securities to reflect the revised estimated cash flows over their revised life and to recognise this change in carrying value in interest expense. Included within net interest income is a credit of £570 million in respect of the securities that remained outstanding following the exchange offer. In December 2011, the Group decided to defer payment of non-mandatory coupons on certain securities and, instead, settle them using an Alternative Coupon Satisfaction Mechanism (ACSM) on their contractual terms. This change in expected cashflows resulted in a gain of £126 million in net interest income from the recalculation of the carrying value of these securities. Excluding these amounts net interest income was £544 million, or 4 per cent, lower at £12,002 million in 2011 compared to £12,546 million in 2010 and the net interest margin was 6 basis points lower at 1.63 per cent in 2011 compared to 1.69 per cent in 2010. An increase in margin in Commercial was more than offset by reduced margins in Retail, Wholesale and Wealth and International. Margins in Commercial improved as a result of an increase in deposit balances, a consequently larger funding surplus and a more favourable deposit mix. In Retail margins decreased due to muted demand for credit and previous de-risking of the lending portfolios with a resulting reduction in unsecured balances. In Wholesale margins decreased slightly with the impact of higher funding costs almost fully offset by re-pricing activity and increased deposit margins and values. Margins in Wealth and International decreased reflecting the increased strains of lost earnings on higher impaired asset balances and higher funding costs although this was largely offset by stronger deposit margins in the Wealth businesses and higher deposit balances and margins in the Group s International on-line deposit business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Net interest income was £3,520 million, or 39 per cent, higher at £12,546 million in 2010 compared to £9,026 million in 2009. Interest and similar income was £1,102 million, or 4 per cent, higher at £29,340 million in 2010 compared to £28,238 million in 2009; and interest and similar expense was £2,418 million, or 13 per cent, lower at £16,794 million in 2010 compared to £19,212 million in 2009. In the Retail division, this reflected higher asset pricing (partly due to mortgage customers moving onto and staying on standard variable rates and lending being priced to more appropriately reflect risk and rising funding costs), in part offset by the impact on interest expense of lower LIBOR to base rate spreads although there had been a reduction in the more expensive deposit balances. In the Wholesale division, lending was also being re-priced to reflect customer risk profiles resulting in higher customer margins on new business and from re-pricing on renewals. Across the Group, there had been some increase in funding costs as a result of the Group s improved funding profile but there had been a benefit from a £723 million reduction in the amounts payable to unit holders in those Open-Ended Investment Companies included in the consolidated results of the Group (although, since these are policyholder items, there was no impact on profit attributable to shareholders).

Average interest-earning assets were £91,620 million, or 11 per cent, lower at £741,883 million in 2010 compared to £833,503 million in 2009. This reduction reflected the successful removal of assets which were outside of the Group s risk appetite from the Group s balance sheet.

Average interest-earning assets in Retail were £11,175 million, or 3 per cent, lower at £373,108 million in 2010 compared to £384,283 million in 2009. Average personal mortgage balances were £7,141 million, or 2 per cent, lower at £342,731 million in 2010 compared to £349,872 million in 2009, in part reflecting a slight reduction in demand in the UK mortgage market in 2010; Retail had continued to focus on supporting the housing market with 70 per cent of new lending being for house purchases rather than re-mortgages. Average other personal lending balances were £4,034 million, or 12 per cent, lower at £30,377 million in 2010 compared to £34,411 million in 2009 as a result of reduced customer demand for credit and customers continuing to reduce their personal indebtedness, with reductions in both unsecured loan and credit card balances.

Average interest-earning assets across the rest of the Group were £80,445 million, or 18 per cent, lower at £368,775 million in 2010 compared to £449,220 million in 2009. Relationship lending and similar average interest-earning assets in Wholesale were £19,621 million, or 11 per cent, lower at £154,996 million in 2010 compared to £174,617 million in 2009 as demand for new corporate lending and refinancing of existing facilities was more than offset by the level of maturities, reflecting a continuing trend of subdued corporate lending and customer deleveraging. Such balances in Wealth and International were £645 million, or 1 per cent, lower at £68,238 million in 2010 compared to £68,883 million in 2009. Average interest-earning assets in Commercial were £920 million, or 3 per cent, lower at £29,512 million in 2010 compared to £30,432 million in 2009. The remainder of the Group s average interest-earning assets, which include certain non-relationship and treasury-related balances in the Wholesale division and the bank deposits held in the insurance businesses, were £59,259 million, or 34 per cent, lower at £116,029 million in 2010 compared to £175,288 million in 2009; this reflected planned balance sheet reductions.

The Group s net interest margin increased by 61 basis points to 1.69 per cent in 2010 compared to 1.08 per cent in 2009 with increases in Retail, Wholesale and Commercial only partly offset by reduced margins in the Wealth and International business. Margins in Retail improved as a result of improved asset pricing and decreases in the LIBOR to base rate spread. In Wholesale margins were also improved, again as result of higher asset pricing to reflect customer risk. Declining margins in Wealth and International reflected reduced base rates, a very competitive deposit environment and the impact of impaired lending balances.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2011 £m	2010 £m	2009 £m
Fee and commission income:			
Current account fees	**1,053**	1,086	1,088
Credit and debit card fees	**877**	812	765
Other[1]	**3,005**	3,094	2,875
	4,935	4,992	4,728
Fee and commission expense	**(1,391)**	(1,682)	(1,517)
Net fee and commission income	**3,544**	3,310	3,211
Net trading income	**(368)**	15,724	19,098
Insurance premium income	**8,170**	8,148	8,946
Liability management gains	**599**	423	1,498
Other	**2,169**	3,893	3,992
Other operating income	**2,768**	4,316	5,490
Total other income	**14,114**	31,498	36,745

1 In previous years the Group has included annual management charges on non-participating investment contracts within insurance claims. In light of developing practice, these amounts (2011: £606 million; 2010: £577 million; 2009: £474 million) are now included within net fee and commission income.

2011 COMPARED WITH 2010

Other income was £17,384 million, or 55 per cent, lower at £14,114 million in 2011 compared to £31,498 million in 2010, as a result of the factors discussed below.

Fee and commission income was little changed at £4,935 million in 2011 compared with £4,992 million at 2010; a reduction of £57 million or 1 per cent. Current account fees were £33 million, or 3 per cent, lower at £1,053 million in 2011 compared to £1,086 million in 2010, following a restructuring of the customer tariff. An increase of £65 million, or 8 per cent, in credit and debit card fees from £812 million in 2010 to £877 million in 2011 resulted from increased customer activity, particularly over the internet. Other fees and commissions were £89 million, or 3 per cent, lower at £3,005 million in 2011 compared with £3,094 million in 2010.

Fee and commission expense was £291 million, or 17 per cent, lower at £1,391 million in 2011 compared to £1,682 million in 2010.

Net trading income was £16,092 million lower at a deficit of £368 million in 2011 compared with a surplus of £15,724 million in 2010. Net trading income within the insurance businesses was a deficit of £518 million in 2011 compared to a surplus of £13,749 million in 2010, which reflected the market performance in 2011, however this decrease along with the increase in long-term insurance premium income were largely offset by the overall decrease in insurance claims expense. A loss of £5 million in 2011, compared with a loss in 2010 of £620 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 £2,440 million, or 94 per cent lower at £155 million in 2011 compared with £2,595 million in 2010. This decrease in the banking business reflected poor trading conditions and, in particular a total charge of £718 million for derivative valuation adjustments, compared to £42 million in 2010.

Insurance premium income was largely unchanged at £8,170 million in 2011 compared with £8,148 million in 2010; an increase of £22 million. Earned premiums in respect of the Group s long-term life and pensions business were £181 million, or 3 per cent, higher at £6,954 million in 2011 compared to £6,773 million in 2010. General insurance earned premiums were £159 million, or 12 per cent, lower at £1,216 million in 2011 compared with £1,375 million in 2010.

During December 2011 the Group completed the exchange of certain existing subordinated debt securities issued by Lloyds TSB Bank plc and HBOS plc for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call before 31 December 2012. This exchange resulted in a gain on extinguishment of the existing securities of £599 million, compared with £423 million in 2010, being the difference between the carrying value of the securities extinguished and the fair value of the new securities issued together with related fees and costs.

Other operating income, excluding the liability management gains, was £1,724 million, or 44 per cent, lower at £2,169 million in 2011 compared with £3,893 million in 2010; this was mainly driven by a significant decline in the movement in value of in-force business from a profit of £789 million in 2010 to a loss of £622 million in 2011, particularly reflecting non-economic assumption changes and economic variance (see note 30 to the financial statements), along with lower levels of operating lease rentals receivable and lower gains on disposal of available-for-sale financial assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Other income was £5,247 million lower at £31,498 million in 2010 compared to £36,745 million in 2009, as a result of the factors discussed below.

Fee and commission income was £264 million, or 6 per cent, higher at £4,992 million in 2010 compared to £4,728 million in 2009. Current account fees were little changed at £1,086 million in 2010 compared to £1,088 million in 2009 but credit and debit card fees were £47 million, or 6 per cent, higher at £812 million in 2010 compared to £765 million in 2009. Other fee and commission income was £219 million, or 8 per cent, higher at £3,094 million in 2010 compared to £2,875 million in 2009.

Fee and commission expense was £165 million, or 11 per cent, higher at £1,682 million in 2010 compared to £1,517 million in 2009. There had been increases in fees payable related to added-value account packages and higher levels of card fees payable, as well as increased levels of fees payable in respect of the Group s fund management activities.

Net trading income was £3,374 million lower at £15,724 million in 2010 compared to £19,098 million in 2009. Net trading income within the insurance businesses was £2,551 million, or 16 per cent, lower at £13,749 million in 2010 compared to £16,300 million in 2009 which reflected a more subdued market performance in 2010 (equity market values increased by 9 per cent in 2010 compared to 22 per cent in 2009) although this decrease and the reduction in long-term insurance premium income were largely offset by the decrease in the insurance claims expense. A loss of £620 million, which was £193 million, or 45 per cent, higher than the loss of £427 million in 2009, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group in 2009. Net trading income within the Group s banking activities was £630 million, or 20 per cent, lower at £2,595 million in 2010 compared to £3,225 million in 2009 as the Group continued to reduce activities outside of its risk appetite.

Insurance premium income was £798 million, or 9 per cent, lower at £8,148 million in 2010 compared to £8,946 million in 2009. Earned premiums in respect of the Group s long-term life and pensions business were £687 million, or 9 per cent lower, at £6,773 million in 2010 compared to £7,460 million in 2009, this reflected reduced new business sales, mainly as a result of the withdrawal, during 2009, of certain HBOS legacy products with lower returns. General insurance earned premiums were £111 million lower at £1,375 million in 2010 compared to £1,486 million in 2009; this primarily reflected the Group s withdrawal from the payment protection insurance market in July 2010.

During 2009 and 2010, as part of the Group s management of capital, the Group exchanged certain existing subordinated debt securities for new subordinated debt securities and ordinary shares. These exchanges resulted in a gain on extinguishment of the existing liabilities of £423 million (2009: £1,498 million), being the difference between the carrying value of the securities extinguished and the fair value of the new securities issued together with related fees and costs. On 18 February 2010, as part of the Group s recapitalisation and exit from its proposed participation in the Government Asset Protection Scheme, Lloyds Banking Group plc issued 3,141 million ordinary shares in exchange for certain existing preference shares and preferred securities. This exchange resulted in a gain of £85 million. During March 2010 the Group entered into a bilateral exchange, under which certain Enhanced Capital Notes denominated in Japanese Yen were exchanged for an issue of new Enhanced Capital Notes denominated in US Dollars; the securities subject to the exchange were cancelled and a profit of £20 million arose. In addition, during May and June 2010 the Group completed the exchange of a number of outstanding capital securities issued by Lloyds Banking Group plc and certain of its subsidiaries for ordinary shares in Lloyds Banking Group plc. The securities subject to exchange were cancelled, generating a total profit of £318 million for the Group.

Other operating income, excluding the gains on capital transactions, was £99 million lower at £3,893 million in 2010 compared to £3,992 million in 2009; increased gains on disposal of available-for-sale financial assets were more than offset by lower levels of operating lease rentals receivable and a reduction in the income arising from the movement in value of in-force business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATING EXPENSES

	2011 £m	2010[1] £m	2009 £m
Administrative expenses:			
Staff:			
Salaries	**3,784**	3,787	3,902
Performance-based compensation	**361**	533	491
Social security costs	**432**	396	383
Pensions and other post-retirement benefit schemes:			
Curtailment gain		(910)	
Other	**401**	628	744
	401	(282)	744
Restructuring costs	**124**	119	412
Other staff costs	**1,064**	1,069	743
	6,166	5,622	6,675
Premises and equipment:			
Rent and rates	**547**	602	569
Hire of equipment	**22**	18	20
Repairs and maintenance	**188**	199	226
Other	**294**	358	341
	1,051	1,177	1,156
Other expenses:			
Communications and data processing	**954**	1,126	668
Advertising and promotion	**398**	362	335
Professional fees	**576**	742	540
Customer goodwill payments provision		500	
Financial services compensation scheme levies	**179**	46	73
UK bank levy	**189**		
Provision in relation to German insurance business litigation	**175**		
Other	**1,122**	1,061	1,237
	3,593	3,837	2,853
Depreciation and amortisation:			
Depreciation of tangible fixed assets	**1,434**	1,635	1,716
Amortisation of acquired value of in-force non-participating investment contracts	**78**	76	75
Amortisation of other intangible assets	**663**	721	769
	2,175	2,432	2,560
Impairment of tangible fixed assets[2]	**65**	202	
Goodwill impairment			240
Total operating expenses, excluding payment protection insurance provision and Government Asset Protection Scheme fee	**13,050**	13,270	13,484
Payment protection insurance provision		3,200	
Government Asset Protection Scheme fee			2,500
Total operating expenses	**13,050**	16,470	15,984
Cost:income ratio (%)[3]	**62.8**	66.0	68.7

1 During 2011, the Group has reviewed the analysis of certain cost items and as a result has reclassified some items of expenditure; comparatives for 2010 have been restated accordingly.

2 £65 million (2010: £52 million; 2009: nil) of the impairment of tangible fixed assets relates to integration activities.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

Operating expenses decreased by £3,420 million, or 21 per cent, to £13,050 million in 2011 compared with £16,470 million in 2010. This decrease principally reflected the £3,200 million payment protection insurance provision made in 2010.

Staff costs were £544 million, or 10 per cent, higher in 2011 at £6,166 million compared to £5,622 million in 2010. However, excluding the net pension curtailment gain of £910 million in 2010, staff costs were actually lower by £366 million, a decrease of 6 per cent from £6,532 million in 2010. Salaries were largely unchanged at £3,784 million in 2011 compared with £3,787 million in 2010 as the impact of annual pay rises, and some enhancement of benefits following the harmonisation of terms and conditions across the Group, was offset by staff reductions. Pensions costs, excluding the curtailment gain in 2010, were £227 million, or 36 per cent, lower at £401 million in 2011 compared to £628 million in 2010, principally as a result of increased asset levels in the defined benefit schemes at the end of 2010 leading to a higher expected return. Staff bonuses were £172 million, or 32 per cent, lower at £361 million in 2011 compared with £533 million in 2010. variable pay is reflective of the performance of the business and total discretionary bonus awards are approximately 30 per cent lower than last year with bonuses above £2,000 subject to deferral and adjustment. Social security costs were £36 million, or 9 per cent, higher at £432 million in 2011 compared with £396 million in 2010 in part due to an increase in the percentage payable. Staff restructuring costs at £124 million in 2011 compared with £119 million in 2010, and other staff costs, at £1,064 million in 2011 compared with £1,069 million remained largely unchanged.

Premises and equipment costs were £126 million, or 11 per cent, lower at £1,051 million in 2011 compared to £1,177 million in 2010. Rent and rates was £55 million, or 9 per cent, lower at £547 million in 2011 compared to £602 million in 2010, mainly as a result of the closure of operations in Ireland; and other premises and equipment costs decreased by £64 million or 18 per cent, in part due to profits on disposal of operating lease assets and other equipment.

Other expenses (excluding the payment protection insurance provision charge of £3,200 million from 2010) were £244 million, or 6 per cent, lower at £3,593 million in 2011 compared with £3,837 million in 2010. Other expenses in 2010 included a charge of £500 million in respect of the customer goodwill payments provision, which was not repeated in 2011; and in 2011 there was a charge of £175 million in respect of German insurance business litigation, £189 million for the UK bank levy and a total of £179 million for Financial Services Compensation Scheme levies compared to only £46 million in 2010. Excluding these items, other expenses in 2011 were £241 million, or 7 per cent, lower at £3,050 million compared to £3,291 million in 2010. Communications and data processing costs were £172 million, or 15 per cent, lower at £954 million in 2011 compared with £1,126 million in 2010 as a result of increased amounts of software expenditure being suitable for capitalisation as the integration programme has progressed. Professional fees were £166 million, or 22 per cent, lower at £576 million in 2011 compared with £742 million in 2010 following reduced expenditure within the integration programme and on a number of specific projects.

Depreciation and amortisation costs were £257 million, or 11 per cent, lower at £2,175 million in 2011 compared with £2,432 million in 2010. This reflects reductions in the operating lease asset portfolio, certain tranches of equipment now being fully depreciated and some reduction in the charge for the amortisation of acquisition intangibles.

A charge of £65 million arose in respect of impairment of tangible fixed assets, all of which related to integration activities; in 2010, £52 million of the total charge of £202 million related to integration activities with the remainder related to impairment of assets held by an oil drilling rig business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Operating expenses increased by £486 million, or 3 per cent, to £16,470 million in 2010 compared to £15,984 million in 2009. This increase principally reflected the £3,200 million payment protection insurance provision in 2010, which more than offset the non-repetition of the £2,500 million fee paid in 2009 to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme.

Staff costs were £1,053 million, or 16 per cent, lower at £5,622 million in 2010 compared to £6,675 million in 2009. Staff costs in 2010 were reduced by a curtailment gain related to the Group s pension schemes. Following changes by the Group to the terms of its UK defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee s actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during 2010 there was also a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group s defined benefit obligation of £1,081 million and a reduction in the Group s unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement in 2010. Excluding the pension curtailment gain of £910 million in 2010, staff costs were £143 million, or 2 per cent, lower at £6,532 million in 2010 compared to £6,675 million in 2009. Salaries were £115 million, or 3 per cent, lower at £3,787 million in 2010 compared to £3,902 million in 2009 as the impact of annual pay rises had been more than offset by staff reductions; performance-based compensation was £42 million, or 9 per cent, higher at £533 million in 2010 compared to £491 million in 2009; pension costs, excluding the curtailment gain, were £116 million, or 16 per cent, lower at £628 million in 2010 compared to £744 million in 2009, principally as a result of increased asset levels in the defined benefit schemes at the end of 2009 which led to a higher expected return; staff restructuring costs were £293 million, or 71 per cent, lower at £119 million in 2010 compared to £412 million in 2009 principally as the significant staff rationalisations as part of the Group integration programme in 2009 were not repeated in 2010; and other staff costs were £324 million, or 44 per cent, higher at £1,069 million in 2010 compared to £743 million in 2009, which largely reflected increased use of agency staff in relation to the integration programme.

Premises and equipment costs were £21 million, or 2 per cent, higher at £1,177 million in 2010 compared to £1,156 million in 2009. Rent and rates were £33 million, or 6 per cent, higher at £602 million in 2010 compared to £569 million in 2009, as a result of rent reviews and integration-related expenditure; and other premises and equipment costs were £17 million, or 5 per cent, higher at £358 million in 2010 compared to £341 million in 2009.

Other expenses were £984 million higher at £3,837 million in 2010 compared to £2,853 million in 2009. These costs in 2010 included a £500 million customer goodwill payments provision. Lloyds Banking Group had been in discussions with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the Halifax brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc had applied for a voluntary variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of the Financial Services and Markets Act 2000 (FSMA).

Excluding the customer goodwill payments provision, other expenses in 2010 were £484 million, or 17 per cent, higher at £3,337 million compared to £2,853 million in 2009. Communications and data processing costs were £458 million, or 69 per cent, higher at £1,126 million in 2010 compared to £668 million in 2009 and professional fees were £202 million, or 37 per cent, higher at £742 million in 2010 compared to £540 million in 2009; in both cases reflecting increased levels of integration-related expenditure.

Depreciation and amortisation costs were £128 million, or 5 per cent, lower at £2,432 million in 2010 compared to £2,560 million in 2009.

A charge of £202 million (2009: nil) arose in respect of the impairment of tangible fixed assets. During 2009, the Group had acquired an oil drilling rig construction business through a previous lending relationship and consolidated the results and net assets of the business from the date that it exercised control; during 2010, as a result of a deteriorating market, the Group impaired the oil drilling rigs under construction held by the business by £150 million to reflect their reduced value in use. A further £52 million impairment charge related to the write-off of certain tangible fixed assets as a result of integration activities.

In 2009, a charge of £240 million had arisen in respect of the impairment of goodwill; there was no impairment charge in respect of goodwill in 2010.

Total operating expenses in 2010 included a £3,200 million payment protection insurance provision. On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial Review was heard in January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. Subsequent to the publication of the judgment, the Group had been in discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group had conducted of compliance with applicable sales standards which was continuing, the Group had concluded that there were certain circumstances where customer contact and/or redress would be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2011 **£m**	2010 £m	2009 £m
Impairment losses on loans and receivables:			
Loans and advances to banks		(13)	(3)
Loans and advances to customers	**8,020**	10,727	15,783
Debt securities classified as loans and receivables	**49**	57	248
Total impairment losses on loans and receivables	**8,069**	10,771	16,028
Impairment of available-for-sale financial assets	**80**	106	602
Other credit risk provisions	**(55)**	75	43
Total impairment charged to the income statement	**8,094**	10,952	16,673

2011 COMPARED WITH 2010

Impairment losses decreased by £2,858 million, or 26 per cent, to £8,094 million in 2011 compared to £10,952 million in 2010.

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

The impairment charge in respect of loans and advances to customers was £2,707 million, or 25 per cent, lower at £8,020 million compared to £10,727 million in 2010.

In Retail there was a higher secured impairment charge, with the increase on 2010 largely reflecting a less certain outlook for house prices, and provisioning against existing credit risks which have longer emergence periods due to current low interest rates. These factors were partially offset by an improvement in the quality of the secured portfolio. Secured asset quality remained good and the number of customers entering arrears reduced through 2011 compared to 2010. The stock of properties in repossession remained stable and the sales prices of repossessed properties continued to be at expected values. The proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100 per cent decreased to 12 per cent at 31 December 2011, benefitting from the regional mix of lending. The value of the portfolio with an indexed loan-to-value of greater than 100 per cent and more than three months in arrears was stable at just over £3 billion. There was a decrease in the unsecured impairment charge, reflecting continued improving new business quality and portfolio trends as a result of its conservative risk appetite, with a focus on lending to existing customers.

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

In Commercial, the impairment charge decreased, reflecting the benefits of the low interest rate environment, which helped maintain defaults at a lower level, and the continued application of the Group s prudent credit risk appetite.

In Wealth and International, impairment charges were also lower. The reduction predominantly reflects lower impairment charges in the Irish portfolio where the rate of impaired loan migration slowed. The impairment charge as a percentage of average loans and advances to customers improved. Impaired loans increased by £0.4 billion with an increase of £1.9 billion in Ireland partly offset by a reduction in the Australasian book as a result of write-offs and disposals, resulting in 42.8 per cent of the International portfolios (66.0 per cent of the Irish portfolio) being classified as impaired compared with 35.1 per cent in 2010.

There was no impairment charge in respect of loans and advances to banks in 2011, whereas in 2010 there had been a credit of £13 million following releases in respect of a small number of specific exposures. The impairment charge in respect of debt securities classified as loans and receivables was £8 million, or 14 per cent, lower at £49 million in 2011 compared to £57 million in 2010 and the impairment charge in respect of available-for-sale financial assets was £26 million, or 25 per cent, lower at £80 million in 2011 compared to £106 million in 2010.

There was a release of £55 million in respect of other credit provisions in 2011, as a number of commitments have now been drawn down; in 2010 a charge of £75 million resulted from a small number of specific new cases.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2010 COMPARED WITH 2009

Impairment losses decreased by £5,721 million, or 34 per cent, to £10,952 million in 2010 compared to £16,673 million in 2009.

The reduction in the Group s impairment charge in 2010 reflected stabilisation of the wholesale portfolios and improved retail affordability and performance. Improvements in Wholesale, Commercial and Retail more than offset increased impairment charges in Ireland and Australia, the latter caused by difficult market conditions. The Group s through the cycle credit policies and procedures, which focus on the development of enduring client relationships, had resulted in higher quality new business being originated across the UK and very little new origination took place outside the UK. The Group s level of impairment was managed in the challenging economic environment by the Wholesale business support units, also covering Commerial, and Retail collection and recovery units. The business support model was expanded from Wholesale across Wealth and International division, with a central team established to manage the Group s business support activity globally. The Group had also strengthened resources within Retail collections and recoveries to enable more timely engagement with customers experiencing difficulties to drive more effective customer outcomes. The Group had actively reduced limits to Portugal, Ireland, Italy, Greece and Spain over 2009 and 2010, with the associated country risk profile modest in the context of the Group s asset base.

The impairment charge in respect of loans and advances to customers was £5,056 million, or 32 per cent, lower at £10,727 million in 2010 compared to £15,783 million in 2009. This improvement reflected reduced impairment charges in Retail, as a result of the improved quality of new business and a slow recovery in the UK economy, Wholesale, where stabilising economic conditions have led to lower impairment charges, particularly in the corporate real estate and real estate-related UK and US portfolios, and Commercial; only partly offset by increased impairment charges in Wealth and International as a result of difficult market conditions in a number of locations abroad, particularly Ireland and Australia, and especially in relation to the commercial real estate portfolios in those locations. The level of losses continued to be dominated by the economic environment in Ireland, and to a lesser extent had also been influenced by the performance of specific areas of the Australian economy.

In Retail, there was a lower secured impairment charge reflecting reduced impaired loan levels and improved arrears in the first half of 2010, although in the second half, and particularly in the last quarter, the Group had seen some signs of strain, with fewer customers returning their accounts to order than was the case six months previously. Although house prices fell slightly over 2010, the proportion of the mortgage portfolio with an indexed loan-to-value of greater than 100 per cent was broadly stable at 13 per cent. The value of the portfolio with an indexed loan-to-value greater than 100 per cent and more than three months in arrears increased by £0.2 billion and at 31 December 2010 was £3.2 billion, representing 0.9 per cent of the portfolio. The number of mortgage customers new to arrears had also remained relatively stable over 2010, and was well below the peak experienced in the second half of 2008. There was a decrease in the unsecured impairment charge, reflecting continued improving portfolio trends resulting from application of the Group s risk appetite, management actions taken over 2009 and 2010, and stable unemployment. Unsecured impaired loans decreased as a result of fewer cases going into arrears, improved quality of new business and increased write off of impaired loans.

The Wholesale impairment charge decreased as a result of the significant actions which were taken in the first half of 2009 on the heritage HBOS portfolios (including the identification of large impairments subsequent to the HBOS acquisition, especially in corporate real estate, real estate-related and Corporate (UK and US) portfolios), together with the stabilising UK and US economic environment in 2010, with a low interest rate environment helping to maintain defaults at a lower level, and a number of write backs due to asset disposals.

The Commercial impairment charge was lower, again reflecting some stabilisation in the UK economy and the benefit to customers of the low interest rate environment.

The impairment charge in respect of loans and advances to banks improved by £10 million to a credit of £13 million compared to a credit of £3 million in 2009; this reflected releases in respect of a small number of specific exposures. The impairment charge in respect of debt securities classified as loans and receivables decreased by £191 million, or 77 per cent, to £57 million in 2010 compared to £248 million in 2009. Impairment losses in respect of available-for-sale financial assets were £496 million lower at £106 million in 2010 compared to £602 million in 2009. The charge in respect of other credit risk provisions was £32 million, or 74 per cent, higher at £75 million in 2010 compared to £43 million in 2009, as a result of a small number of specific new cases that arose in 2010.

TAXATION

	2011 **£m**	2010 £m	2009 £m
UK corporation tax:			
Current tax on profits for the year	**(93)**	(146)	(227)
Adjustments in respect of prior years	**(146)**	310	(310)
	(239)	164	(537)
Double taxation relief		1	10
	(239)	165	(527)
Foreign tax:			
Current tax on profits for the year	**(90)**	(82)	(221)
Adjustments in respect of prior years	**36**	49	40
	(54)	(33)	(181)
Current tax credit (charge)	**(293)**	132	(708)
Deferred tax	**257**	193	2,619
Taxation (charge) credit	**(36)**	325	1,911

2011 COMPARED WITH 2010

The rate of tax is influenced by the geographic and business mix of profits. In 2011, a tax charge of £36 million arose on the loss before tax of £342 million and in 2010 a tax credit of £325 million arose on the loss before tax of £2,919 million. The statutory corporation tax rates were 26.5 per cent for 2011 and 28.0 per cent for 2010. 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. The tax attributable to UK life insurance policyholder earnings and the Group s interest in Open Ended Investment Companies was a credit of £72 million in 2011 and a charge of £315 million in 2010. The changes in UK corporation tax rates lead to an additional charge of £420 million in 2011 (2010: £169 million) and in both years there was an additional charge arising in respect of tax losses where no deferred tax has been recognised (2011: £261 million; 2010: £487 million) but in 2011 this was more than offset by a credit of £332 million from the recognition of tax losses not previously recognised. The Group does not expect the tax rate, excluding the impact of policyholders tax and Open Ended Investment Companies, to vary significantly from the average UK corporation tax rate.

2010 COMPARED WITH 2009

In 2010, a tax credit of £325 million arose on a loss before tax of £2,919 million and in 2009 a tax credit of £1,911 million arose on a profit before tax of £1,042 million. The statutory corporation tax rate was 28 per cent in both years. The tax attributable to UK life insurance policyholder earnings and the Group s interest in Open Ended Investment Companies was a charge of £315 million for 2010 compared to a charge of £410 million in 2009. The tax position in 2009 was also particularly distorted by the gain on acquisition of £11,173 million, which did not attract a tax charge. In both 2010 and 2009, there was also an impact from tax losses, mostly in overseas jurisdictions, where deferred tax assets were not recognised, leading to an additional charge of £487 million in 2010 (2009: £332 million). The remainder of the variation in effective tax rates reflected normal fluctuations in disallowed and non-taxable items.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INTEGRATION COSTS AND BENEFITS

The Group successfully achieved the Integration programme target of delivering run-rate cost synergies and other operating efficiencies of £2 billion per annum from the programme by the end of 2011.

The sustainable run-rate synergies achieved as at 31 December 2011 totalled £2,054 million, excluding a number of one-off savings. The table below analyses the run-rate synergies as at 31 December 2011 by division.

	2011		
	Synergy run-rate as at 31 December 2011 £m	**Allocation of Group Operations run-rate to divisions £m**	**Run-rate by market facing division £m**
Retail	**346**	**454**	**800**
Wholesale and Commercial	**324**	**270**	**594**
Wealth and International	**273**	**31**	**304**
Insurance	**204**	**59**	**263**
Group Operations	**857**	**(857)**	
Central items	**50**	**43**	**93**
Total	**2,054**		**2,054**

Cost synergies have been delivered through the integration of HBOS operations, processes and IT systems. These synergies have arisen through procurement; property with 83 head office sites vacated; IT cost savings and job reductions.

Integration costs of £1,097 million were incurred in the year and have been excluded from the combined businesses results. This brings the total integration costs since the HBOS acquisition to £3,846 million.

Migrating the business systems to a single platform

2011 saw the single biggest event of the Integration programme with the successful migration of the core business systems to a single IT platform. The Group has moved 30 million customer accounts and transferred 35 billion pieces of data between systems successfully. This has been one of the largest ever financial services IT integrations and at its peak it involved many thousands of colleagues across the organisation.

There were three major components to the system migrations:

- The Lloyds TSB Branch Counter System (ICS) was introduced to all Halifax and Bank of Scotland branches and 3,800 HBOS Automated Teller Machines (ATMs) and 667 Intelligent Deposit Machines (IDMs) were moved across to the Lloyds Banking Group IT network.

- The market leading Mortgage Sales Platform, already in use in Halifax and Bank of Scotland branches, was successfully rolled out to 800 Lloyds TSB mortgage advisors in England and Wales.

- In September 2011 30 million HBOS current accounts and savings accounts and Commercial and UK Private Banking accounts, were migrated onto the Lloyds Banking Group IT system. This customer data migration was successfully achieved after five proving cycles, 11 dress rehearsals including two full trial account migrations, over 250,000 business tests and 27,000 colleagues trained totalling 1.5 million hours.

The vast majority of integration activity is now complete, with a handful of peripheral migrations to be completed in 2012.

SIMPLIFICATION COSTS AND BENEFITS

The successful delivery of the Integration programme has provided a platform and single set of processes that now enables the Group to commence its next transformational journey. A core element of this transformational agenda is the Simplification programme. The programme is structured around four key initiatives:

Operations & Processes getting processes right end-to-end, with the right IT in the right places.

Sourcing better understanding needs across the Group and getting the right deals from suppliers.

Organisation focusing on how the Group is structured and the way it works.

Channels and Products simplifying products whilst continuing to improve and innovate channels.

The programme is well underway having achieved £178 million of Simplification and other cost savings in 2011, equivalent to an annual run-rate saving of £242 million. The programme is now targeting £1.7 billion of savings by 2014, an increase of £0.2 billion over previous guidance.

Simplification costs of £185 million were incurred in the year and have been excluded from the combined businesses results.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 combined businesses basis as explained below (see also note 4 to the consolidated financial statements).

The Group Executive Committee (GEC) has been determined to be the chief operating decision maker for the Group. The Group s operating segments reflect its organisational and management structures. GEC reviews the Group s internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment s net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. 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.

The segmental results and comparatives are presented on the basis reviewed by the chief operating decision maker and as a consequence include the pre-acquisition results of HBOS for the period from 1 January 2009 to 16 January 2009; during 2011 the chief operating decision maker has commenced reviewing the results of the Group s Commercial business separately to the Wholesale segment. As a consequence, the Group s activities are now organised into five financial reporting segments: Retail, Wholesale, Commercial, Wealth and International and Insurance.

During the third quarter of 2011, the Group implemented a new approach to its allocation methodologies for funding costs and capital that ensures that the cost of funding is more fully reflected in each segment s results. The new methodology is designed to ensure that funding costs are allocated to the segments and that the allocation is more directly related to the size and behavioural duration of asset portfolios, with a similar approach applied to recognise the value to the business from the Group s growing deposit base. Comparative figures have been restated accordingly.

Comparisons of results on a historical consolidated statutory basis are dominated by the impact of the acquisition of HBOS as the 2009 statutory results include the results of HBOS from 16 January 2009, together with 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 a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described below.

In order to reflect the impact of the acquisition of HBOS, the following adjustments have been made:

the 2009 results assume HBOS had been owned throughout that year;

the gain on acquisition of HBOS (in 2009) and amortisation of purchased intangible assets have been excluded; and

the unwind of acquisition-related fair value adjustments is shown as one line in the combined businesses income statements.

In order to better present business performance the effects of liability management, volatile items and asset sales are shown on a separate line in the combined businesses income statement and the following items, not related to acquisition accounting, have also been excluded:

integration, simplification and EC mandated retail business disposal costs;

volatility arising in insurance businesses;

insurance gross-up;

goodwill impairment;

the provision in relation to German insurance business litigation;

the payment protection insurance provision;

the customer goodwill payments provision;

the curtailment gain in 2010 in respect of the Group s defined benefit pension schemes;

the loss on disposal of businesses in 2010; and

the Government Asset Protection Scheme (GAPS) fee paid in December 2009.

Readers should be aware that the combined businesses 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.

The results of the businesses are set out below:

	2011	2010[1]	2009[1]
	£m	£m	£m
Retail	**3,636**	3,986	955
Wholesale	**828**	2,514	(4,682)
Commercial	**499**	291	(200)
Wealth and International	**(3,936)**	(4,950)	(2,433)
Insurance	**1,422**	1,326	1,203
Group Operations and Central items:			
Group Operations	**(56)**	(52)	(143)
Central items	**292**	(903)	(1,000)
	236	(955)	(1,143)
Profit (loss) before tax combined businesses	**2,685**	2,212	(6,300)

1 As discussed above, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RECONCILIATION OF COMBINED BUSINESSES PROFIT (LOSS) BEFORE TAX TO STATUTORY PROFIT (LOSS) BEFORE TAX FOR THE YEAR

	Note	**2011 £m**	2010 £m	2009 £m
Profit (loss) before tax combined businesses		**2,685**	2,212	(6,300)
Integration, simplification and EC mandated retail business disposal costs	1	**(1,452)**	(1,653)	(1,096)
Volatility arising in insurance businesses	2	**(838)**	306	478
Amortisation of purchased intangibles and goodwill impairment	4	**(562)**	(629)	(993)
Provision in relation to German insurance business litigation	5	**(175)**		
Payment protection insurance provision	6		(3,200)	
Customer goodwill payments provision	7		(500)	
Curtailment gain in respect of defined benefit pension schemes	8		910	
Loss on disposal of businesses	9		(365)	
Pre-acquisition results of HBOS plc	11			280
Negative goodwill credit	12			11,173
Government Asset Protection Scheme fee	13			(2,500)
(Loss) profit before tax statutory		**(342)**	(2,919)	1,042

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

Integration and simplification costs of £1,097 million and £185 million respectively were incurred in 2011 compared with integration costs of £1,653 million in 2010 and £1,096 million in 2009; these relate primarily to migrating business systems to a single IT platform, including the single biggest event of the Integration programme. The major components were migrating 30 million HBOS accounts onto the Lloyds Banking Group IT system, introduction of the Lloyds TSB Branch counter system to Halifax and Bank of Scotland branches and roll out of the HBOS mortgage sales platform to Lloyds TSB mortgage advisors. The vast majority of the integration activity is now complete, with a handful of peripheral migrations to be completed in 2012.

As part of the European Commission s decision approving state aid to the Group, the Group is required to dispose of a retail banking business with at least 600 branches, a 4.6 per cent share of the personal current accounts market in the UK and up to 19.2 per cent of Lloyds Banking Group s mortgage assets. This business is to be disposed of before the end of November 2013 and consists of the TSB brand, the branches, savings accounts and branch-based mortgages of Cheltenham & Gloucester, the branches and branch-based customers of Lloyds TSB Scotland and a related banking licence, additional Lloyds TSB branches in England and Wales, with branch-based customers and Intelligent Finance. Costs incurred in relation to this disposal in the year ended 31 December 2011 totalled £170 million (2010: £nil; 2009: £nil).

2. 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, which primarily reflects the gross up of policyholder tax included in the Group tax charge.

In 2011, the Group s statutory result before tax included negative insurance and policyholder interests volatility totalling £838 million compared to positive volatility of £306 million in 2010 and £478 million in 2009.

Volatility comprises the following:

	2011 £m	2010 £m	2009 £m
Insurance volatility	**(557)**	100	237
Policyholder interests volatility	**(283)**	216	298
Insurance hedging arrangements	**2**	(10)	(57)
Total	**(838)**	306	478

Management believes that excluding volatility from profit before tax on a combined businesses basis 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 combined businesses 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 profit before tax on a combined businesses basis.

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance volatility

The Group s insurance businesses have liability products 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 sterling 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)	**2012**	**2011**	2010	2009
	%	**%**	%	%
Gilt yields (gross)	**2.48**	**3.99**	4.45	3.74
Equity returns (gross)	**5.48**	**6.99**	7.45	6.74
Dividend yield	**3.00**	**3.00**	3.00	3.00
Property return (gross)	**5.48**	**6.99**	7.45	6.74
Corporate bonds in unit-linked and with-profit funds (gross)	**3.08**	**4.59**	5.05	4.34
Fixed interest investments backing annuity liabilities (gross)	**3.89**	**4.78**	5.30	5.72

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) is included within insurance volatility. Changes in market variables also affect the realistic valuation of the guarantees and options embedded within the With Profits Funds, the value of the in-force business and the value of shareholders funds.

The liabilities in respect of the Group s UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds. In accordance with the approach adopted in previous years, the value of in-force business for the UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings. The illiquidity premium is estimated to be 119 basis points as at 31 December 2011 (31 December 2010: 75 basis points; 31 December 2009: 75 basis points). The insurance businesses experienced negative volatility of £557 million during 2011, compared to positive volatility of £100 million in 2010 and £237 million in 2009. The negative insurance volatility during the year ended 31 December 2011 primarily reflected the underperformance of equity markets in the second half of 2011 and lower cash returns compared to long-term expectations. The positive volatility of £100 million in 2010 was primarily driven by strong performance of equity and property investments relative to the expected return. During 2010, equity market values had increased by 9 per cent and property returns had reached 19 per cent. Partly offsetting this were lower than expected returns on cash and fixed interest assets. This benefit in 2010 was lower than the £237 million positive volatility reported in 2009, as 2009 included significant benefits from reductions in corporate bond spreads, which did not occur in 2010, and greater out-performance of equity markets (during 2009, equities recovered by 22 per cent); these increases in 2009 being only partly offset by a reduction in gilts, reflecting an increase in yields and a reduction in property values of 6.6 per cent.

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 the combined businesses results. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders over the long term.

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 impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Over the longer term the charges levied to policyholders to cover policyholder tax on investment returns and the related tax provisions are expected to offset. In practice 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. Other sources of volatility include the minorities share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

During the year ended 31 December 2011, the statutory profit before tax included a charge to other income of £283 million which related to the policyholder interests volatility (2010: credits of £216 million in other income; 2009: charge of £298 million in other income). The charge in 2011 included the impact of deferred tax asset impairments due to less optimistic economic forecasts and changes in expected policyholder tax provisions. Policyholder tax liabilities increased during 2011 and led to a tax charge during the period. Strong market conditions in the latter part of 2010 had resulted in increased policyholder tax liabilities and led to a policyholder tax charge of £315 million (2009: charge of £410 million) for the year in the Group s tax charge. The market recovery in 2009 had increased policyholder tax liabilities and led to a policyholder tax charge during that year in the Group s tax charge; although this was partly offset by a credit relating to differences in the expected levels of policyholder tax provisions and charges.

Group hedging arrangements

The statutory results for the year ended 31 December 2011 also include a credit in relation to the Group s insurance hedging arrangements of £2 million (2010: charge of £10 million; 2009: charge of £57 million). To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group has been purchasing put option contracts since 2009.

The contracts purchased in 2009 led to a charge of £57 million in the year ended 31 December 2009 and expired in January 2010, resulting in a charge of £7 million in the year ended 31 December 2010. New protection against significant market falls, using option contracts, was acquired by the Group in January 2010, financed by selling some upside potential from equity market movements. There was no initial cost associated with these hedging arrangements. On a mark-to-market basis a loss of £3 million was recognised on these contracts in the year ended 31 December 2010. These contracts expired in January 2011, at which point a further charge of £3 million was recognised in the year ended 31 December 2011; again these contracts were replaced and a mark-to-market gain of £5 million has been recognised for the remainder of 2011.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

3. 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.

4. Amortisation of purchased intangibles and goodwill impairment

A total of £4,650 million of customer-related intangibles, brands, core deposit intangibles and purchased credit card relationships were recognised on the acquisition of HBOS in 2009 and these are being amortised over their estimated useful lives, where this has been determined to be finite. This has resulted in a charge of £562 million in the year ended 31 December 2011 (2010: £629 million; 2009: £753 million).

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income. The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased and the core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates.

The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group s asset finance business was reviewed for impairment in 2009 due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit within Asset Finance was reassessed resulting in a goodwill impairment charge of £240 million in the year ended 31 December 2009.

5. Provision in relation to German insurance business litigation

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. CMIG has won the majority of decisions to date, although a small number of regional district and appeal courts have found against CMIG on specific grounds. CMIG s strategy includes defending claims robustly and appealing against adverse judgments. The ultimate financial effect, which could be significant, will only be known once all relevant claims have been resolved. However, consistent with this strategy, and having regard to the costs involved in managing these claims, and the inherent risks of litigation, the Group has recognised a provision of £175 million. Management believes this represents the most appropriate estimate of the financial impact, based upon a series of assumptions, including the number of claims received, the proportion upheld, and resulting legal and administration costs.

6. Payment protection insurance provision

There has been intensive scrutiny of the payment protection insurance (PPI) market in recent years. On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA sought an order quashing the FSA Policy Statement and an order quashing the decision of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial Review hearing was held in January 2011 and on 20 April 2011 judgment was handed down by the High Court dismissing the BBA s application. After publication of the judgment, the Group entered into discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result, and given the initial analysis that the Group conducted of compliance with applicable sales standards, which is continuing, the Group concluded that there are certain circumstances where customer contact and/or redress will be appropriate. Accordingly the Group made a provision in its financial statements for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such contact and/or redress, including administration expenses.

7. Customer goodwill payments provision

Following discussions with the FSA regarding the application of an interest rate variation clause in certain Bank of Scotland plc variable rate mortgage contracts, Bank of Scotland plc applied for a Voluntary Variation of Permission (VVOP) in February 2011 and agreed to initiate a customer review and contact programme and to make goodwill payments to affected customers. The Group made a provision of £500 million in respect of this matter during the year ended 31 December 2010. Since that time further information has become available which has resulted in Bank of Scotland plc applying for, and being granted, an amended VVOP by the FSA in November 2011. No additional provision was required during the year ended 31 December 2011.

8. Curtailment gain in respect of defined benefit pension schemes

Following changes by the Group to the terms of its UK defined benefit pension schemes, all future increases to pensionable salary will be capped each year at the lower of: Retail Prices Index inflation; each employee s actual percentage increase in pay; and 2 per cent of pensionable pay. In addition to this, during the second half of 2010 there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes was a reduction in the Group s defined benefit obligation of £1,081 million and a reduction in the Group s unrecognised actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement in the year ended 31 December 2010 and an equivalent reduction in the balance sheet liability.

9. Loss on disposal of businesses

During 2009, the Group acquired an oil drilling rig construction business through a previous lending relationship and consolidated the results and net assets of the business from the date it exercised control. In the first half of 2010, as a result of a deteriorating market, the Group impaired the oil drilling rigs under construction held by the business by £150 million to reflect their reduced value in use. This impairment was recognised in the Wholesale segment. In the second half of 2010, the Group reached agreement to dispose of its interests in the two wholly-owned subsidiary companies through which this business operates; the sale was completed in January 2011. The Group extended vendor financing, on normal commercial terms and negotiated on an arms length basis, to facilitate the acquisition of the rig holding companies. The loan is not contingent on the performance of the oil rigs under construction. Accordingly, as at 31 December 2010, the subsidiaries were derecognised.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

10. Unwind of acquisition-related fair value adjustments

The statutory (IFRS) and the combined businesses income statements include the impact of the acquisition-related adjustments arising from the acquisition of HBOS in 2009. On a statutory (IFRS) basis the acquisition-related adjustments affect a number of line items whereas the Group s combined businesses 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, are disposed of or become impaired. Generally, this leads to: higher interest expense as the value of HBOS s own debt accretes to par; higher other income arising on sale of debt securities from the pre-acquisition HBOS available-for-sale portfolio, as the gain or loss on sale is not reduced by re-cycling the pre-acquisition negative fair value movements reflected in reserves; and a lower impairment charge reflecting the impact of acquisition balance sheet valuation adjustments.

Further information on the drivers of the fair value unwind is included in the commentary on the segment performance in the Operating and Financial Review.

11. Pre-acquisition results of HBOS plc

The acquisition of HBOS plc on 16 January 2009 had a significant effect on the comparability of the Group s financial position and results, as a consequence, the combined businesses basis results are prepared as if HBOS had been owned by the Group for the full year 2009.

12. Negative goodwill credit

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc. The consideration for the acquisition of HBOS comprised the issue of 7,776 million ordinary shares in Lloyds Banking Group plc together with the costs of acquisition. In determining the fair value of the consideration, the Company used the share price of its equity securities quoted on the London Stock Exchange, as at the date of completion.

As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill was recognised as a Gain on acquisition in the income statement for the year ended 31 December 2009.

The exercise to fair value the assets and liabilities of HBOS took into account prevailing market conditions at the time of completion and, where appropriate, the Group engaged independent external advisers. As the consideration paid was significantly less than the provisional fair value of the net assets acquired, the results of the fair value calculations were subject to additional challenge in accordance with the requirements of IFRS 3.

On the date that the acquisition was announced (18 September 2008) the implied goodwill was a small positive amount based on the share price of the Company and the originally announced conversion factor of 0.833 Lloyds Banking Group plc shares for each HBOS share. However, a number of factors led to negative goodwill being recognised on completion of the transaction.

By the time of the recommended offer, it had become increasingly difficult for HBOS to raise funds in wholesale markets and HBOS faced an outflow of customer deposits, reflecting reduced investor and depositor confidence. Subsequent to the announcement of the offer, turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. For HBOS, confidence continued to deteriorate amid ongoing funding difficulties and concerns over the extent of future credit losses. Measures by national authorities and central banks failed to stem this turbulence and the UK Government decided in October 2008 that it would be appropriate for the UK banking sector to increase its level of capitalisation. The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by the Company completed. As a consequence of the capital that HBOS was required to issue and the impact of market conditions on the future prospects of the new group, the terms of the final agreed offer were revised down to a ratio of 0.605. Additionally, the share price of the Company fell from 280p at the date of the announcement to 98.4p on 15 January 2009 reflecting both the dilutive impact of the capital that the Company raised and the turmoil in the banking sector and equity markets in general. These factors combined to reduce the value of the consideration for HBOS.

13. Government Asset Protection Scheme fee

The Group entered into an agreement in March 2009 relating to its proposed participation in the Government Asset Protection Scheme (GAPS). However, following its rights issue in November 2009, the Group withdrew from its proposed participation and agreed to pay HM Treasury £2,500 million in recognition of the benefits to the Group s trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group; this fee was paid in December 2009 (see *Major Shareholders and Related Party Transactions Information about the Lloyds Banking Group s relationship with the UK Government Other related party transactions with the UK Government GAPS withdrawal deed*).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RETAIL

Retail operates the largest retail bank in the UK and is a leading provider of current accounts, savings, personal loans, credit cards and mortgages. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland and Cheltenham & Gloucester, it serves over 30 million customers through one of the largest branch and fee free ATM networks in the UK.

Retail is focused on effectively meeting the needs of its customers. The division provides current accounts including packaged accounts and basic and social banking accounts. It is also the largest provider of personal loans in the UK, as well as being the UK s leading credit card issuer. Retail provides one in five new residential mortgages making it one of the leading UK mortgage lenders and provided over 52,000 mortgages to help first time buyers in 2011. Retail is the largest private sector savings provider in the UK. It is also a major general insurance and Bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest income	**7,497**	8,648	7,543
Other income	**1,649**	1,607	1,804
Effects of liability management, volatile items and asset sales	**48**		
Total income	**9,194**	10,255	9,347
Operating expenses	**(4,438)**	(4,644)	(4,566)
Trading surplus	**4,756**	5,611	4,781
Impairment	**(1,970)**	(2,747)	(4,227)
Share of results of joint ventures and associates	**11**	17	(6)
Profit before tax and fair value unwind	**2,797**	2,881	548
Fair value unwind	**839**	1,105	407
Profit before tax	**3,636**	3,986	955

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2011 COMPARED WITH 2010

Profit before tax for Retail in 2011 of £3,636 million was £350 million, or 9 per cent, lower than 2010.

Profit before tax and fair value unwind decreased to £2,797 million, a reduction of 3 per cent compared to 2010, driven by higher funding costs and the muted demand for credit.

Total income decreased by £1,061 million, or 10 per cent, to £9,194 million. This was driven by a reduction in net interest income of £1,151 million, while other income increased by £42 million.

Net interest income reduced by 13 per cent compared to 2010. One of the main drivers was the increase in wholesale funding costs which were not matched by average customer rates. Net interest margin in 2011 decreased by 22 basis points to 2.09 per cent. Income growth was also constrained by muted demand for credit. Previous de-risking of the lending portfolio, with a resulting reduction in unsecured balances, also contributed to the reduction in income albeit with a proportionately greater reduction in impairment. Net interest margin, minus impairment rate, remained stable reflecting progress in de-risking the balance sheet. Finally, increased competition for deposits and strong balance growth resulted in an increase in the average rate paid on customer deposits.

Other income increased by 3 per cent in 2011 to £1,649 million from £1,607 million largely as a result of higher bancassurance income, driven by an increase in the value of protection products sold through the branch network. Total income also includes the gain on the disposal of VISA Inc shares.

Operating expenses and other costs fell by 4 per cent compared to 2010 and the cost:income ratio was 48.3 per cent (2010: 45.3 per cent). Operating expenses benefited from integration activities, the start of the simplification programme, and other day-to-day cost management activities to offset inflation. The Group continues to invest in the Retail business to improve products and services for its customers including digital platforms and branches. During 2011 Retail completed a major milestone in the

Integration programme, the consolidation of its main Retail product systems. This now creates a solid platform to deliver the simplification programme.

Credit performance across the business continued to be supported by a conservative approach to risk, a continued focus on existing customers and low interest rates. The impairment charge on loans and advances decreased by £777 million, or 28 per cent, to £1,970 million driven by reductions in the unsecured charge. The unsecured impairment charge reduced to £1,507 million from £2,455 million in 2010, reflecting the impact of the continued conservative approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge increased to £463 million from £292 million in 2010 largely reflecting a less certain outlook on house prices and appropriate provisioning against existing credit risks which have longer emergence periods due to current low interest rates. These factors were partially offset by underlying improvement in the quality of the secured portfolio.

The fair value unwind net credit was £839 million compared with £1,105 million in 2010. This reduction was driven largely by the maturing balances of the pre-acquisition portfolio.

Total customer balances remained stable at £599,900 million as Retail continued to maintain its relationships with customers. The mix of these balances continued to move towards customer deposits as customers continued to reduce their personal indebtedness and Retail continued to make strong progress in attracting savings balances. This change in customer balance composition has additionally supported the Group s funding although it has also contributed to a reduction in income and profit.

Loans and advances to customers decreased by £10,919 million, or 3 per cent, to £352,812 million, compared to 31 December 2010. This was driven by reduced customer demand for new credit, existing customers continuing to reduce their personal indebtedness, run off of lending outside of the Group s risk appetite and Retail maintaining a conservative approach to risk. The reduction in lending to customers was in part due to the repayment of unsecured debt where balances reduced by £2,719 million, or 10 per cent. Secured balances reduced by £8,200 million, or 2 per cent. The proportion of mortgages on standard variable rate, or equivalent products, now stands at 56 per cent and is expected to remain broadly stable in 2012.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Retail s gross mortgage lending was £27,977 million in 2011 which was equivalent to a market share of 20 per cent. Retail s new mortgage lending continued to be focused on home purchase with 70 per cent of lending being for house purchase rather than re-mortgaging.

Total customer deposits increased by £11,497 million, or 5 per cent, to £247,088 million in 2011. This increase was largely driven by strong growth in tax free cash ISA balances. Retail continues to perform well in the savings market despite the high levels of competition, with a strong stable of savings brands providing customers with an award winning range of products to meet their savings needs.

2010 COMPARED WITH 2009

Profit before tax from Retail was £3,031 million higher at £3,986 million compared to £955 million in 2009; profit in 2010 included £1,105 million in respect of the unwinding of the fair value adjustments arising on the acquisition of HBOS plc by the Group compared with £407 million in 2009.

Profit before tax and fair value unwind increased by £2,333 million to £2,881 million in 2010 compared to £548 million in 2009. This increase in profit was driven by higher income and a significant reduction in impairment losses, in the context of a stabilising economy, partly offset by an increase in operating expenses.

Total income increased by £908 million, or 10 per cent, to £10,255 million compared with £9,347 million in 2009 reflecting an increase in net interest income of £1,105 million, partially offset by a reduction in other income of £197 million.

Net interest income increased by 15 per cent. The net interest margin was 2.31 per cent compared with 1.95 per cent in 2009. Asset margins expanded in 2010 as a result of decreases in the LIBOR to base rate spread and stable customer interest rates. The asset margin also widened partly as a result of mortgage customers continuing to move onto, and staying on, standard variable rates and assets being priced to more appropriately reflect risk, offset by rising funding costs. The liability margin, on the other hand, has reduced as the effect of lower LIBOR to base rate spreads was partially offset by the reduction of expensive deposit balances.

Lending to customers in Retail, net of impairment provisions and fair value adjustments, was £7,327 million, or 2 per cent, lower at £363,731 million at the end of 2010 compared with £371,058 million at 31 December 2009. This reflected reduced customer demand for credit and customers continuing to reduce their personal indebtedness.

Retail s gross new mortgage lending was £30,113 million in 2010 representing a market share of 22.1 per cent. New mortgage lending continued to be focused on supporting the housing market, with 70 per cent of the lending being for house purchase rather than re-mortgaging. Retail remained the largest lender to first time buyers in the market helping over 50,000 customers to buy their first home. It also continued to be an industry leader in its support for shared equity and shared ownership schemes. Average loan-to-value on new mortgage lending in 2010 was 60.9 per cent compared with 59.3 per cent in 2009, whilst average indexed loan-to-value on the mortgage portfolio was 55.6 per cent at 31 December 2010 compared with 54.8 per cent at 31 December 2009 and reflected the net fall in house prices in 2010.

Total customer deposits were £11,442 million, or 5 per cent, higher at £235,591 million at 31 December 2010 compared with £224,149 million at the end of 2009. The growth was predominantly from instant access and tax free cash ISA accounts, rather than more expensive term deposits. Retail continued to perform well in the savings market, with a strong stable of savings brands which can be tailored to customer demands.

Other income decreased by 11 per cent in 2010 to £1,607 million from £1,804 million in 2009 largely as a result of changes to current account overdraft charges. Retail continued to focus on having fees and rates that customers understand. It was believed that this will result in stronger customer relationships as well as supporting the deepening of those relationships. An example of this focus is the changes to the overdraft charging structure for Halifax and Bank of Scotland personal current accounts at the end of 2009, which delivered a more suitable product proposition and an improved customer experience and resulted in a reduction in other income of approximately £90 million. Similarly, the changes to the Lloyds TSB current account pricing model, which became effective at the end of 2010, provided a simpler, more sustainable proposition for customers, resulting in an overall reduction in the cost of overdraft usage.

Operating expenses increased by £78 million, or 2 per cent, to £4,644 million compared with £4,566 million in 2009. This was against a background of an increase in total income of 10 per cent and reflected ongoing cost control and synergies from the integration. The cost:income ratio for the year ended 31 December 2010 was 45.3 per cent compared to 48.8 per cent in 2009.

Impairment losses decreased by £1,480 million, or 35 per cent, to £2,747 million in 2010 compared with £4,227 million in 2009. Impairment losses as a percentage of average loans and advances to customers were 0.74 per cent in 2010 compared with 1.11 per cent in 2009. This reduction was driven primarily by the improved quality of new business and effective portfolio management, combined with the continued slow recovery of the economy. Across Retail in 2010, there were fewer cases going into arrears.

Unsecured impairment losses reduced by £983 million to £2,455 million compared with £3,438 million in 2009. This reflected a continuation of the improving portfolio trends resulting from the Group s prudent risk appetite, with a focus on lending towards existing customers, combined with stable unemployment. Secured impairment losses of £292 million, compared with £789 million in 2009, reflected a reduction in impaired loans and improved arrears in 2010, together with the stabilising economy, more stable house prices, low interest rates and prudent lending criteria.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impaired loans in the unsecured portfolio decreased by £838 million to £2,981 million which represented 10.7 per cent of closing loans and advances to customers at 31 December 2010, compared with 11.9 per cent at 31 December 2009. The movement in impaired loans is consistent with the trends seen in both the flow of accounts to arrears and arrears balances, both of which have fallen across all unsecured products during 2010. This is a result of tightening credit policy across the credit lifecycle, including stronger controls on customer affordability, set against a stable economic environment. Retail s exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers changing financial circumstances. The portfolios results are supported by pre-recessionary levels of early arrears for accounts acquired in the last two years, highlighting an underlying improvement in the risk profile of the business. Impairment provisions decreased by £606 million, compared with 31 December 2009, to £1,507 million. Impairment provisions, as a percentage of impaired loans, decreased to 50.6 per cent at 31 December 2010 from 55.3 per cent at 31 December 2009, largely driven by more stringent criteria for new and existing unsecured collections repayment plans resulting in highly provided assets being written off.

Impaired loans in the secured portfolio decreased by £427 million to £6,769 million at 31 December 2010 and, as a percentage of closing loans and advances to customers, reduced to 2.0 per cent from 2.1 per cent at 31 December 2009. The reduction in impaired loans reflects the continued ability of customers to afford their mortgage payments in a low interest rate environment. The number of customers going into arrears remained stable throughout 2010. In the second half of 2010 fewer accounts in arrears returned to order, resulting in higher early arrears balances for 31 December 2010 compared to 30 June 2010. As reported at the 2009 year end, Specialist lending remained closed to new business and this book is in run-off.

The fair value unwind was a net credit of £1,105 million compared with a net credit of £407 million in 2009. The net fair value unwind was larger in 2010 than in 2009 and reflected a smaller charge related to the fixed rate mortgage portfolios as mortgages reached the end of their fixed term and borrowers moved to standard variable products. This was partially offset by a reduction in the credit attributed to the fixed rate savings portfolio as fixed rate term deposits, existing prior to acquisition, matured.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WHOLESALE

The division comprises Wholesale Banking and Markets (WBM), Wholesale Business Support Unit and the Group s Asset Finance business. The Wholesale Banking and Markets business serves corporates with turnover above £15 million, and financial institutions with a range of relationship focused propositions, segmented according to customer need.

Wholesale Banking and Markets businesses are grouped into three areas, coverage and product, with a support function providing centralised coordination of critical business processes and activities.

Coverage comprises of Corporate Banking, Mid Markets and Sales. Corporate Banking is responsible for the overall management of relationships with major corporate and institutional customers principally in the UK. Similarly Mid Markets manages the relationships with mid market corporates, which operate on a pan-UK basis. Sales provides customers with tailor-made risk management solutions through liability, foreign exchange, commodity and interest rate management products.

Product comprises of Capital Markets, Portfolio Management, Trading, Structured Corporate Finance, Transaction Banking, Structured Transactions Group and Lloyds Development Capital. These product units work alongside the coverage teams to provide specialised lending, access to capital markets and multi product financing solutions to WBM s customers. In addition, these product units provide access to financial markets in order to meet the Group s balance sheet management requirements, and provide trading infrastructure to support execution of customer driven risk management transactions.

Wholesale Business Support Unit supports corporate customers that encounter difficulties during economic downturns. Wholesale operates three teams to support customers in such difficulties Corporate, Specialist Finance and Corporate Real Estate.

Asset Finance consists of a number of leasing and speciality lending businesses including Contract Hire (Lex Autolease) and Consumer Finance (Black Horse Motor and Personal Finance).

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest income	**2,139**	2,847	3,447
Other income	**3,335**	3,974	3,787
Effects of liability management, volatile items and asset sales	**(1,415)**	(295)	(77)
Total income	**4,059**	6,526	7,157
Costs:			
Operating expenses	**(2,518)**	(2,752)	(3,018)
Impairment of tangible fixed assets		(150)	
	(2,518)	(2,902)	(3,018)
Trading surplus	**1,541**	3,624	4,139
Impairment	**(2,901)**	(4,064)	(14,861)
Share of results of joint ventures and associates	**14**	(95)	(720)
Loss before tax and fair value unwind	**(1,346)**	(535)	(11,442)
Fair value unwind	**2,174**	3,049	6,760
Profit (loss) before tax	**828**	2,514	(4,682)

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2011 COMPARED WITH 2010

Wholesale s profit before tax decreased by £1,686 million, or 67 per cent, to £828 million in 2011, compared to £2,514 million in 2010. The decrease comprised of £2,467 million lower income, an £875 million fall in fair value unwind, partially offset by £384 million lower costs, a £1,163 million decrease in the impairment charge, and the elimination of losses in joint venture businesses. The profit performance was impacted by the effects of net derivative valuation adjustments and asset disposals net of associated fair value unwind.

Wholesale s income performance was impacted by lower asset balances, losses on asset disposals in the year to strengthen the balance sheet and net derivative valuation adjustments. Net derivative valuation adjustments of £718 million were driven primarily by a fall in long-term sterling interest rates and higher market credit spreads. Losses on disposal of £697 million were realised from the disposal of assets and were offset by a related fair value unwind. Excluding these items, income reduced by £1,347 million or 20 per cent, primarily as a consequence of economic and market conditions, which resulted in customer deleveraging, higher funding costs, and lower trading revenues.

	2011	2010	Change
	£m	£m	%
Total income	**4,059**	6,526	(38)
Adjustments to exclude:			
Net derivative valuation adjustments	**718**	42	
Gains and losses on asset sales	**697**	253	
Total income excluding net derivative valuation adjustments and gains and losses on asset sales	**5,474**	6,821	(20)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Net interest income decreased by £708 million, or 25 per cent, to £2,139 million in 2011 compared to £2,847 million in 2010. The decrease reflects a continued decrease of interest-earning asset balances in line with the Group s targeted balance sheet reduction of loans and advances to customers and banks, debt securities and available-for-sale positions. Net interest income was also adversely affected by higher funding costs. This was partially offset by an increase in the liability margin resulting from the increased market value of deposits.

The net banking margin, which excludes trading activity, decreased by three basis points to 1.56 per cent in 2011 compared to 1.59 per cent in 2010. This principally reflects increased wholesale funding costs, partly offset by customer re-pricing and increased deposit margins and volumes. Asset margins decreased as the benefit of higher customer rates was more than offset by funding costs, whilst liability margins improved.

Other income decreased by £639 million, or 16 per cent, to £3,335 million in 2011 compared to £3,974 million in 2010, mainly reflecting lower income in Asset Finance and reduced trading revenues. The effect of losses on asset disposals from the continued focus on balance sheet reductions and net derivative valuations adjustments due to the increased market implied credit risk associated with customer derivative balances resulted in losses of £1,415 million in 2011 compared to £295 million in 2010.

Operating expenses decreased by £234 million, or 9 per cent, to £2,518 million in 2011 compared to £2,752 million in 2010. The decrease reflected further savings from the Integration programme, lower operating lease depreciation, lower bonus accruals and other ongoing cost management actions to mitigate the impact of inflationary increases. This was partially offset by continued investment in customer facing resources and systems.

The impairment charge decreased by £1,163 million, or 29 per cent, to £2,901 million compared to £4,064 million in 2010, reflecting a sustained decrease since the peak in 2009. As a percentage of average loans and advances to customers, the impairment charge improved to 1.95 per cent in 2011 compared to 2.23 per cent in 2010. This reflected risk management initiatives and lower defaults from continued low interest rates despite a subdued economic environment.

The share of results from joint ventures and associates comprised a profit of £14 million, an improvement of £109 million compared to 2010, due to the non-recurrence of losses and impairments taken in 2010.

Fair value unwind decreased £875 million to £2,174 million in 2011 compared to £3,049 million in 2010 due to lower impairments in the loan book, reduced release on the treasury asset book and a risk based approach to release on certain treasury assets given market conditions, partially offset by favourable exchange rate movements.

2010 COMPARED WITH 2009

Profit before tax from Wholesale improved by £7,196 million to a profit of £2,514 million compared to a loss of £4,682 million in 2009. The improvement of £7,196 million includes a credit of £3,049 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc, which was reduced by £3,711 million compared to £6,760 million in 2009.

Loss before tax and fair value unwind of £535 million improved by £10,907 million from a loss of £11,442 million in 2009. The improvement was driven by a decrease in the impairment charge, a decrease in the negative share of results of joint ventures and associates and a decrease in costs, only partially offset by lower income.

Total income decreased by £631 million, or 9 per cent, to £6,526 million in 2010 due to lower net interest income and the effects of asset sales and net derivative valuation adjustments.

Net interest income was £600 million, or 17 per cent, lower at £2,847 million in 2010 compared to £3,447 million in 2009. The decline in net interest income primarily reflects lower interest-earning asset balances in line with the Group s targeted balance sheet reduction, mainly in loans and advances to customers, debt securities and available-for-sale positions. Net interest income was affected by higher funding costs and lower lending volumes, partly offset by higher customer margins on new business and from re-pricing on renewals.

Banking net interest income, which excludes trading activity, increased by £155 million, to £2,469 million in 2010 compared to £2,314 million in 2009, with the banking net interest margin increasing by 26 basis points to 1.59 per cent in 2010 compared to 1.33 per cent in 2009.

Other income was £187 million, or 5 per cent, higher at £3,974 million in 2010 compared to £3,787 million in 2009. Other income in 2010 benefited from investment gains in Wholesale Equity as a result of stabilisation in market conditions and improved fund investment performance, strong fee income across structuring and capital markets and more favourable performance in Treasury and Trading; although these benefits were partially offset by a decrease in mark-to-market gains in Wholesale Markets, due to lower levels of market movement compared to 2009, and lower operating lease income. The effects of liability management, volatile items and asset sales was a deficit of £295 million in 2010 compared to a deficit of £77 million in 2009. This deterioration primarily reflected the fact that 2010 experienced losses on sale of assets in targeted balance sheet reductions and adverse derivative valuation adjustments.

Operating expenses decreased by £266 million, or 9 per cent, to £2,752 million in 2010 compared to £3,018 million in 2009. The decrease reflected reduced levels of operating lease depreciation and cost savings attributable to the Integration programme. This was partially offset by additional costs in the Business Support Unit and continued investment in customer facing resources and systems.

The impairment charge decreased by £10,797 million to £4,064 million in 2010 compared to £14,861 million in 2009. The impairment charge on loans and advances as a percentage of average loans and advances to customers improved to 2.23 per cent in 2010 compared to 6.38 per cent in 2009. The decrease reflected reductions, notably in the heritage HBOS corporate real estate and real estate-related portfolios and heritage HBOS Corporate (UK and US) portfolios, and write backs from asset disposals, due to the stabilising economic environment, low interest rates which helped to maintain defaults at reduced levels, the stabilisation of UK real estate prices and provisioning against base case assumptions undertaken on the acquired heritage HBOS portfolios in the first half of 2009.

The share of losses from joint ventures and associates comprised a small loss for the year ended 31 December 2010 of £95 million, a decrease of £625 million. This represented a net reduction in both the value and size of the portfolio compared to the prior year. The majority of the portfolio was valued at nil with a remaining portfolio carrying value of approximately £128 million at 31 December 2010.

Wholesale s fair value unwind credit of £3,049 million decreased by £3,711 million in 2010 from £6,760 million in 2009 due to lower impairments in 2010 relating to the HBOS assets that were fair valued on acquisition, partially offset by charges relating to the expected losses on acquired debt securities and by fair value releases on sales.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL

The Commercial business serves in excess of a million small and medium sized enterprises (SMEs) and community organisations with turnover up to £15 million. Customers range from start-up enterprises to established corporations, with a range of propositions aligned to customer needs. The business comprises Commercial Banking and Commercial Finance, the invoice discounting and factoring business which also offers hire purchase, leasing and supplier finance products.

Commercial supports the trading, investment and protection needs of business customers, principally in the UK. Its vision is to be the relationship bank of choice across the UK for SME customers; committed to supporting the economy and communities through encouraging enterprise, providing access to finance and fair and transparent pricing. As part of this the business is working to meet Lending Commitments, agreed with the UK Government, with a focus on a through the cycle credit policy and a proactive programme of support. Lloyds Banking Group is investing both in Commercial and in other parts of the Group to enhance products and services to SMEs and support the lives and prospects of customers through their business life cycle.

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest	**1,251**	1,127	1,084
Other income	**446**	457	489
Total income	**1,697**	1,584	1,573
Operating expenses	**(948)**	(992)	(1,088)
Trading surplus	**749**	592	485
Impairment	**(303)**	(382)	(822)
Profit (loss) before tax and fair value unwind	**446**	210	(337)
Fair value unwind	**53**	81	137
Profit (loss) before tax	**499**	291	(200)

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2011 COMPARED WITH 2010

Profit before tax increased by £208 million, or 71 per cent, to £499 million in 2011 compared to £291 million in 2010; this was due to higher income, combined with a reduction in impairments and costs.

Total income increased by £113 million, or 7 per cent, to £1,697 milion in 2011 compared to £1,584 million in 2010. Net interest income grew by £124 million, or 11 per cent, to £1,251 million in 2011 compared to £1,127 million in 2010 due largely to the increase in deposit balances, and a higher net interest margin. This deposit balance growth, the beneficial effect of the consequently larger funding surplus, and a more favourable deposit mix were the key drivers behind the 47 basis point increase in banking net interest margin. Other operating income decreased by 2 per cent, reflecting subdued levels of business activity in the early part of the year and reduced levels of money transmission income reflecting the greater use of electronic banking facilities by customers.

Operating expenses reduced by £44 million, or 4 per cent, to £948 million in 2011 compared to £992 million in 2010, primarily as a result of integration cost savings including lower back office staffing requirements.

The impairment charge reduced by £79 million, or 21 per cent, to £303 million in 2011 compared to £382 million in 2010 due to an overall improvement in the credit quality of the portfolio reflected in a reduction in observed default and delinquency rates. This is supported by the success of the specialist relationship support, which helps customers facing difficult business conditions.

Lending to customers in Commercial, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £196 million higher at £28,750 million at 31 December 2011 compared to £28,554 million at the end of 2010. This reflects the continuing support given to small and medium sized businesses, fully offsetting the reduction in assets outside the Group s risk appetite.

Customer deposits have risen by £796 million, or 3 per cent, from £31,311 million at 31 December 2010 to £32,107 million at 31 December 2011. This increase reflects ongoing success in SME recruitment, combined with targeted support in key customer segments such as the education and legal sectors.

Risk-weighted assets decreased by £1,118 million, or 4 per cent, from £26,552 million at 31 December 2010 to £25,434 million at 31 December 2011, reflecting the improved mix and risk profile of the portfolio.

2010 COMPARED WITH 2009

Profit before tax from Commercial increased by £491 million to a profit of £291 million in 2010 compared to a loss of £200 million in 2009. Profit before tax and fair value unwind increased by £547 million to a profit of £210 million in 2010 compared to a loss of £337 million in 2009, largely as a result of lower impairment charges.

Total income increased by £11 million, or 1 per cent, to £1,584 million in 2010 compared to £1,573 million in 2009.

Lending to customers in Commercial, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £73 million lower at £28,554 million at 31 December 2010 compared to £28,627 million at the end of 2009. Customer deposits were £881 million, or 3 per cent, higher at £31,311 million at 31 December 2010 compared to £30,430 million at the end of 2009.

Net interest income was £43 million, or 4 per cent, higher at £1,127 million in 2010 compared to £1,084 million in 2009. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, improved by 29 basis points to 3.74 per cent in 2010 compared to 3.45 per cent in 2009.

Other income was £32 million lower at £457 million in 2010 compared to £489 million in 2009, mainly due to a decline in money transmission fees and commission income.

Operating expenses decreased by £96 million, or 9 per cent, to £992 million in 2010 compared to £1,088 million in 2009 as a result of embedded cost savings programmes across Commercial delivering positive results, leading to an improvement in the cost: income ratio to 62.6 per cent in 2010 from 69.2 per cent in 2009.

Impairment losses decreased by £440 million to £382 million in 2010 compared to £822 million in 2009. Impairment losses on loans and advances as a percentage of average loans and advances to customers were 1.24 per cent in 2010 compared to 2.72 per cent in 2009. There was an overall improvement in the credit quality of the portfolio and a reduction in observed default rates.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WEALTH AND INTERNATIONAL

The Wealth business comprises private banking, wealth management and asset management. Wealth s global private banking and wealth management operations cater to the full range of wealth clients from affluent to Ultra High Net Worth within the UK, UK expatriates and others with UK connections. The private banking and wealth management business operates under the Lloyds TSB and Bank of Scotland brands. The asset management business, Scottish Widows Investment Partnership, has a broad client base, managing assets for Lloyds Banking Group customers as well as a wide range of clients including pension funds, charities, local authorities, Discretionary Managers and Financial Advisers. In addition, the Group holds a 60 per cent stake in St James s Place, the UK s largest independent listed wealth manager.

The International business comprises the Group s other international banking businesses outside the UK, with the exception of corporate business in North America which is managed through the Group s Wholesale division. These largely comprise corporate, commercial and asset finance business in Australia and Continental Europe and retail businesses in Germany and the Netherlands.

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest income	**828**	1,050	1,140
Other income	**1,197**	1,123	1,128
Effects of liability management, volatile items and asset sales		37	
Total income	**2,025**	2,210	2,268
Operating expenses	**(1,548)**	(1,536)	(1,544)
Trading surplus	**477**	674	724
Impairment	**(4,610)**	(5,988)	(4,078)
Share of results of joint ventures and associates	**3**	(8)	(21)
Loss before tax and fair value unwind	**(4,130)**	(5,322)	(3,375)
Fair value unwind	**194**	372	942
Loss before tax	**(3,936)**	(4,950)	(2,433)
Wealth	**189**	220	198
International	**(4,319)**	(5,542)	(3,573)
Loss before tax and fair value unwind	**(4,130)**	(5,322)	(3,375)

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2011 COMPARED WITH 2010

Loss before tax and fair value unwind reduced by £1,192 million, or 22 per cent, to £4,130 million in 2011 compared to £5,322 million in 2010 as a lower impairment charge, predominantly in Ireland, more than offset lower income and higher costs.

Total income decreased by £185 million, or 8 per cent, to £2,025 million in 2011 compared to £2,210 in 2010.

Net interest income decreased by £222 million, or 21 per cent, to £828 million in 2011 compared to £1,050 million in 2010. There was a reduction of 25 per cent in constant currency terms. Higher funding costs and the increased strain of impaired assets, reflected in a reduction in net lending margins together with lower lending volumes impacting net interest income were partially offset by the impact of the stronger Australian dollar in International. Deposit margins increased, reflecting changing product mix predominantly as a result of continued deposit inflows in the on-line deposit business at higher margins together with improving margins across the Wealth businesses.

Other income increased by £74 million, or 7 per cent, to £1,197 million in 2011 compared to £1,123 million in 2010 mainly due to foreign exchange benefits in International. Excluding the impact of foreign exchange, other income decreased by 1 per cent.

Operating expenses and other costs increased by £12 million, or 1 per cent to £1,548 million in 2011 compared to £1,536 million in 2010, due to increased investment in the International deposit business, the impact of the stronger Australian dollar and Swiss franc and additional regulatory costs in Wealth. On a constant currency basis, operating expenses reduced by 1 per cent, reflecting cost saving initiatives.

The impairment charge reduced by £1,378 million or 23 per cent, to £4,610 million in 2011 compared to £5,988 million in 2010. Following increased charges in the last quarter of 2010, driven by the significant deterioration in the economic environment in Ireland, the rate of impaired loan migration has slowed in 2011.

The impairment charge within Wealth increased by £54 million to £100 million in 2011 compared to £46 million in 2010 primarily due to increased charges in the Group s Spanish mortgage book reflecting deterioration in the local property markets and economic outlook in Spain.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The impairment charge in International decreased by £1,432 million, or 24 per cent, to £4,510 million in 2011 compared to £5,942 million in 2010.

This impairment charge is analysed by key geography in the following table.

	Impairment charges	
	2011	2010
	£m	£m
Ireland	**3,187**	4,264
Australia	**1,034**	1,362
Wholesale Europe	**204**	210
Latin America/Middle East	**64**	97
Netherlands	**21**	9
	4,510	5,942

The impairment charge reduced by £1,432 million, or 24 per cent, to £4,510 million due to reduced impairment charges in Ireland and Australia.

2010 COMPARED WITH 2009

The results of Wealth and International deteriorated by £2,517 million, or 103 per cent, to a loss before tax of £4,950 million in 2010 compared to a loss of £2,433 million in 2009.

Loss before tax and fair value unwind deteriorated by £1,947 million, or 58 per cent, to £5,322 million compared to a loss of £3,375 million in 2009, due, in particular, to a higher impairment charge, predominantly in Ireland. An improvement in profits in the Wealth business was more than offset by the increased losses in the International business.

Net interest income decreased by £90 million, or 8 per cent, to £1,050 million in 2010 compared to £1,140 million in 2009, as a 12 basis points decline in the banking net interest margin more than offset the favourable impact of foreign currency movements, particularly the Australian dollar, and the income on the £7 billion European loan portfolio transferred in from the Wholesale division in the second half of 2009.

Other income was £32 million, or 3 per cent, higher at £1,160 million in 2010 compared to £1,128 million in 2009. This increase reflected favourable foreign exchange movements and restrained growth in the Wealth business, with lower asset management fee income following the sale of the external fund management business of Insight Investment in November 2009.

Operating expenses decreased by £8 million, or 1 per cent, to £1,536 million in 2010 compared to £1,544 million in 2009, with cost savings achieved from integration, particularly in the asset management businesses in Wealth, partly offset by investment in International s German deposit taking operation, increased risk management resources to manage impaired asset portfolios in Ireland and Australia, costs associated with the closure of the Irish business, and the effect of stronger foreign currency rates.

The impairment charge was £1,910 million, or 47 per cent, higher at £5,988 million in 2010, compared to £4,078 million in 2009, reflecting the material deterioration in the economic environment in Ireland in the last quarter of 2010, that resulted in EU-IMF financial support in late November 2010, and the tightening of liquidity in the second half of 2010 in regional Australian property markets to which the Group is exposed.

The impairment charge is summarised by key geography in the following table.

	2010	2009
	£m	£m
Ireland	**4,264**	2,949
Australia	**1,362**	849
Wholesale Europe	**210**	129
Latin America/Middle East	**97**	69
Netherlands	**9**	11
International	**5,942**	4,007

Wealth	**46**	71
Wealth and International	**5,988**	4,078

Loans and advances to customers decreased by £8,191 million, or 13 per cent, to £55,357 million at 31 December 2010 compared to £63,548 million at the end of 2009, reflecting net repayments of some £4.1 billion, and additional impairment provisions in the International businesses, partly offset by foreign exchange movements of some £1.1 billion.

Customer deposits increased by £3,747 million, or 13 per cent, to £32,784 million at 31 December 2010 compared to £29,037 million at the end of 2009, due to strong inflows in UK Private Banking and Bank of Scotland Germany, partly offset by outflows in Ireland following the closure of the Irish retail branch network.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE

The Insurance division provides long-term savings, protection and investment products and general insurance products to customers in the UK and Europe and consists of three elements:

Life, Pensions and Investments UK

The UK Life, Pensions and Investments business is the leading Bancassurance provider in the UK and has one of the largest intermediary channels in the industry. The business provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels using the Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows brands.

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.

Life, Pensions and Investments Europe

The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands.

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 TSB, Halifax and Bank of Scotland brands.

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest income	**(67)**	(39)	(59)
Other income	**2,687**	2,799	2,944
Effects of liability management, volatile items and asset sales		15	
Total income	**2,620**	2,775	2,885
Insurance claims	**(343)**	(542)	(637)
Total income, net of insurance claims	**2,277**	2,233	2,248
Operating expenses	**(812)**	(854)	(974)
Share of results of joint ventures and associates		(10)	(22)
Profit before tax and fair value unwind	**1,465**	1,369	1,252
Fair value unwind	**(43)**	(43)	(49)
Profit before tax	**1,422**	1,326	1,203
Profit before tax and fair value unwind by business unit			
Life, Pensions and Investments:			
UK business	**886**	830	792
European business	**82**	127	95

Total Life, Pensions and Investments	**968**	957	887
General Insurance	**497**	412	365
Profit before tax and fair value unwind	**1,465**	1,369	1,252

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

Profit before tax from Insurance was £96 million, or 7 per cent higher, at £1,422 million compared to £1,326 million in 2010. In 2010 income was reduced by a non-recurring charge of £70 million in respect of the Group s decision to cease writing new PPI business. Excluding this charge profit before tax and fair value unwind increased by £26 million, or 2 per cent in 2011.

Total income, net of insurance claims, increased by £44 million, or 2 per cent, to £2,277 million from £2,233 million in 2010. This is attributable to strong sales of corporate pensions through the intermediary channel and the continued change in new business mix within Life, Pensions and Investments UK (LP&I UK) towards a more profitable protection business reflecting a focus on meeting customer needs in an area where there is a general level of under provision in the UK. Improved claims experience within General Insurance which has been offset by lower PPI related income is also a significant contributor to this.

Insurance claims of £343 million were £199 million, or 37 per cent lower, than £542 million in 2010, mainly due to improved claims experience as a result of the run off of the PPI business and lower unemployment claims and lower property claims following the severe weather events that impacted January and December 2010.

Operating expenses and other costs decreased by £42 million, or 5 per cent, from £854 million to £812 million due mainly to a continued focus on cost management and delivery of integration cost savings, partly offset by an additional charge in relation to an industry wide Financial Services Compensation Scheme (FSCS) levy in 2011.

2010 COMPARED WITH 2009

Profit before tax from Insurance was £123 million higher, or 10 per cent, at £1,326 million compared to £1,203 million in 2009. Profit before tax and fair value unwind was £117 million higher, or 9 per cent, at £1,369 million compared to £1,252 million in 2009.

Net interest income was £20 million, or 34 per cent, better at a deficit of £39 million in 2010 compared to a deficit of £59 million in 2009.

Other income decreased by £130 million, or 4 per cent, to £2,814 million in 2010 compared to £2,944 million in 2009 largely resulting from the decrease in PPI income as a result of the Group s decision to cease writing payment protection business, partially off-set by improved new business income and the higher than expected return from improved investment markets.

Total income, net of insurance claims, decreased by £15 million, or 1 per cent, to £2,233 million in 2010 compared to £2,248 million in 2009, primarily reflecting lower PPI income and claims arising from the freeze events in 2010, which are offset by reduced payment protection insurance claims and improved investment markets.

Insurance claims were £95 million, or 15 per cent, lower at £542 million in 2010 compared to £637 million in 2009 reflecting improved unemployment claims experience. The home book has been particularly affected by the freeze events experienced in January and December 2010. This was partly offset by the benefits of ongoing claims processing improvements and integration.

Operating expenses decreased by £120 million, or 12 per cent, to £854 million in 2010 compared to £974 million in 2009 due to a continued focus on cost management and delivery of integration synergies.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LIFE, PENSIONS AND INVESTMENTS
UK BUSINESS

	2011	2010[1]	2009[1]
	£m	£m	£m
Net interest income	**(62)**	(48)	(86)
Other income	**1,458**	1,408	1,474
Total income	**1,396**	1,360	1,388
Operating expenses	**(510)**	(530)	(596)
Profit before tax and fair value unwind	**886**	830	792
Profit before tax and fair value unwind analysis			
New business profit insurance business[2]	**382**	332	328
investment business[2]	**(51)**	(65)	(196)
Total new business profit	**331**	267	132
Existing business profit[3]	**539**	611	606
Experience and assumption changes	**16**	(48)	54
Profit before tax and fair value unwind	**886**	830	792

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2 As required under IFRS, products are split between insurance and investment contracts depending on the level of insurance risk contained. For insurance contracts, the new business profit includes the net present value of profits expected to emerge over the lifetime of the contract, including profits anticipated in periods after the year of sale; for investment contracts the figure reflects the profit in the year of sale only, after allowing for the deferral of initial income and expenses. Consequently the recognition of profit for investment contracts is deferred relative to insurance contracts.

3 The disclosure of existing business profit has been changed to better reflect the performance of the business. Existing business profit includes the expected return on shareholder s net assets and experience and assumption changes are disclosed separately.

2011 COMPARED WITH 2010

Total new business profit increased by £64 million, or 24 per cent, to £331 million. The increase is primarily attributable to strong sales of corporate pensions through the intermediary channel, the continued growth of protection business in the bancassurance channel as the Group helps more customers and address the sizeable protection gap that exists in the UK and reduction in lower margin business following the launch of the integrated bancassurance proposition in June 2010.

Existing business profit has decreased by £72 million, or 12 per cent, to £539 million. The decrease predominantly reflects higher interest payments following capital restructuring initiatives, a reduction in the assumed rate of return, and lower levels of shareholder net assets following capital repatriation initiatives in 2010.

The net impact of experience variances and assumption changes has increased to a credit of £16 million in 2011 from a charge of £48 million in 2010. The benefit mainly reflects the absence of the £70 million charge taken in 2010 from the Group s decision to cease writing new PPI business.

2010 COMPARED WITH 2009

Profit before tax and fair value unwind increased by £38 million, or 5 per cent, to £830 million in 2010 compared to £792 million in 2009. New business profit increased by £135 million, or 102 per cent, to £267 million. The increase primarily reflects a reduction in initial commission on OEICs sold through the branch network and cost reductions through integration across the sales channels in addition to progress made on product participation choices.

Existing business profit increased by £5 million, or 1 per cent, to £611 million in 2010 compared to £606 million in 2009. This predominantly reflected higher asset values and a higher assumed rate of return following improved market conditions in the second half of 2009.

Profits arising from experience and assumption changes decreased by £102 million to a loss of £48 million mainly reflecting the non-recurrence of benefits recognised in 2009, including a liability management gain of £30 million. During 2010 a review was undertaken into the charging between the funds of Clerical Medical prior to the acquisition of HBOS, giving rise to a charge of £132 million. In addition, assumptions regarding future maintenance expenses within the Clerical Medical business were aligned to reflect the heritage Lloyds TSB approach, giving rise to a charge of £119 million.

These charges relate to pre-acquisition matters and were largely offset by the release of fair value provisions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EUROPEAN BUSINESS

2011 COMPARED WITH 2010

Profit before tax and fair value unwind decreased by £45 million, or 35 per cent, to £82 million in 2011 compared to £127 million in 2010. The reduction is driven largely by a non-recurring charge following clarification by the German regulator (BaFin) surrounding the deduction of tax and policy-holder distributions and experience and assumption charges.

2010 COMPARED WITH 2009

Profit before tax and fair value unwind increased by £32 million, or 34 per cent, to £127 million in 2010 compared to £95 million in 2009 driven largely by experience and assumption changes. New business sales reflected difficult economic and market conditions in Germany, the division s main European market.

NEW BUSINESS

The table below provides an analysis of the present value of new business premiums (PVNBP) for business written by the Insurance division, split between the UK and European Life, Pensions and Investments businesses. PVNBP is the measure of new business premiums for the life and pensions business and OEIC sales that management monitors because it provides an indication of the performance of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums.

		2011			2010			2009	
	UK £m	**Europe £m**	**Total £m**	UK £m	Europe £m	Total £m	UK £m	Europe £m	Total £m
Protection	**708**	**53**	**761**	574	56	630	519	49	568
Payment protection	**21**		**21**	70		70	153		153
Savings and investments	**1,133**	**246**	**1,379**	1,617	315	1,932	2,689	312	3,001
Individual pensions	**1,480**	**144**	**1,624**	1,606	141	1,747	2,275	185	2,460
Corporate and other pensions	**4,423**		**4,423**	2,750		2,750	2,600		2,600
Retirement income	**747**		**747**	889		889	887		887
Managed fund business	**116**		**116**	177		177	146		146
Life and pensions	**8,628**	**443**	**9,071**	7,683	512	8,195	9,269	546	9,815
OEICs	**1,591**		**1,591**	2,633		2,633	3,704		3,704
Total	**10,219**	**443**	**10,662**	10,316	512	10,828	12,973	546	13,519
Analysis by channel									
Intermediary	**6,415**	**443**	**6,858**	5,365	512	5,877	5,639	546	6,185
Bancassurance	**3,216**		**3,216**	4,432		4,432	6,997		6,997
Direct	**588**		**588**	519		519	337		337
Total	**10,219**	**443**	**10,662**	10,316	512	10,828	12,973	546	13,519

2011 COMPARED WITH 2010

Total sales (PVNBP) have reduced by £166 million, or 2 per cent to £10,662 million in 2011 compared to £10,828 million in 2010. New business margins have improved to 4.0 per cent in 2011 from 3.5 per cent in 2010. This partly reflects the launch of the integrated bancassurance proposition in June 2010 which has resulted in a change in mix away from higher single premium savings products towards lower premium, higher margin, protection business.

Despite the reduction in sales total new business profit within LP&I UK increased by £64 million, or 24 per cent, to £331 million.

Sales (PVNBP), excluding OEICs have increased by 11 per cent, and although OEIC sales have decreased by 40 per cent the new business margin on these sales has increased, reflecting the focus on value over volume.

Within the intermediary channel the increase in sales of £981 million, or 17 per cent, mainly reflects strong sales of corporate pensions in LP&I UK. The increase in sales has been achieved whilst maintaining the new business margin on corporate pension business.

In the bancassurance channel the reduction in sales reflects a change in mix away from savings products which generate a higher PVNBP towards protection business, which although more profitable, generates lower PVNBP. Sales of savings products have been particularly affected by recent stock market turbulence and lower consumer confidence, particularly in the second half of the year. Despite the reduction in PVNBP there was an increase in new business profit largely as a result of the increase in protection sales reflecting success in helping customers address their protection needs.

2010 COMPARED WITH 2009

The present value of new business premiums reduced by £2,691 million, or 20 per cent, to £10,828 million in 2010 compared to £13,519 million in 2009. This largely reflected the withdrawal in 2009 of certain HBOS legacy products with lower returns.

In the Bancassurance channel the reduction reflects the removal from sale of an HBOS guaranteed investment plan sold in 2009 and, since the integrated Bancassurance proposition was launched in June 2010, a change in mix away from savings products towards more profitable protection business in line with the legacy Lloyds TSB strategy. Sales of OEICs have been further adversely affected by a reduction in the volume of capital protected products given improved investment markets. However, sales of protection products have increased by 11 per cent and the aggregate new business margin has increased.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Within the Intermediary channel the reduction in volumes primarily reflects the withdrawal of low returning HBOS individual pension products, partly offset by an increase in sales of the on-going Retirement Account pension product and strong sales of corporate pensions.

GENERAL INSURANCE

	2011	2010[1]	2009[1]
	£m	£m	£m
Home insurance	**857**	862	874
Payment protection insurance	**125**	253	349
Other	**53**	70	69
Net operating income	**1,035**	1,185	1,292
Claims paid on insurance contracts (net of reinsurance)	**(343)**	(542)	(637)
Operating income, net of claims	**692**	643	655
Operating expenses	**(195)**	(221)	(268)
Share of results of joint ventures and associates		(10)	(22)
Profit before tax and fair value unwind	**497**	412	365

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2011 COMPARED WITH 2010

Profit before tax and fair value unwind from General Insurance increased by £85 million, or 21 per cent to £497 million compared to £412 million in 2010. The increase was primarily due to improved PPI claims experience from the run off of this business line, the absence of severe weather related claims as experienced in 2010 and lower expenses.

Total income for home insurance was broadly unchanged from 2010 at £857 million and reflects the maturity and competitiveness of the market.

Claims of £343 million were £199 million, or 37 per cent lower, than £542 million in 2010, mainly due to improved claims experience as a result of the run off of the PPI business and lower unemployment claims and lower property claims following the severe weather events that impacted January and December 2010.

Operating expenses decreased by £26 million, or 12 per cent, to £195 million in 2011 compared to £221 million in 2010 primarily as a result of further delivery of integration savings and a continued focus on cost management.

2010 COMPARED WITH 2009

Profit before tax and fair value unwind from General Insurance increased by £47 million, or 13 per cent, to £412 million in 2010 compared to £365 million in 2009, due primarily to improved unemployment claims experience plus integration synergies, after taking account of lower income resulting from ceasing to write new PPI business and freeze related claims.

Underwriting income for home insurance showed modest growth of £25 million, or 3 per cent, to £922 million in 2010 compared to £897 million in 2009. Home commission payable was adversely affected by the alignment of commission arrangements between the legacy businesses during the year.

PPI underwriting income decreased by £187 million, or 26 per cent, to £544 million in 2010 compared to £731 million in 2009 reflecting the continued impact on new business volumes from the market wide move to monthly premiums in 2009 and the Group s withdrawal from the payment protection market on 23 July 2010. Changes in commission payable reflected lower volumes of PPI written during the year.

Claims were £95 million, or 15 per cent, lower at £542 million in 2010 compared to £637 million in 2009 reflecting lower unemployment claims experience. The home book has been particularly affected by the freeze events experienced in January and December 2010. This has been partly offset by the benefits of ongoing claims processing improvements and integration.

Operating expenses decreased by £47 million, or 18 per cent, to £221 million in 2010 compared to £268 million in 2009 primarily as a result of the alignment of commission arrangements on home insurance, the delivery of integration savings and a continued focus on cost management.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GROUP OPERATIONS

	2011 £m	2010[1,2] £m	2009[1,2] £m
Total income	**42**	(12)	(43)
Direct costs:			
Information technology	**(1,031)**	(1,204)	(1,249)
Operations	**(596)**	(656)	(704)
Property	**(909)**	(966)	(981)
Sourcing	**(56)**	(58)	(60)
Support functions	**(73)**	(89)	(109)
	(2,665)	(2,973)	(3,103)
Result before recharges to divisions	**(2,623)**	(2,985)	(3,146)
Total net recharges to divisions	**2,567**	2,930	2,978
Share of results of joint ventures and associates		3	3
Loss before tax and fair value unwind	**(56)**	(52)	(165)
Fair value unwind			22
Loss before tax	**(56)**	(52)	(143)

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies.

2 Comparative figures have also been amended to reflect the centralisation of operations across the Group as part of the integration programme. To ensure a fair comparison of 2011 performance, 2010 and 2009 direct costs have been changed with an equivalent offsetting adjustment in recharges to divisions.

2011 COMPARED WITH 2010

Loss before tax from Group Operations increased by £4 million to £56 million in 2011 compared to £52 million in 2010.

Total income, excluding recharges to divisions, improved by £54 million, to £42 million in 2011 compared to a deficit of £12 million in 2010.

Direct costs were £308 million, or 10 per cent, lower at £2,665 million in 2011 compared to £2,973 million in 2010; this reflected the continued focus on cost management and the delivery of integration synergy savings and Simplification benefits.

Information Technology costs decreased by 14 per cent primarily with integration savings offsetting inflationary savings; Operations costs decreased by 9 per cent through the continuing rationalisation of the major Operations functions; Group Property costs decreased by 6 per cent due to the continuing consolidation of the heritage property portfolios helping to deliver further integration benefits; Group Sourcing costs decreased by 3 per cent and Sourcing has also played a major part in helping to deliver Group wide sourcing synergies.

Support functions costs were £16 million, or 18 per cent, lower at £73 million in 2011 compared to £89 million in 2010.

Recharges to divisions were £363 million lower at £2,567 million in 2011 compared to £2,930 million in 2010.

2010 COMPARED WITH 2009

Loss before tax from Group Operations improved by £91 million to £52 million in 2010 compared to £143 million in 2009. The loss in 2009 included a credit of £22 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind improved by £113 million to £52 million in 2010 compared to £165 million in 2009.

Total income, excluding recharges to divisions, improved by £31 million, to a deficit of £12 million in 2010 compared to a deficit of £43 million in 2009.

Direct costs were £130 million, or 4 per cent, lower at £2,973 million in 2010 compared to £3,103 million in 2009; this reflected the continued focus on cost management and the delivery of integration savings.

Information Technology costs decreased by 4 per cent primarily due to the further impact of integration benefits; Operations costs decreased by 7 per cent due to the continuing rationalisation of the major Operations functions and lower charges in respect of joint ventures; Group Property costs decreased by 2 per cent due to the continuing consolidation of the heritage property portfolios helping to deliver further integration benefits. Support functions costs were £20 million, or 18 per cent, lower at £89 million in 2010 compared to £109 million in 2009.

Recharges to divisions were £48 million lower at £2,930 million in 2010 compared to £2,978 million in 2009.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CENTRAL ITEMS

	2011 **£m**	2010[1] £m	2009[1] £m
Net interest income (expense)	**585**	571	(26)
Other income	**(49)**	(73)	(79)
Effects of liability management, volatile items and asset sales	**1,293**	150	1,519
Total income	**1,829**	648	1,414
Operating expenses	**(259)**	(107)	(294)
Trading surplus	**1,570**	541	1,120
Impairment	**(3)**		
Share of results of joint ventures and associates	**(1)**	2	(1)
Profit before tax and fair value unwind	**1,566**	543	1,119
Fair value unwind	**(1,274)**	(1,446)	(2,119)
Profit (loss) before tax	**292**	(903)	(1,000)

1 As discussed on page 32, divisional results for 2010 and 2009 have been restated to reflect new funding cost and capital allocation methodologies

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 internal audit, group risk, group compliance, group finance and group IT and operations.

2011 COMPARED WITH 2010

Total income increased by £1,181 million to £1,829 million primarily due to an £1,143 million increase in volatility and liability management effects. This included an £872 million increase in liability management gains. In addition, there was a £615 million reduction in the mark-to-market losses arising from the equity conversion feature of the Group s Enhanced Capital Notes, partly offset by a £344 million adverse movement on banking volatility, which is attributed to ineffectiveness in hedge accounting relationships and banking book derivatives not mitigated through hedge accounting.

Liability management gains arose on transactions undertaken as part of the Group s management of capital, largely the exchange of certain debt securities for other debt instruments or, for 2010 only, ordinary shares. These transactions resulted in a gain of £1,295 million in 2011, which comprises £696 million recognised in statutory net interest income, reflecting a reduction in the carrying value of certain debt securities as a result of changes in expected cash flows, and £599 million recognised in statutory other income relating to the exchange of existing securities into new securities. The gain in 2010 (£423 million) was recognised in statutory other income.

In 2011, volatile items comprised reductions in fair valuation of the equity conversion feature of the Group s Enhanced Capital Notes of £5 million (2010: £620 million) and positive banking volatility of £3 million (2010: £347 million). There were no asset sales in either 2011 or 2010 reported in central items.

Operating expenses increased by £152 million to £259 million primarily due to financial services compensation scheme costs of £161 million (Group total: £179 million) and bank levy costs of £189 million, partly offset by lower pension costs held centrally.

Fair value unwind decreased by £172 million to a charge of £1,274 million primarily due to deal maturities leading to reduced amortisation.

2010 COMPARED WITH 2009

Total income decreased by £766 million to £648 million primarily due to a £1,369 million reduction in volatility and liability management effects. This included a £1,045 million reduction in liability management gains. In addition, there was a £193 million increase in the mark-to-market losses arising from the equity conversion feature of the Group s Enhanced Capital Notes and a £131 million adverse movement in banking volatility, which is attributed to ineffectiveness in hedge accounting relationships and banking book derivatives not mitigated through hedge accounting.

Liability management gains arose on transactions undertaken in both 2009 and 2010 as part of the Group s management of capital which exchanged certain debt securities for ordinary shares or other debt instruments. These transactions resulted in a gain of £423 million in 2010 compared to a gain of £1,498 million in 2009 (of which £1,468 million was reflected in Central items). The fair value of the equity conversion feature of the Group s Enhanced Capital Notes decreased by £620 million in 2010 compared to a decrease of £427 million in 2009.

Net interest income was £597 million higher at £571 million in 2010 compared to a deficit of £26 million in 2009, in part reflecting improved net interest from interest rate risk management activities compared to 2009.

Operating expenses reduced by £187 million to £107 million due to lower professional fees and other costs associated with capital transactions and projects.

Fair value unwind improved by £673 million to a charge of £1,446 million primarily due to the effect of the liability management transactions leading to a reduced amortisation rate. Gains on liability management transactions included accelerated fair value amortisations.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2011 Average balance £m	**2011 Interest income £m**	**2011 Yield %**	2010 Average balance £m	2010 Interest income £m	2010 Yield %	2009 Average balance[1] £m	2009 Interest income £m	2009 Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	**81,001**	**628**	**0.78**	70,808	512	0.72	65,440	769	1.18
Loans and advances to customers	**594,152**	**23,950**	**4.03**	592,120	26,085	4.41	673,226	25,023	3.72
Debt securities	**18,616**	**590**	**3.17**	31,248	1,377	4.41	39,911	1,469	3.68
Available-for-sale financial assets	**34,305**	**886**	**2.58**	45,519	1,311	2.88	54,926	977	1.78
Held-to-maturity investments	**7,958**	**262**	**3.29**	2,188	55	2.51			
Total interest-earning assets of banking book	**736,032**	**26,316**	**3.58**	741,883	29,340	3.95	833,503	28,238	3.39
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**63,418**	**2,201**	**3.47**	65,176	2,412	3.70	59,849	2,224	3.72
Total interest-earning assets	**799,450**	**28,517**	**3.57**	807,059	31,752	3.93	893,352	30,462	3.41
Allowance for impairment losses on loans and receivables	**(19,548)**			(17,146)			(9,551)		
Non-interest earning assets	**200,939**			220,098			164,056		
Total average assets and interest income	**980,841**	**28,517**	**2.91**	1,010,011	31,752	3.14	1,047,857	30,462	2.91

	2011 Average interest earning assets £m	**2011 Net interest income £m**	**2011 Net interest margin %**	2010 Average interest earning assets £m	2010 Net interest income £m	2010 Net interest margin %	2009 Average interest earning assets £m	2009 Net interest income £m	2009 Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	**736,032**	**12,698**	**1.73**	741,883	12,546	1.69	833,503	9,026	1.08
Trading securities and other financial assets at fair value through profit or loss	**63,418**	**1,722**	**2.72**	65,176	2,172	3.33	59,849	1,706	2.85
	799,450	**14,420**	**1.80**	807,059	14,718	1.82	893,352	10,732	1.20

1 During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2011 Average balance £m	2011 Interest expense £m	2011 Cost %	2010 Average balance[1] £m	2010 Interest expense £m	2010 Cost %	2009 Average balance[1] £m	2009 Interest expense £m	2009 Cost %
Liabilities and shareholders funds									
Deposits by banks	**27,748**	**222**	**0.80**	40,918	319	0.78	93,234	883	0.95
Liabilities to banks under sale and repurchase agreements	**16,536**	**267**	**1.61**	20,658	513	2.48	42,794	1,399	3.27
Customer deposits	**365,418**	**6,080**	**1.66**	344,138	5,381	1.56	341,292	4,410	1.29
Liabilities to customers under sale and repurchase agreements	**7,572**	**68**	**0.90**	42,530	231	0.54	41,890	256	0.61
Debt securities in issue	**227,497**	**5,045**	**2.22**	234,107	5,833	2.49	247,079	6,318	2.56
Other interest-bearing liabilities	**19,242**	**(219)**	**(1.14)**	12,882	898	6.97	10,865	1,621	14.92
Subordinated liabilities	**33,918**	**2,155**	**6.35**	32,962	3,619	10.98	43,033	4,325	10.05
Total interest-bearing liabilities of banking book	**697,931**	**13,618**	**1.95**	728,195	16,794	2.31	820,187	19,212	2.34
Total interest-bearing liabilities of trading book	**26,407**	**479**	**1.81**	26,115	240	0.92	28,639	518	1.81
Total interest-bearing liabilities	**724,338**	**14,097**	**1.95**	754,310	17,034	2.26	848,826	19,730	2.32
Interest-free liabilities									
Non-interest bearing customer accounts	**31,519**			19,403			6,902		
Other interest-free liabilities	**179,705**			189,274			158,881		
Non-controlling interests and shareholders funds	**45,279**			47,024			33,248		
Total average liabilities and interest expense	**980,841**	**14,097**	**1.44**	1,010,011	17,034	1.69	1,047,857	19,730	1.88

1 During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of average balances and interest for 2011, 2010 and 2009 between domestic and international offices is as follows:

	Domestic			Foreign			Total		
2011	**Average balance £m**	**Interest income £m**	**Yield %**	**Average balance £m**	**Interest income £m**	**Yield %**	**Average balance £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	**192,714**			**8,225**			**200,939**		
Total average assets and interest income	**897,486**	**25,831**	**2.88**	**83,355**	**2,686**	**3.22**	**980,841**	**28,517**	**2.91**
Percentage of assets applicable to foreign activities (%)							**8.50**		

	Domestic			Foreign			Total		
	Average balance £m	**Interest expense £m**	**Cost %**	**Average balance £m**	**Interest expense £m**	**Cost %**	**Average balance £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	**153,439**			**26,266**			**179,705**		
Minority interests and shareholders funds	**31,068**			**14,211**			**45,279**		
Total average liabilities and interest expense	**897,486**	**13,108**	**1.46**	**83,355**	**989**	**1.19**	**980,841**	**14,097**	**1.44**
Percentage of liabilities applicable to foreign activities (%)							**7.39**		

	Domestic			Foreign			Total		
	Average balance[1]	Interest income	Yield	Average balance	Interest income	Yield	Average balance[1]	Interest income	Yield
2010	£m	£m	%	£m	£m	%	£m	£m	%
Assets									
Loans and receivables:									
Loans and advances to banks	55,288	408	0.74	15,520	104	0.67	70,808	512	0.72
Loans and advances to customers	535,544	24,035	4.49	56,576	2,050	3.62	592,120	26,085	4.41
Debt securities	29,662	1,359	4.58	1,586	18	1.13	31,248	1,377	4.41
Available-for-sale financial assets	35,296	1,236	3.50	10,223	75	0.73	45,519	1,311	2.88
Held-to-maturity investments	2,188	55	2.51				2,188	55	2.51
Total interest-earning assets of banking book	657,978	27,093	4.12	83,905	2,247	2.68	741,883	29,340	3.95
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,472	2,208	3.71	5,704	204	3.58	65,176	2,412	3.70
Total interest-earning assets	717,450	29,301	4.08	89,609	2,451	2.74	807,059	31,752	3.93
Allowance for impairment losses on loans and advances	(10,760)			(6,386)			(17,146)		
Non-interest earning assets	213,195			6,903			220,098		
Total average assets and interest income	919,885	29,301	3.19	90,126	2,451	2.72	1,010,011	31,752	3.14
Percentage of assets applicable to foreign activities (%)							8.92		

	Domestic			Foreign			Total		
	Average balance[1]	Interest expense	Cost	Average balance	Interest expense	Cost	Average balance[1]	Interest expense	Cost
	£m	£m	%	£m	£m	%	£m	£m	%
Liabilities and shareholders funds									
Deposits by banks	24,041	219	0.91	16,877	100	0.59	40,918	319	0.78
Liabilities to banks under sale and repurchase agreements	14,933	419	2.81	5,725	94	1.64	20,658	513	2.48
Customer deposits	334,395	5,108	1.53	9,743	273	2.80	344,138	5,381	1.56
Liabilities to customers under sale and repurchase agreements	42,457	231	0.54	73			42,530	231	0.54
Debt securities in issue	204,200	5,214	2.55	29,907	619	2.07	234,107	5,833	2.49
Other interest-bearing liabilities	12,882	898	6.97				12,882	898	6.97
Subordinated liabilities	32,951	3,618	10.98	11	1	9.09	32,962	3,619	10.98
Total interest-bearing liabilities of banking book	665,859	15,707	2.36	62,336	1,087	1.74	728,195	16,794	2.31
Total interest-bearing liabilities of trading book	26,115	240	0.92				26,115	240	0.92
Total interest-bearing liabilities	691,974	15,947	2.30	62,336	1,087	1.74	754,310	17,034	2.26
Interest-free liabilities									
Non-interest bearing customer accounts	18,463			940			19,403		
Other interest-free liabilities	174,928			14,346			189,274		
Minority interests and shareholders funds	34,520			12,504			47,024		
Total average liabilities and interest expense	919,885	15,947	1.73	90,126	1,087	1.21	1,010,011	17,034	1.69
Percentage of liabilities applicable to foreign activities (%)							8.06		

[1] During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2009	Domestic Average balance[1] £m	Domestic Interest income £m	Domestic Yield %	Foreign Average balance £m	Foreign Interest income £m	Foreign Yield %	Total Average balance[1] £m	Total Interest income £m	Total Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	57,500	594	1.03	7,940	175	2.20	65,440	769	1.18
Loans and advances to customers	617,498	22,928	3.71	55,728	2,095	3.76	673,226	25,023	3.72
Debt securities	38,189	1,439	3.77	1,722	30	1.74	39,911	1,469	3.68
Available-for-sale financial assets	46,787	896	1.92	8,139	81	1.00	54,926	977	1.78
Total interest-earning assets of banking book	759,974	25,857	3.40	73,529	2,381	3.24	833,503	28,238	3.39
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,571	2,213	3.71	278	11	3.96	59,849	2,224	3.72
Total interest-earning assets	819,545	28,070	3.43	73,807	2,392	3.24	893,352	30,462	3.41
Allowance for impairment losses on loans and advances	(5,740)			(3,811)			(9,551)		
Non-interest earning assets	159,516			4,540			164,056		
Total average assets and interest income	973,321	28,070	2.88	74,536	2,392	3.21	1,047,857	30,462	2.91
Percentage of assets applicable to foreign activities (%)							7.11		

	Domestic Average balance[1] £m	Domestic Interest expense £m	Domestic Cost %	Foreign Average balance £m	Foreign Interest expense £m	Foreign Cost %	Total Average balance[1] £m	Total Interest expense £m	Total Cost %
Liabilities and shareholders funds									
Deposits by banks	63,207	653	1.03	30,027	230	0.77	93,234	883	0.95
Liabilities to banks under sale and repurchase agreements	42,794	1,399	3.27				42,794	1,399	3.27
Customer deposits	333,678	4,255	1.28	7,614	155	2.04	341,292	4,410	1.29
Liabilities to customers under sale and repurchase agreements	41,827	256	0.61	63			41,890	256	0.61
Debt securities in issue	222,212	6,099	2.74	24,867	219	0.88	247,079	6,318	2.56
Other interest-bearing liabilities	10,865	1,621	14.92				10,865	1,621	14.92
Subordinated liabilities	42,183	4,276	10.14	850	49	5.76	43,033	4,325	10.05
Total interest-bearing liabilities of banking book	756,766	18,559	2.45	63,421	653	1.03	820,187	19,212	2.34
Total interest-bearing liabilities of trading book	28,639	518	1.81				28,639	518	1.81
Total interest-bearing liabilities	785,405	19,077	2.43	63,421	653	1.03	848,826	19,730	2.32
Interest-free liabilities									
Non-interest bearing customer accounts	6,253			649			6,902		
Other interest-free liabilities	157,426			1,455			158,881		
Minority interests and shareholders funds	24,237			9,011			33,248		
Total average liabilities and interest expense	973,321	19,077	1.96	74,536	653	0.88	1,047,857	19,730	1.88
Percentage of liabilities applicable to foreign activities (%)							6.46		

1 During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

56

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 2011 compared with 2010 and for 2010 compared with 2009. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2011 compared with 2010 Increase/(decrease)			2010 compared with 2009[1] 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	**116**	**79**	**37**	(257)	39	(296)
Loans and advances to customers	**(2,135)**	**82**	**(2,217)**	1,062	(3,573)	4,635
Debt securities	**(787)**	**(400)**	**(387)**	(92)	(382)	290
Available-for-sale financial assets	**(425)**	**(290)**	**(135)**	334	(271)	605
Held-to-maturity investments	**207**	**190**	**17**	55	55	
Total banking book interest receivable and similar income	**(3,024)**	**(339)**	**(2,685)**	1,102	(4,132)	5,234
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	**(211)**	**(61)**	**(150)**	188	197	(9)
Total interest receivable and similar income	**(3,235)**	**(400)**	**(2,835)**	1,290	(3,935)	5,225
Interest payable						
Deposits by banks	**(97)**	**(105)**	**8**	(564)	(408)	(156)
Liabilities to banks under sale and repurchase agreements	**(246)**	**(67)**	**(179)**	(886)	(550)	(336)
Customer deposits	**699**	**354**	**345**	971	45	926
Liabilities to customers under sale and repurchase agreements	**(163)**	**(314)**	**151**	(25)	3	(28)
Debt securities in issue	**(788)**	**(147)**	**(641)**	(485)	(323)	(162)
Other interest bearing liabilities	**(1,117)**	**(72)**	**(1,045)**	(723)	141	(864)
Subordinated liabilities	**(1,464)**	**61**	**(1,525)**	(706)	(1,106)	400
Total banking book interest payable	**(3,176)**	**(290)**	**(2,886)**	(2,418)	(2,198)	(220)
Total interest payable on trading and other liabilities at fair value through profit or loss	**239**	**5**	**234**	(278)	(23)	(255)
Total interest payable	**(2,937)**	**(285)**	**(2,652)**	(2,696)	(2,221)	(475)

1 During 2011 the Group has revised its treatment of offset accounts; average balances for 2010 and 2009 have been restated accordingly.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT

All narrative on pages 58 to 131 is unaudited unless otherwise stated. Tables are both audited and unaudited as stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

The Group s approach to risk is founded on a robust control framework and a strong risk management culture which guides the way all employees approach their work, the way they behave and the decisions they make.

PROGRESS IN 2011

The Group has a fully embedded conservative approach to, and prudent appetite for, risk and has in place disciplined controls over the risk profile for all new business, aligned to the strategic review.

The Group has made good progress in reducing assets which deliver below-hurdle returns, which are outside the Group s risk appetite or may be distressed, are subscale or have an unclear value proposition, or have a poor fit with the Group s customer strategy and improving the asset quality ratio.

Excellent progress in de-risking the Retail books. Solid progress in Wholesale and good progress to tackle the issues in the International books.

The continued focus on the Group s conduct risk agenda to ensure it is achieving the best outcomes for its customers and is completely aligned with being the best bank for customers.

PRIORITIES FOR 2012

Risk Division s mission in 2012 is to support sustainable growth, through:

Strategy: Supporting the delivery of the Group s strategic plan, within risk appetite

Risk Infrastructure: Continue to invest in and develop risk systems

Risk Culture: Build and leverage on strong risk culture of business ownership

Regulatory Change: Be a role model

People Agenda: Continue to attract, retain and develop high quality people

THE GROUP S APPROACH TO RISK

GOVERNANCE

The Group s approach to risk is founded on a robust control framework and a strong risk management culture which guides the way all employees approach their work, behave and make decisions promptly.

Board-level engagement, coupled with the direct involvement of senior management in group-wide risk issues at Group Executive Committee level, ensures that issues are promptly escalated and remediation plans are initiated.

The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.

RISK APPETITE

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

CULTURE

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

The Group has a conservative business model embodied by a risk culture founded on prudence and individual accountability, where the needs of customers are paramount.

The focus has been and remains on building and sustaining long-term relationships with customers, through good and bad economic times.

ENTERPRISE-WIDE RISK MANAGEMENT

The Group uses an Enterprise-Wide Risk Management framework for the identification, assessment, measurement and management of risk.

It seeks to maximise value for shareholders over time by aligning risk appetite with corporate strategy, assessing the impact of emerging risks and developing risk tolerances and mitigating strategies.

The framework seeks to strengthen the Group s ability to identify and assess risks, aggregate and report group-wide risks and refine risk appetite.

DECISION MAKING

The Risk Committee, chaired by a Non-Executive Director, comprises other Non-Executive Directors and oversees the Group s risk exposures. The Chief Risk Officer regularly informs the Risk Committee of the aggregate risk profile and has direct access to the Chairman and members of the Risk Committee.

The Group Risk Committee and the Group Asset and Liability Committee are chaired by the Group Chief Executive. The aggregate group wide risk profile and risk appetite are discussed at these monthly meetings.

RISK AS A STRATEGIC DIFFERENTIATOR

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

STRONG CONTROL FRAMEWORK

A strong control framework remains a priority for the Group and is the foundation for the delivery of effective risk management.

The Group optimises performance by allowing business units to operate within approved parameters.

The Group s approach to risk management ensures that business units remain accountable for risk.

CONSERVATIVE APPROACH

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

BOARD LEVEL REPORTING

The Group continues to enhance its capabilities by providing to the Board both qualitative and quantitative data including stress testing analysis on risks associated with strategic objectives.

Taking risks which are well understood, consistent with strategy and appropriately remunerated, is a key driver of shareholder return.

Risk analysis and reporting supports the identification of opportunities as well as risks and provide an aggregate view of the overall risk portfolio.

The Group s key risks, management actions and performance against risk appetite are monitored and reported at Group level.

ACCOUNTABILITY

Risk is included as one of the five principal criteria within the Group s balanced scorecard on which business area and individual s performance is judged.

Business executives have specified risk management objectives, and incentive schemes take account of performance against these.

The Risk function oversees the performance assessment of business areas and senior staff to ensure adherence to the Group s risk and control frameworks and oversees that performance has been achieved within risk appetite.

RISK DIVISION

During 2011 good progress has been made in creating a more agile risk function through further delayering the management structure and simplifying the operating model.

This reinforces the model of a strong and independent risk function that keeps the Group safe, supports sustainable business growth and minimises losses within risk appetite.

RISK TRANSFORMATION

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

STATE FUNDING AND STATE AID

HM Treasury currently holds approximately 40.1 per cent of the Group s ordinary share capital. United Kingdom Financial Investments Limited (UKFI) as manager of HM Treasury s shareholding continues to operate in line with the framework document between UKFI and HM Treasury managing the investment in the Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group, although there have been no indications that the Government intends to change the existing operating arrangements.

The Group made a number of undertakings to HM Treasury arising from the capital and funding support, including the provision of additional lending to certain mortgage and business sectors for the two years to 28 February 2011, and other matters relating to corporate governance and colleague remuneration. The lending commitments were subject to prudent commercial lending and pricing criteria, the availability of sufficient funding and sufficient demand from creditworthy customers. These lending commitments were delivered in full in the second year.

The subsequent agreement (known as Merlin) between five major UK banks (including the Group) and the Government in relation to gross business lending capacity in the 2011 calendar year was subject to a similar set of criteria. The Group delivered in full its share of the commitments by the five banks, both in respect of lending to SMEs and in respect of overall gross business lending. The Group has made a unilateral lending pledge for 2012 as part of its publicly announced SME charter.

In addition, the Group is subject to European state aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and remedy any distortion of competition and trade in the European Union (EU) arising from the state aid given to the Group. This has placed a number of requirements on the Group including an asset reduction target from a defined pool of assets by the end of 2014 and the disposal of certain portions of its retail business by the end of November 2013. In June 2011 the Group issued an Information Memorandum to potential bidders of this retail banking business, which the European Commission confirmed met the requirements to commence the formal sale process for the sale no later than 30 November 2011. On 14 December 2011 the Group announced that having reviewed the formal offers made, its preferred option was for a direct sale and that it was entering into exclusive discussions with The Co-operative Group. The Group is also continuing to progress an Initial Public Offering (IPO) in parallel. The Group continues to work closely with the EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the Restructuring Plan.

RISK GOVERNANCE

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

The risk governance structure is intended to strengthen risk evaluation and management, whilst also positioning the Group to manage the changing regulatory environment in an efficient and effective manner. The risk governance structure for Lloyds Banking Group is shown in table 1.1.

BOARD AND BOARD COMMITTEES

The Board, assisted by Risk Committee and Audit Committee, approves the Group s overall governance, risk and control frameworks and risk appetite. The Board also reviews the Group s aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board s agreed appetite for risk. The roles of the Board, Audit Committee and Risk Committee are shown in the corporate governance section on page 156 and further key risk oversight roles are described below.

The **Risk Committee**, which comprises Non-Executive Directors, oversees and challenges the development, implementation and maintenance of the Group s risk management framework, ensuring that its strategy, principles, policies and resources are aligned internally to its risk appetite as well as externally to regulation, corporate governance and industry best practice. The Risk Committee regularly reviews the Group s risk exposures across the primary risk drivers and the detailed risk types.

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

Group committees as shown in table 1.1, and in particular by:

The **Group Asset and Liability Committee** is responsible for the strategic management of the Group s assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.

The **Group Incident Executive** sets the strategic direction for the Group s response to significant incidents which could affect its ability to continue to operate, and instigates any tactical initiatives required.

The **Group Stress Testing Committee** is responsible for reviewing, challenging and recommending to the Group Executive Committee the annual stress testing of the Group s operating plan based on internal and FSA recommended scenarios, annual European Banking Authority stress tests, and other Group-wide macroeconomic stress tests.

The **Group Product Governance Committee** provides strategic and senior oversight over design, launch and management of products, including new product approval, annual product reviews and management of risk in the back book.

The **Group Risk Committee** reviews and recommends the Group s risk appetite and governance, risk and control frameworks, high-level group policies and the allocation of risk appetite. The Group Risk Committee regularly reviews risk exposures and risk/reward returns.

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

Credit Risk Committees, which are responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group s credit risk appetite, setting of high-level Group credit policy, and compliance with regulatory credit requirements. Risk Committees monitor and review the Group s aggregate credit risk exposures and concentrations of risk on behalf of the Group Risk Committee.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The **Group Market Risk Committee**, which on behalf of the Group Asset and Liability Committee, monitors and reviews the Group s aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.

The **Insurance Risk Committee** monitors, reviews and makes recommendations on the risk management framework, risk strategy and appetite for the Insurance business, ensuring that the policy and oversight framework for insurance risk management is appropriate. The committee reviews and challenges relevant insurance reporting and issues arising, including: the Group s aggregate portfolio of insurance risk against approved plans and risk appetite and the need and opportunity for effecting insurance risk mitigation.

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

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

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

The **Group Model Governance Committee** is 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 a small number defined as highly material to the Group, which are approved by the Group Risk Committee. This also meets FSA BIPRU requirements regarding the governance and approval for Internal Ratings Based models, including Internal Assessment models, Market Risk VaR and Advanced Measurement approach models.

Table 1.1: **Risk governance structures**

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

Business Unit Managing Directors/Executives have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group s policies and are within the parameters set by the Board, Group Executive Committee and Risk Division. Compliance with policies and parameters is overseen by the Risk Committee, the Group Risk Committee, the Group Asset and Liability Committee, and Risk Division, and independently challenged by Group Audit.

RISK MANAGEMENT OVERSIGHT

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

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

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

Table 1.2: **Risk management framework**

RISK MANAGEMENT IN THE BUSINESS

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

All business areas complete a control effectiveness review annually (see page 165), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives of each business area and each Group Executive Committee member certify the accuracy of their assessment.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT FRAMEWORK

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

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

The principal elements of the framework are shown in table 1.2. These map to the components of the internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The **Lloyds Banking Group business strategy and objectives** are used to determine the Group s high level risk appetite and measures and metrics for the primary risk drivers (see table 1.3).

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

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

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

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

During 2011, the Group s Policy Framework has been reviewed with a view to simplification, which will be implemented over the coming year. Colleagues are expected to be aware of and to comply with the policies and procedures which apply to them and their work. Line management in each business area has primary responsibility for ensuring that they do so.

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

Clear and consistent **risk identification** is undertaken using a common risk language to define and categorise risks (see table 1.3), also supporting risk aggregation and standardised reporting.

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PRINCIPAL RISKS AND UNCERTAINTIES

At present the most significant risks faced by the Group, which are derived from the primary risk drivers and detailed risk types in table 1.3, are shown below. These risks could impact on the success of delivering against the Group s long-term strategic objectives. For further information on the economy see page 14 Overview and Trend Information.

LIQUIDITY AND FUNDING

RISK DEFINITION

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.

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.

PRINCIPAL RISKS

Liquidity and funding continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long term wholesale funding markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.

The combination of right-sizing the balance sheet and continued development of the retail deposit base has seen the Group s wholesale funding requirement reduce in the past year. The progress the Group has made to date in diversifying its funding sources has further strengthened its funding base.

During the first half of 2011 the Group accelerated term funding initiatives and the run down of certain asset portfolios allowing a further reduction in total government and central bank facilities. The Group repaid its remaining drawings under the Bank of England SLS scheme in full during 2011. Outstandings under the Credit Guarantee Scheme reduced in line with their contractual maturities, with £23.5 billion remaining at the end of December 2011. The outstanding amount matures during 2012.

The second half of 2011 has seen more difficult funding markets as investor confidence was impacted by concerns over the US debt ceiling and subsequent downgrade. This was followed by increased fears over Eurozone sovereign debt levels, downgrades and possible defaults and concerns are ongoing over the potential downside effects from financial market volatility. Despite this the Group continued to fund adequately, maintaining a broadly stable stock of primary liquid assets during the year and meeting its regulatory liquidity ratio targets at all times.

Liquidity is managed at the aggregate Group level, with active monitoring at both business unit and Group level. Monitoring and control processes are in place to address both internal and regulatory requirements. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event.

The Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group s liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The Group s stress testing framework considers these factors, including the impact of a range of economic and liquidity stress scenarios over both short and longer term horizons. Internal stress testing results at 31 December 2011 show that the Group has liquidity resources representing more than 130 per cent of modelled outflows from all wholesale funding sources, corporate deposits and rating dependent contracts under the Group s severe liquidity stress scenario. In 2011, the Group has maintained its liquidity levels in excess of the ILG regulatory minimum (FSA s Individual Liquidity Adequacy Standards) at all times. Funding projections show the Group will achieve the proposed Basel III liquidity and funding requirements in advance of expected implementation dates.

The Group s stress testing shows that further credit rating downgrades may reduce investor appetite for some of the Group s liability classes and therefore funding capacity. In the fourth quarter of 2011, the Group experienced downgrades in its long-term rating of between one and two notches from three of the major rating agencies. The impact that the Group experienced following the downgrades was consistent with the Group s modelled outcomes based on the stress testing framework. The Group has materially reduced its wholesale funding in recent years and operates a well diversified funding platform which together lessen the impact of stress events.

The Group s borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group s results of operations, financial condition and prospects. In particular, reduction in the credit rating of the Group or deterioration in the capital markets perception of the Group s financial resilience, could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator over the last 12 months the spread between an index of A rated long term senior unsecured bank debt and an index of similar BBB rated bank debt, both of which are publicly available, has ranged between 60 and 115 basis points. The applicability to and implications for the Group s funding cost would depend on the type of issuance, and prevailing market conditions. The impact on the Group s funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

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

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

At 31 December 2011, the Group had £202 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows, as illustrated in the table below. This liquidity 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

The Group has maintained its liquidity levels in excess of the ILG regulatory minimum (FSA s Individual Liquidity Adequacy Standards) at all times. Funding projections show the Group will achieve the proposed Basel III liquidity and funding metrics in advance of expected implementation dates. The Liquidity Coverage Ratio (LCR) is due to be implemented on 1 January 2015 and the Net Stable Funding Ratio (NSFR) has a 1 January 2018 implementation date. The European Commission released its proposal for implementing Basel III into Europe (CRD IV) in July 2011 and discussions over the final detail are ongoing.

The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group s liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The key dependencies on successfully funding the Group s balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the group s balance sheet; the repayment of the government Credit Guarantee Scheme facilities in accordance with the agreed terms; no more than limited further deterioration in the UK s and the Group s credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group s funding plan. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Term wholesale funding issuance for the year totalled £35 billion, in excess of plan, representing £2 billion pre-funding of the requirement for 2012.

The Group term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) improved to 55 per cent (50 per cent at 31 December 2010) due to good progress in new term issuance and a reduction in short term money market funding. the wholesale funding position includes debt issued under the legacy government Credit Guarantee Scheme, for which the last maturity will occur in 2012.

Total wholesale funding reduced by £47 billion to £251 billion, with the volume with a residual maturity less than one year falling £35 billion to £113 billion.

The ratio of customer loans to deposits improved to 135 per cent compared with 154 per cent at 31 December 2010. Loans and advances reduced by £41 billion and customer deposits increased by £23 billion, representing growth of 6 per cent in 2011.

For further information on Liquidity and funding risk, see page 70.

CREDIT

RISK DEFINITION

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

PRINCIPAL RISKS

Risks arising in the Retail, Wholesale, Commercial, and Wealth and International divisions, reflecting the risks inherent in the Group s lending activities and, to a much lesser extent in the Insurance division in respect of investment of own funds. Adverse changes in the credit quality of the Group s UK and/ or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group s assets and materially increase the Group s write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors, including, inter alia, increased unemployment, reduced asset values, lower consumer spending, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last four years, the global banking crisis and economic downturn has driven cyclically high bad debt charges. These have arisen from the Group s lending to:

Wholesale customers (including those in Wealth and International): where companies continue to face difficult business conditions. Impairment levels have reduced materially since the peak of the economic downturn and more aggressive risk appetite in the HBOS businesses when elevated corporate default levels and illiquid commercial property markets resulted in heightened impairment charges. The UK economy remains fragile. Consumer and business confidence is low, consumer spending has been falling over the past year, the reduction in public sector spending is deepening and exports are failing to offset domestic weakness. The possibility of further economic weakness remains. Financial market instability represents an additional downside risk. The Group has exposure in both the UK and internationally, including Europe, Ireland, USA and Australia, particularly in commercial real estate lending, where the Group had a high level of lending secured on secondary and tertiary assets.

Retail customers (including those in Wealth and International): have seen UK bad debts reduce further in 2011 as a result of risk management activity and more stable, low interest rates and UK economic conditions. These portfolios will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates being possible impacts to the secured and unsecured retail exposures.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

The Group follows a relationship based business model with risk management processes, appetites and experienced staff in place. Further details on mitigating actions are detailed on pages 88 to 90.

For further information on Credit risk, see page 87.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

REGULATORY

RISK DEFINITION

Regulatory risk is the risk of reductions in earnings and/ or value, through financial or reputational loss, from failing to comply with the applicable laws, regulations or codes.

PRINCIPAL RISKS

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group. This is particularly the case in the current market environment, which continues to witness high levels of government and regulatory intervention in the banking sector.

Lloyds Banking Group faces increased political and regulatory scrutiny as a result of the Group s perceived size and systemic importance following the acquisition of HBOS Group.

Independent Commission on Banking

The Government appointed an Independent Commission on Banking (ICB) to review possible measures to reform the banking system and promote stability and competition. The ICB published its final report on 12 September 2011 putting forward recommendations to require ring-fencing of the retail activities of banks from their investment banking activities and additional capital requirements beyond those required under current drafts of the Capital Requirements Directive IV. The Report also makes recommendations in relation to the competitiveness of the UK banking market, including enhancing the competition remit of the new Financial Conduct Authority (FCA), implementing a new industry-wide switching solution by September 2013, and improving transparency. The ICB, which following the final report was disbanded, had the authority only to make recommendations, which the Government could choose to accept or reject.

The ICB specifically recommended in relation to the Group s EC mandated branch disposal (Project Verde), that, to create a strong challenger in the UK banking market, the entity which results from the divestment should have a share of the personal current account (PCA) market of at least 6 per cent (although this does not need to arise solely from the current accounts acquired from the Company) and a funding position at least as strong as its peers. The ICB did not specify a definitive timeframe for the divested entity to achieve a 6 per cent market share of PCAs but recommended that a market investigation should be carefully considered by competition authorities if a strong and effective challenger has not resulted from the Company s divestment by 2015. The ICB did not recommend explicitly that the Company should increase the size of the Project Verde disposal agreed with the European Commission but recommended that the Government prioritise the emergence of a strong new challenger over reducing market concentration through a substantially enhanced divestment by the Group.

The Government published its response to the ICB recommendations on 19 December 2011. The Government supported the recommendation that an entity with a larger share of the PCA market than the 4.6 per cent originally proposed might produce a more effective competitor. In relation to the Group s announcement that it was to pursue exclusive negotiations with the Co-operative Group, the Government commented that such a transaction would deliver a significant enhancement of the PCA market share, with the share divested by the Group combining with the Co-operative Group s existing share to create a competitor with approximately 7-8 per cent. The Government also stated that the execution of the divestment is a commercial matter, and it has no intention of using its shareholding to deliver an enhancement.

New Regulatory Regime

On 27 January 2012, the Government published the Financial Services Bill. The proposed new UK regulatory architecture will see the transition of regulatory and supervisory powers from the FSA to the new Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA). The PRA will be responsible for supervising banks, building societies and other large firms. The FCA will focus on consumer protection and market regulation. The Bill is also proposing new responsibilities and powers for the FCA. The most noteworthy are the proposed greater powers for the FCA in relation to competition and the proposal to widen its scope to include consumer credit. The Bill is expected to take effect in early 2013.

In April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from the FSA to the new FCA and PRA in 2013. Until this time the responsibility for regulating and supervising the activities of the Group and its subsidiaries will remain with the FSA. On 2 April the FSA will introduce a new twin peaks model and the intention is to move the FSA as close as possible to the new style of regulation outlined in the Bill. There will be two independent groups of supervisors for banks, insurers and major investment firms covering prudential and conduct. (All other firms (those not dual regulated) will be solely supervised by the conduct supervisors).

In addition, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory matters across the EU.

Capital and Liquidity

Evolving capital and liquidity requirements continue to be a priority for the Group. The Basel Committee on Banking Supervision has put forward proposals for a reform package which changes the regulatory capital and liquidity standards, the definition of capital, introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2013 and 2018.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Anti Bribery

The Bribery Act 2010 came fully into force on 1 July 2011. It enhances previous laws on bribery and is supported by some detailed guidance issued by the Ministry of Justice on the steps a business needs to take to embed adequate procedures to prevent bribery. A company convicted of failing to have adequate procedures to prevent bribery could receive an unlimited fine. The Group operates a Group-wide Anti-Bribery Policy, applicable to all of its businesses, operations and employees, which incorporates the requirements of the UK Bribery Act 2010.

Sanctions

The Group takes very seriously its responsibilities for complying with legal and regulatory sanctions requirements in all the jurisdictions in which it operates. In order to assist adherence to relevant economic sanctions legislation, the Group has enhanced its internal compliance processes including those associated with customer and payment screening. The Group has continued the delivery of a programme of staff training regarding policies and procedures for detecting and preventing economic sanctions non-compliance.

US Regulation

Significant regulatory initiatives from the US impacting the Group include the Dodd-Frank Act which imposes specific requirements for systemic risk oversight, asset securitisation activities, securities market conduct and oversight, bank capital standards, arrangements for the liquidation of failing systemically significant financial institutions and restrictions to the ability of banking entities to engage in proprietary trading activities and make investments in certain private equity and hedge funds (known as the Volcker Rule). Furthermore, under the so-called swap push-out provisions of the Dodd-Frank Act, the derivatives activities of US banks and US branch offices of foreign banks will be restricted, which may necessitate a restructuring of how the Group conducts its derivatives activities. Entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants will be required to register with the SEC or the US Commodity Futures Trading Commission, or both, and will become subject to the requirements as to capital, margin, business conduct, recordkeeping and other requirements applicable to such entities. The Dodd-Frank Act also grants the SEC discretionary rule-making authority to impose a new fiduciary standard on brokers, dealers and investment advisers, and expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the United States with respect to violations of the antifraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.

European Regulation

At a European level, the pace of regulatory reform has increased with a number of new directives or changes to existing directives planned in the next 12 months including a revised Markets in Financial Instruments Directive, Transparency Directive, Insurance Mediation Directive and a Fifth Undertakings in Collective Investments in Transferable Securities Directive as well as a proposed Directive regulating Packaged Retail Investment Products.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

Independent Commission on Banking

The Group continues to play a constructive role in the debate with the Government and other stakeholders on all issues under consideration in relation to the ICB s recommendations.

New Regulatory Regime

The Group continues to work closely with the regulatory authorities and industry associations to ensure that it is able to identify and respond to regulatory changes and mitigate against risks to the Group and its stakeholders.

Capital and Liquidity

The Group is continuously assessing the impacts of regulatory developments which could have a material effect on the Group and is progressing its plans to implement regulatory changes and directives through change management programmes.

Anti Bribery

The Group has no appetite for bribery and explicitly prohibits the payment, offer, acceptance or request of a bribe, including facilitation payments .

The Group has enhanced its internal compliance processes including those associated with payment screening, colleague training and hospitality.

US and European Regulation

The Group is continuously assessing the impacts of regulatory developments which could have a material effect on the Group and is progressing its plans to implement regulatory changes and directives through change management programmes. The Group is also continuing to progress its plans to achieve Solvency II compliance.

For further information on Regulatory risk, see page 128.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MARKET RISK

RISK DEFINITION

The risk of reductions in earnings and/or value, through financial or reputational loss, from unfavourable market moves, including changes in, and increased volatility of, interest rates, market-implied inflation rates, credit spreads, foreign exchange rates, and equity, property and commodity prices.

PRINCIPAL RISKS

The Group has a number of market risks, the principal ones being:

There is a risk to the Group s banking income arising from the level of interest rates and the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

Equity market movements and changes in credit spreads impact the Group s results.

The main equity market risks arise in the life assurance companies and staff pension schemes.

Credit spread risk arises in the life assurance companies, pension schemes and banking businesses.

Continuing concerns about the fiscal position in Eurozone countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

Market risk is managed within a Board approved framework using a range of metrics to monitor the Group s profile against its stated appetite and potential market conditions.

Market Risk is reported regularly to appropriate committees.

The Group s trading activity is small relative to its peers and is not considered to be a principal risk. The average 95 per cent 1-day trading Value at Risk (VaR) was £6 million for the year to 31 December 2011.

For further information on Market risk, see page 125.

CUSTOMER TREATMENT

RISK DEFINITION

The risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment.

PRINCIPAL RISKS

Customer treatment and how the Group manages its customer relationships affect all aspects of the Group s operations and are closely aligned with achievement of the Group s strategic vision to be the best bank for customers. As a provider of a wide range of financial services products across different brands and numerous distribution channels to an extremely broad and varied customer base, the Group faces significant conduct risks, such as: products or services not meeting the needs of its customers; sales processes which could result in selling products to customers which do not meet their needs; failure to deal with a customer s complaint effectively where the Group has got it wrong and not met customer expectations.

There remains a high level of scrutiny regarding the treatment of customers by financial institutions from regulatory bodies, the press and politicians. The FSA in particular continues to drive focus on conduct of business activities through its supervision activity.

There is a risk that certain aspects of the Group s business may be determined by 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.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

The Group s Conduct Risk Strategy and supporting framework have been designed to support its vision and strategic aim to put the customer at the heart of everything the Group does. The Group has developed and implemented a framework to enable us to deliver the right outcomes for its customers, which is supported by policies and standards in key areas, including product governance, sales, responsible lending, customers in financial difficulties, claims and complaints handling.

The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns.

For further information on Customer treatment, see page 128.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PEOPLE

RISK DEFINITION

The risk of reductions in earnings or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to people.

PRINCIPAL RISKS

The quality and effectiveness of the Group s people are fundamental to its success. Consequently, the Group s management of material people risks is critical to its capacity to deliver against its long-term strategic objectives. Over the next year the Group s ability to manage people risks successfully may be affected by the following key drivers:

- The Group s continuing structural consolidation and the sale of part of the branch network under Project Verde may result in disruption to the Group s ability to lead and manage its people effectively.
- The continually changing, more rigorous regulatory environment may impact the Group s people strategy, remuneration practices and retention.
- Macroeconomic conditions and negative media attention on the banking sector may impact retention, colleague sentiment and engagement.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

- Strong focus on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre staff together with implementation of rigorous succession planning
- A continued focus on people risk management across the Group.
- Ensuring compliance with legal and regulatory requirements related to Approved Persons and the FSA Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and people risk priorities.
- Strengthening risk management culture and capability across the Group, together with further embedding of risk objectives in the colleague performance and reward process.

For further information on people risk, see page 128.

INSURANCE RISK

RISK DEFINITION

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

PRINCIPAL RISKS

The major sources of insurance risk are within the insurance businesses and the Group s defined benefit staff pension schemes (pension schemes). Insurance risk is inherent in the insurance business and can be affected by customer behaviour. Insurance risks relate primarily to mortality, longevity, morbidity, persistency, expenses, property and unemployment. The primary insurance risk of the Group s pension schemes is related to longevity.

Insurance risk within the insurance businesses has the potential to significantly impact the earnings and capital position of the Insurance Division of the Group. For the Group s pension schemes, insurance risk could significantly increase the cost of pension provision and impact the balance sheet of the Group.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. Key examples include:

Insurance risk is reported regularly to appropriate committees and boards.

Actuarial assumptions are reviewed in line with experience and in-depth reviews are conducted regularly. Longevity assumptions for the Group s pension schemes are reviewed annually together with other IFRS assumptions. Expert judgement is required.

Insurance risk is controlled by robust processes including underwriting, pricing-to-risk, claims management, reinsurance and other risk mitigation techniques.

For further information on Insurance risk, see page 130.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FULL ANALYSIS OF RISK DRIVERS

Table 1.3: **Risk drivers**

RISK DRIVERS

The Group s risk language is designed to capture the Group s primary risk drivers. A description of each primary risk driver , including definition, appetite, control and exposures, is included below. These are further sub-divided into 33 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in table 1.3.

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

FINANCIAL SOUNDNESS

Financial soundness risk has three key risk components: liquidity and funding risk; capital risk; and financial and prudential regulatory reporting, disclosure and tax risk.

LIQUIDITY AND FUNDING RISK

DEFINITION

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

RISK APPETITE

Liquidity and funding risk appetite for the banking businesses is set by the Board and reviewed on an annual basis. This statement of the Group s overall appetite for liquidity 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. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The Group Chief Executive, assisted by the Group Asset and Liability Committee regularly reviews performance against risk appetite.

EXPOSURE

Liquidity exposure represents the amount of potential outflows in any future period less committed inflows. Liquidity is considered from both an internal and regulatory perspective.

MEASUREMENT

A series of measures are used across the Group to monitor both short and long-term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. The Board approved liquidity risk appetite links a number of these measures to balance sheet progression set out in the Group funding plan, with regular reporting to the Group Asset and Liability Committee 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 56 to the financial statements on page F-129 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. This forms the foundation of the Group s liquidity controls.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 both short-term liquidity management and long-term funding strategy. 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. 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 has been supported by stable funding from the wholesale markets with a reduced dependence on short-term funding. A substantial proportion of the retail deposit base is made up of customers current and savings accounts which, although repayable on demand, have traditionally in aggregate provided a stable source of funding. Additionally, the Group accesses the short-term wholesale markets to raise interbank deposits and to issue certificates of deposit and commercial paper to meet short-term obligations. The Group s short-term money market funding is based on a qualitative analysis of the market s capacity for the Group s credit. The Group has developed strong relationships with certain wholesale market segments, and also has access to corporate customers to supplement its retail deposit base.

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. The Group holds sizeable balances of high grade marketable debt securities as set out in Table 1.9 which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (European Central Bank, Federal Reserve, Bank of England and Reserve Bank of Australia).

MONITORING

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group s committee structure, in particular the Group Asset and Liability Committee 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 oversight.

Daily monitoring and control processes are in place to address both statutory and prudential liquidity requirements. In addition, the framework has two other important components:

Firstly, the Group stress tests its potential cash flow mismatch position under various scenarios on an ongoing basis. The cash flow mismatch position considers on-balance sheet cash flows, commitments received and granted, and material derivative cash flows. Specifically, commitments granted include the pipeline of new business awaiting completion as well as other standby or revolving credit facilities. Behavioural adjustments are developed, evaluating how the cash flow position might change under each stress scenario to derive a stressed cash flow position. Scenarios cover both Lloyds Banking Group name specific and systemic difficulties. The scenarios and the assumptions are reviewed at least annually to gain assurance they continue to be relevant to the nature of the business.

Secondly, the Group has a contingency funding plan embedded within the Group Liquidity Policy which has been designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing.

The Group has invested considerable resource to ensure that it satisfies the governance, reporting and stress testing requirements of the FSA s new ILAS liquidity regime. The Group has noted the industry move towards strategic balance sheet measures of the funding profile and has started to monitor and forecast the Group s Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR). The Group is aware that the regulatory liquidity landscape is subject to potential change. Specifically, in relation to the papers issued by the Basel Committee on Banking Supervision (Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring) the Group has actively participated in the industry-wide consultation and calibration exercises which took place through 2010.

During the year, the individual entities within the Group, and the Group, complied with all of the externally imposed liquidity and funding requirements to which they are subject.

LIQUIDITY AND FUNDING MANAGEMENT IN 2011

Liquidity and funding continues to remain a key area of focus for the Group and the industry as a whole. Like all major banks, the Group is dependent on confidence in the short and long term wholesale funding markets. Should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.

The second half of 2011 has seen more difficult funding markets as investor confidence was impacted by concerns over the US debt ceiling and subsequent downgrade. This was followed by increased fears over Eurozone sovereign debt levels, downgrades and possible defaults, and concerns are ongoing over the potential downside effects from financial market volatility. Despite this, the Group continued to fund adequately, maintaining a broadly stable stock of primary liquid assets during the year and meeting its regulatory liquidity ratios at all times.

The key dependencies on successfully funding the Group s balance sheet include the continued functioning of the money and capital markets; successful right-sizing of the Group s balance sheet; the repayment of the Government Credit Guarantee Scheme facilities in accordance with the agreed terms; no further deterioration in the Group s credit rating; and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets. Additionally, the Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. These are assumed within the Group s funding plan. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

The combination of right-sizing the balance sheet and continued development of the retail deposit base has seen the Group s wholesale funding requirement reduce materially in the past two years. The progress the Group has made to date in diversifying its funding sources has further strengthened its funding base.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.4: Group funding by type (audited)

	2011 £bn	**2011 %**	2010 £bn	2010 %
Deposits from banks[1]	**25.4**	**3.9**	26.4	3.9
Debt securities in issue:[1]				
Certificates of deposit	**28.0**	**4.3**	42.4	6.2
Commercial paper	**18.0**	**2.7**	32.5	4.8
Medium-term notes[2]	**69.8**	**10.6**	87.7	12.9
Covered bonds	**36.6**	**5.6**	32.1	4.7
Securitisation	**37.5**	**5.7**	39.0	5.7
	189.9	**28.9**	233.7	34.3
Subordinated liabilities[1]	**35.9**	**5.4**	37.9	5.6
Total wholesale funding[3]	**251.2**	**38.2**	298.0	43.8
Customer deposits	**405.9**	**61.8**	382.5	56.2
Total Group funding[4]	**657.1**	**100.0**	680.5	100.0

1 A reconciliation to the Group s balance sheet is provided on page 74.

2 Medium-term notes include £23.5 billion of funding from the Credit Guarantee Scheme.

3 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.

4 Excluding repos and total equity.

Total wholesale funding reduced by £47 billion to £251 billion, with the volume with a residual maturity less than one year falling £35 billion to £113 billion. Term wholesale funding for the year totalled £35 billion, in excess of plan, representing £2 billion pre-funding of the requirement for 2012. The Group term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) improved to 55 per cent (50 per cent at 31 December 2010) due to good progress in new term issuance and a reduction in short term money market funding.

Total wholesale funding is analysed by residual maturity as follows:

Table 1.5: Wholesale funding by residual maturity (audited)

	2011 £bn	**2011 %**	2010 £bn	2010 %
Less than one year	**113.3**	**45.1**	148.6	49.9
One to two years	**26.0**	**10.4**	46.8	15.7
Two to five years	**60.2**	**23.9**	52.3	17.6
More than five years	**51.7**	**20.6**	50.3	16.8
Total wholesale funding	**251.2**	**100.0**	298.0	100.0
Less than one year:				
Of which secured	**24.4**	**21.5**	38.4	25.8
Of which unsecured	**88.9**	**78.5**	110.2	74.2
	113.3	**45.1**	148.6	49.9
Greater than one year:				
Of which secured	**63.0**	**45.7**	55.4	37.1
Of which unsecured	**74.9**	**54.3**	94.0	62.9
	137.9	**54.9**	149.4	50.1

The table below summarises the Group s term issuance during 2011. The challenge of meeting the Group s 2011 issuance plan in a very volatile market was successfully accomplished by the ability of the Group to access a diverse range of markets and currencies, both in unsecured and secured form.

Table 1.6: Analysis of 2011 term issuance (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	**2.5**	**6.1**	**1.9**	**0.8**	**11.3**
Medium-term notes	**0.2**	**4.2**	**2.6**	**2.8**	**9.8**
Covered bonds	**1.2**		**2.4**		**3.6**
Private placements[1]	**3.7**	**1.6**	**4.8**	**0.5**	**10.6**
Total issuance	**7.6**	**11.9**	**11.7**	**4.1**	**35.3**

1 Private placements include structured bonds and term repurchase agreements (repos).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The wholesale funding position includes debt issued under the legacy Government Credit Guarantee Scheme, for which the last maturity will occur in October 2012.

Table 1.7: Analysis of government and central bank facilities (audited)

	2011 £bn	2010 £bn
Credit Guarantee scheme	**23.5**	45.4
Other		51.2
Total government and central bank facilities	**23.5**	96.6

The ratio of customer loans to deposits improved to 135 per cent compared with 154 per cent at 31 December 2010. Loans and advances reduced by £41 billion and customer deposits increased by £23 billion, representing growth of 6 per cent in 2011.

Table 1.8: Group funding position (audited)

	2011 £bn	2010 £bn	Change %
As at 31 December			
Funding requirement			
Loans and advances to customers[1]	**548.8**	589.5	(7)
Loans and advances to banks[2]	**10.3**	10.5	(2)
Debt securities	**12.5**	25.7	(51)
Available-for-sale financial assets secondary[3]	**12.0**	25.7	(53)
Cash balances[4]	**4.1**	3.6	14
Funded assets	**587.7**	655.0	(10)
Other assets[5]	**286.1**	269.6	6
	873.8	924.6	(5)
On balance sheet primary liquidity assets:[6]			
Reverse repurchase agreements	**17.3**	7.3	
Balances at central banks primary[4]	**56.6**	34.5	64
Available-for-sale financial assets primary	**25.4**	17.3	47
Held to maturity	**8.1**	7.9	3
Trading and fair value through profit or loss[7]	**(3.5)**		
Repurchase agreements	**(7.2)**		
	96.7	67.0	44
Total Group assets	**970.5**	991.6	(2)
Less: other liabilities[5]	**(251.6)**	(229.1)	10
Funding requirement	**718.9**	762.5	(6)
Funded by			
Customer deposits[7]	**405.9**	382.5	6
Wholesale funding	**251.2**	298.0	(16)
Repurchase agreements	**15.2**	35.1	(57)
Total equity	**46.6**	46.9	(1)
Total funding	**718.9**	762.5	(6)

1 Excludes £16.8 billion (31 December 2010: £3.1 billion) of reverse repurchase agreements.

2 Excludes £21.8 billion (31 December 2010: £15.6 billion) of loans and advances to banks within the insurance businesses and £0.5 billion (31 December 2010: £4.2 billion) of reverse repurchase agreements.

3 Secondary liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

4 Cash balances and balances at central banks primary are combined in the Group s balance sheet.

5 Other assets and other liabilities primarily include balances in the Group s insurance businesses and the fair value of derivative assets and liabilities.

6 Primary liquidity assets are FSA eligible liquid assets including UK Gilts, US Treasuries, Euro AAA government debt and unencumbered cash balances held at central banks.

7 Excluding repurchase agreements of £8.0 billion (31 December 2010: £11.1 billion).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

ENCUMBERED ASSETS

The Group remains a consistent issuer in a number of secured funding markets, in particular RMBS and covered bonds (see Table 1.6).

The Group s level of encumbrance arising from external issuance of securitisation and covered bonds has remained broadly constant, reflecting the maturity and stability of the Group s utilisation of this form of term funding, and the established cycle of redemptions and new issuance. Total notes issued externally from secured programmes (ABS and covered bonds) have increased from £71.1 billion at 31 December 2010 to £74.1 billion, reflecting gross issuance of £14.9 billion in 2011. A total of £118.5 billion (2010: £143.6 billion) of notes issued under securitisation and covered bond programmes have also been retained internally, the bulk of which are held to provide a pool of collateral eligible for use at central bank liquidity facilities. A small proportion of the retained collateral has been pledged in bilateral financing transactions.

Other assets pledged as collateral in special purpose entities (for example ABCP conduits) decreased from £17.1 billion at 31 December 2010 to £8.8 billion, largely as a result of a reduction in the size of the Group s holdings of debt securities. Within the asset-backed conduits, assets are encumbered as security for short term asset-backed CP investors in the vehicles; such funding forms part of debt securities in issue disclosed in note 37.

Table 1.9: Reconciliation of Group funding figure from table 1.4 to the balance sheet (audited)

	Included in funding analysis (table 1.4) £bn	**Repos £bn**	**Fair value and other accounting methods £bn**	**Balance sheet £bn**
At 31 December 2011				
Deposits from banks	**25.4**	**14.4**		**39.8**
Debt securities in issue	**189.9**		**(4.8)**	**185.1**
Subordinated liabilities	**35.9**		**(0.8)**	**35.1**
Total wholesale funding	**251.2**	**14.4**		
Customer deposits	**405.9**	**8.0**		**413.9**
Total	**657.1**	**22.4**		
At 31 December 2010				
Deposits from banks	26.4	24.0		50.4
Debt securities in issue	233.7		(4.8)	228.9
Subordinated liabilities	37.9		(1.7)	36.2
Total wholesale funding	298.0	24.0		
Customer deposits	382.5	11.1		393.6
Total	680.5	35.1		

LIQUIDITY MANAGEMENT

Liquidity is managed at the aggregate Group level, with active monitoring at both business unit and Group level. Monitoring and control processes are in place to address both internal and regulatory requirements. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event.

The Group carries out stress testing of its liquidity position against a range of scenarios, including those prescribed by the FSA. The Group s liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

The Group s stress testing framework considers these factors, including the impact of a range of economic and liquidity stress scenarios over both short and longer term horizons. Internal stress testing results at 31 December 2011 show that the Group has liquidity resources representing more than 130 per cent of modelled outflows from all wholesale funding sources, corporate deposits and rating dependent contracts under the Group s severe liquidity stress scenario. In 2011, the Group has maintained its liquidity levels in excess of the ILG regulatory minimum (FSA s Individual Liquidity Adequacy Standards) at all times. Funding projections show the Group will achieve the proposed Basel III liquidity and funding requirements in advance of expected implementation dates.

The Group s stress testing shows that further credit rating downgrades may reduce investor appetite for some of the Group s liability classes and therefore funding capacity. In the fourth quarter of 2011, the Group experienced downgrades in its long-term rating of between one and two notches from three of the major rating agencies. The impact that the Group experienced following the downgrades was consistent with the Group s modelled outcomes based on the stress testing framework. The Group has materially reduced its wholesale funding in recent years and operates a well diversified funding platform which together lessen the impact of stress events.

The Group s borrowing costs and issuance in the capital markets are dependent on a number of factors, and increased cost or reduction of capacity could materially adversely affect the Group s results of operations, financial condition and prospects. In particular, reduction in the credit rating of the Group or deterioration in the capital markets perception of the Group s financial resilience, could significantly increase its borrowing costs and limit its issuance capacity in the capital markets. As an indicator over the last 12 months the spread between an index of A rated long term senior unsecured bank debt and an index of similar BBB rated bank debt, both of which are publicly available, has ranged between 60 and 115 basis points. The applicability to and implications for the Group s funding cost would depend on the type of issuance, and prevailing market conditions. The impact on the Group s funding cost is subject to a number of assumptions and uncertainties and is therefore impossible to quantify precisely.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

At 31 December 2011, the Group had £202 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows, as illustrated in the table below. This liquidity 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 1.10: Liquidity portfolio (unaudited)

	2011 £bn	2010 £bn
Primary liquidity	**94.8**	97.5
Secondary liquidity	**107.4**	62.4
Total	**202.2**	159.9

Primary liquidity	**2011 £bn**	2010 £bn	**Average 2011 £bn**	Average 2010 £bn
Central bank cash deposits	**56.6**	34.5	**51.4**	46.7
Government bonds	**38.2**	63.0	**48.4**	41.3
Total	**94.8**	97.5	**99.8**	88.0

Secondary liquidity	**2011 £bn**	2010 £bn	**Average 2011 £bn**	Average 2010 £bn
High-quality ABS/covered bonds	**1.4**	15.3	**8.0**	16.3
Credit institution bonds	**2.1**	5.4	**3.7**	7.2
Corporate bonds	**0.3**	0.4	**0.6**	0.3
Own securities (retained issuance)	**81.6**	34.1	**76.8**	27.4
Other securities	**8.6**	7.2	**9.2**	5.9
Other[1]	**13.4**		**6.4**	
Total	**107.4**	62.4	**104.7**	57.1

1 Includes other central bank eligible assets.

Following the introduction of the FSA s Individual Liquidity Guidance under ILAS, the Group now manages its 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; the liquidity position reflects a buffer over the regulatory minimum. The Group receives no recognition under ILAS for assets held for secondary liquidity purposes.

Primary liquid assets of £94.8 billion represent approximately 133 per cent (95 per cent at 31 December 2010) of the Group s money market funding positions and are approximately 84 per cent (66 per cent at 31 December 2010) of all wholesale funding with a maturity of less than a year, and thus provides 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 open market operations at a number of central banks and routinely makes use of these facilities 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.

On 29 February 2012, the European Central Bank made available to the European banking sector its second Long-Term Refinancing Operation (LTRO). The Group has drawn £11.4 billion under the LTRO for an initial term of three years. Any further use of the LTRO and/or other open market operations of central banks will be based upon prudent liquidity management.

The Group notes the Basel Committee s Principles of Sound Liquidity Risk Management and Supervision (Sound Principles). The planned introduction of the Liquidity Coverage Ratio (LCR - January 2015) and Net Stable Funding Ratio (NSFR - 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 LCR measure promotes short term resilience of the liquidity profile by ensuring that banks have sufficient high quality liquid assets to meet potential funding outflows in a stressed environment within a one month period. The NSFR promotes resilience over a longer time horizon by requiring banks to fund their activities with a more stable source of funding on a going concern basis. This has a time horizon of one year and has been developed to ensure a sustainable maturity structure of assets and liabilities.

The guidance issued by the Basel Committee is still subject to final ratification by the EU and the methodology is likely to be refined on the basis of feedback from banks and regulators during the observation period. The actions already announced to right size the balance sheet are expected to ensure compliance with the future minimum standards. These standards are expected to be 100 per cent for both ratios by their respective effective dates.

HYBRID CAPITAL SECURITIES COUPON PAYMENTS

Since 31 January 2010, the Group has been prohibited under the terms of an agreement with the European Commission, from paying discretionary coupons and dividends on certain of its hybrid capital securities. This prohibition ended on 31 January 2012. The Group recommenced payments on certain hybrid capital securities from 31 January 2012. Future coupons and dividends on these hybrid capital securities will only be paid subject to, and in accordance with, the terms of the relevant securities.

The payments on those of the hybrid capital securities that are not cash-cumulative and which are expected, subject to their terms and conditions, to be paid in 2012 are estimated to amount to approximately £170 million. In the context of recent macro prudential policy discussions, the Board of

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Lloyds Banking Group has decided to issue new Lloyds Banking Group ordinary shares to raise this amount. The Group has entered into an agreement with a third-party financial institution in connection with the issue of these new ordinary shares. Such ordinary shares are expected to be issued, subject to market conditions, by the end of April 2012 at a price determined by reference to the volume weighted average price of the Group s ordinary shares in a period prior to their date of issue.

CONTRACTUAL CASH OBLIGATIONS

The following table sets out the amounts and maturities of Lloyds Banking Group s contractual cash obligations at 31 December 2011.

(unaudited)	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Enhanced capital notes				**9,085**	**9,085**
Long-term debt dated	**648**	**2,076**	**1,977**	**13,245**	**17,946**
Medium-term notes	**31,527**	**15,041**	**9,874**	**12,263**	**68,705**
Commercial paper	**18,091**				**18,091**
Covered bonds	**1,268**	**14,336**	**8,163**	**14,429**	**38,196**
Securitisation notes	**4,869**	**8,093**	**2,396**	**22,054**	**37,412**
Finance leases	**2**	**2**	**2**	**51**	**57**
Operating leases	**348**	**610**	**577**	**1,489**	**3,024**
Capital commitments	**328**	**1**			**329**
Other purchase obligations	**1,073**	**1,598**	**614**	**252**	**3,537**
	58,154	**41,757**	**23,603**	**72,868**	**196,382**

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 £650 million to these schemes in 2012.

At 31 December 2011, Lloyds Banking Group also had £8,058 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2011, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds TSB Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds TSB Bank and HBOS to pay dividends going forward, or for Lloyds TSB 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 2011 is included in note 56 to the consolidated 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 £10,831 million at 31 December 2011 (with £4,989 million expiring within one year;£2,008 million between one and three years;£2,198 between three and five years; and £1,636 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 2011, 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 22 and 23 to the consolidated 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-49, 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 2011 was £756 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CAPITAL RISK

DEFINITION

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

RISK APPETITE

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

EXPOSURE

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

MEASUREMENT

The Group s regulatory capital is divided into tiers depending on level of subordination and ability to absorb losses. Core tier 1 capital as defined in the FSA letter to the British Bankers Association in May 2009, comprises mainly shareholders equity and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected loss over accounting provisions and certain securitisation positions. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and Available-for-Sale assets. Tier 1 capital, as defined by the European Community Banking Consolidation Directive as implemented in the UK by the FSA s General Prudential Sourcebook (GENPRU), is core tier 1 capital plus tier 1 capital securities less 50 per cent of material holdings in financial companies. Tier 2 capital, defined by GENPRU, comprises qualifying subordinated debt and some additional provisions and reserves after deducting 50 per cent of the excess of expected loss over accounting provisions, and certain securitisation positions and material holdings in financial companies. Total capital is the sum of tier 1 and tier 2 capital after deducting investments in subsidiaries and associates that are not consolidated for regulatory purposes. In the case of Lloyds Banking Group, this means that the net assets of its life assurance and general insurance businesses and the non-financial entities that are held by the Group s private equity (including venture capital) businesses, are excluded from its total regulatory capital.

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities; for example, the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital.

The minimum total capital required under pillar 1 of the Basel II framework is the Capital Resources Requirement (CRR) calculated as 8 per cent of risk weighted assets. In addition to the minimum requirements for total capital, the FSA has made statements to explain it also operates a framework of targets and expected buffers for core tier 1 and tier 1 capital.

In order to address the requirements of pillar 2 of the Basel II framework, the FSA currently sets additional minimum requirements through the issuance of Individual Capital Guidance (ICG) for each UK bank calibrated by reference to the CRR. A key input into the FSA s ICG setting process is each bank s Internal Capital Adequacy Assessment Process. The Group has been given an ICG by the FSA. The FSA has made it clear, however, that ICG remains a confidential matter between each bank and the FSA.

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

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

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

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

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

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

Many of the details of the way these reforms will be integrated within the UK are still to be finalised. In the meantime, the Group continues to monitor their development very closely and analyse their potential impact whilst ensuring that the Group continues to have a strong loss absorption capacity exceeding regulatory requirements as currently formulated.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

MITIGATION

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

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

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

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

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

MONITORING

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.11: Capital resources (audited)

	2011 £m	2010 £m
Core tier 1		
Shareholders equity per balance sheet	**45,920**	43,725
Non-controlling interests per balance sheet	**674**	841
Regulatory adjustments to non-controlling interests	**(577)**	(524)
Regulatory adjustments:		
Adjustment for own credit	**(136)**	(8)
Defined benefit pension adjustment	**(1,004)**	(1,052)
Unrealised reserve on AFS debt securities	**(940)**	747
Unrealised reserve on AFS equity	**(386)**	(462)
Cash flow hedging reserve	**(325)**	391
Prudent valuation adjustments	**(32)**	
Other items	**(4)**	(3)
	43,190	43,655
Less: deductions from core tier 1		
Goodwill	**(2,016)**	(2,016)
Intangible assets	**(2,310)**	(2,390)
50% excess of expected losses over impairment	**(720)**	
50% of securitisation positions	**(153)**	(214)
Core tier 1 capital	**37,991**	39,035
Non-controlling preference shares[1]	**1,613**	1,507
Preferred securities	**4,487**	4,338
Less: deductions from tier 1		
50% of material holdings	**(94)**	(69)
Total tier 1 capital	**43,997**	44,811
Tier 2		
Undated subordinated debt	**1,859**	1,968
Dated subordinated debt	**21,229**	23,167
Less: restriction in amount eligible		(620)
Unrealised gains on available for sale equity	**386**	462
Eligible provisions	**1,259**	2,468
Less: deductions from tier 2		
50% excess of expected losses over impairment	**(720)**	
50% of securitisation positions	**(153)**	(214)
50% of material holdings	**(94)**	(69)
Total tier 2 capital	**23,766**	27,162
Supervisory deductions		
Unconsolidated investments life	**(10,107)**	(10,042)
Unconsolidated investments general insurance and other	**(2,660)**	(3,070)
Total supervisory deductions	**(12,767)**	(13,112)
Total capital resources	**54,996**	58,861

1 Covered by grandfathering provisions issued by FSA.

Table 1.12: Risk Weighted Assets and Capital Ratio s (unaudited)

	2011 £m	2010 £m
Risk-weighted assets	**352,341**	406,372
Ratios		
Core tier 1 ratio	**10.8%**	9.6%
Tier 1 capital ratio	**12.5%**	11.0%
Total capital ratio	**15.6%**	14.5%

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.13: Analysis of risk-weighted assets (unaudited)

	2011 **£m**	2010 £m
Divisional analysis of risk-weighted assets		
Retail	**103,237**	109,254
Wholesale	**163,766**	196,164
Commercial	**25,434**	26,552
Wealth and International	**47,278**	58,714
Group Operations and Central items	**12,626**	15,688
	352,341	406,372
Risk type analysis of risk-weighted assets		
Foundation IRB	**90,450**	114,490
Retail IRB	**98,823**	105,475
Other IRB	**9,433**	14,483
Advanced Approach	**198,706**	234,448
Standardised Approach	**103,525**	124,492
Credit risk	**302,231**	358,940
Operational risk	**30,589**	31,650
Market and counterparty risk	**19,521**	15,782
Total risk-weighted assets	**352,341**	406,372

Risk-weighted assets reduced by £54,031 million to £352,341 million, a decrease of 13 per cent. This reflects risk weighted asset reductions across all banking divisions driven by balance sheet reductions, lower lending balances and stronger management of risk.

Retail risk weighted assets reduced by £6,017 million mainly due to lower lending balances and the reducing mix of unsecured lending.

The reduction of Wholesale risk weighted assets of £32,398 million primarily reflects the balance sheet reductions including treasury asset sales and the run down in other asset portfolios that are not central to the Group s strategy. This has been partly offset by an increase in market risk weighted assets, as a result of the implementation of CRD III.

Risk weighted assets within Wealth and International have reduced by £11,436 million as a result of asset run-off and write off and foreign exchange movements.

Integration of model activity previously undertaken on a separate heritage basis was largely completed in 2010 and there have been no significant migrations to IRB methodologies during 2011. In common with other banking groups operating on an IRB basis the Group anticipates moving some activity that is currently measured on the standardised approach over to an IRB methodology. These changes will take place primarily during 2012 and 2013.

TIER 1 CAPITAL

Core tier 1 capital has decreased by £1,044 million largely reflecting losses in the period. In addition there has been an increase in excess of expected losses over impairment losses, reflecting the reduction of legacy lending that is subject to very high provision levels and replacement with new lending.

TIER 2 CAPITAL

Tier 2 capital has decreased in the period by £3,396 million reflecting the increase in excess of expected losses over impairment, as noted above, and a reduction in eligible provisions. In addition, dated subordinated debt has also reduced in the period, partly due to amortisation and partly due to a capital restructuring exercise in December 2011, which resulted in a net overall redemption of dated subordinated debt.

SUPERVISORY DEDUCTIONS

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The movements in core tier 1 and total capital in the period are shown below:

Table 1.14: **Movements in core tier 1 and total capital during the year (audited)**

	Core tier 1 £m	Total £m
At 1 January 2011	**39,035**	**58,861**
Loss attributable to ordinary shareholders	**(451)**	**(451)**
Decrease in regulatory post-retirement benefit adjustments	**48**	**48**
Decrease in goodwill and intangible assets deductions	**80**	**80**
Increase in excess of expected losses over impairment allowances	**(720)**	**(1,440)**
Increase in material holdings deduction		**(50)**
Decrease in eligible provisions		**(1,209)**
Decrease in supervisory deductions from total capital		**345**
Decrease in dated subordinated debt, net of restriction in amount eligible		**(1,318)**
Other movements	**(1)**	**130**
At 31 December 2011	**37,991**	**54,996**

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 large 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 FSA.

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 FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

REGULATORY CAPITAL REQUIREMENTS

Each life insurance company must retain sufficient capital to meet the regulatory capital requirements mandated by the FSA; the basis of calculating the regulatory capital requirement is given below. Except for Scottish Widows 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 FSA 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 FSA.

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-profits business written in a With Profit Fund, 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 includes an allowance for future bonuses. Options and guarantees are valued using a stochastic simulation model which values these liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled Options and guarantees on page 85.

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 Profit 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. The With Profit Insurance Capital Component may be reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the relevant 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 FSA. The figures allow for an anticipated transfer of £85 million from the Non Profit Fund of Scottish Widows Annuities Ltd to its Shareholder fund. During 2011, as part of a project to rationalise the Group structure Clerical Medical was purchased by Scottish Widows for £1,846 million. Scottish Widows recovered £1,485 million of this amount as a result of capital transactions with its holding company.

Table 1.15: **Capital resources (unaudited)**

	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 2011 (statutory basis)						
Shareholders funds:						
Held outside the long-term funds				**1,843**	**632**	**2,475**
Held within the long-term funds			**6,592**		**312**	**6,904**
Total shareholders funds			**6,592**	**1,843**	**944**	**9,379**
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	**242**	**58**				**300**
Value of in-force business			**(5,491)**		**(818)**	**(6,309)**
Other differences between IFRS and regulatory valuation of assets and liabilities			**107**	**(163)**	**124**	**68**
Estimated share of realistic liabilities consistent with the FSA reporting treatment	**(341)**	**(58)**				**(399)**
Qualifying loan capital				**1,997**		**1,997**
Support arrangement assets	**184**		**(184)**			
Available capital resources	**85**		**1,024**	**3,677**	**250**	**5,036**
At 31 December 2010 (statutory basis)						
Shareholders funds:						
Held outside the long-term funds				1,414	721	2,135
Held within the long-term funds			8,029		401	8,430
Total shareholders funds			8,029	1,414	1,122	10,565
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	322	321				643
Value of in-force business			(6,172)		(843)	(7,015)
Other differences between IFRS and regulatory valuation of assets and liabilities			625	(919)	111	(183)
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(409)	(58)				(467)
Qualifying loan capital				1,991		1,991
Support arrangement assets	344		(344)			
Available capital resources	257	263	2,138	2,486	390	5,534

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 a formal arrangement with one of its subsidiary undertakings, Scottish Widows Unit Funds Limited, whereby the subsidiary company can draw down capital from Scottish Widows to finance new business which is reinsured from the parent to its subsidiary. Scottish Widows has also provided subordinated loans to its fellow group undertaking Scottish Widows Bank plc. No such arrangement exists for Clerical Medical.

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 Profit Fund and a Non-Participating Fund and established protected capital support for the with-profits policyholders in existence at the date of demutualisation. Much of that capital support is held in the Non-Participating Fund and, as such, the capital held in that fund is subject to the constraints noted below.

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 FSA permission to include the value of the Support Account

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 suplus admissible assets) in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2011, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,198 million (31 December 2010: £1,693 million) and the estimated value of the Support Account was zero (December 2010: £197 million). However, at 31 December 2011, the excess of realistic liabilities with-profits business written down before demutualisation over the relevant assets was £67 million (31 December 2010: £55 million) which, in accordance with the FSA 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 2011, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £5,494 million (31 December 2010: £4,322 million) and the estimated combined value of the Support Account and Further Support Account was £2,291 million (31 December 2010: £2,446 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 2011 is £117 million (31 December 2010: £147 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long-Term Fund to meet both policyholders reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

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. Capital within the Clerical Medical Non Profit Fund is available to meet the With Profit Fund requirements.

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 1.16: **Movements in available capital resources (unaudited)**

	Scottish Widows With Profit	Clerical Medical With Profit	UK Non Profit Fund	UK Life Shareholder Fund	Overseas Life Business	Total Life Business

	Fund £m	Fund £m	£m	£m	£m	£m
At 31 December 2010	257	263	2,138	2,486	390	5,534
Changes in estimations and in demographic assumptions used to measure life assurance liabilities	(24)	41	289	91	(6)	391
Dividends and capital transactions			(1,483)	1,057	(156)	(582)
Change in support arrangements	(160)		160			
New business and other factors	12	(304)	(80)	43	22	(307)
At 31 December 2011	**85**		**1,024**	**3,677**	**250**	**5,036**

WITH PROFITS FUNDS

Available capital in the Scottish Widows With Profit Fund has decreased from £257 million at 31 December 2010 to an estimated £85 million at 31 December 2011. This is largely as a result of a reduction in the support arrangements from the Non Profit Fund. Available capital in the Clerical medical With Profit Fund has decreased from £263 million at 31 December 2010 to an estimated zero at 31 December 2011. The fund is in the process of distributing the free estate. Ultimately all surplus will be distributed to policyholders hence the available capital at 31 December 2011 is zero.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

UK NON PROFIT FUNDS

Available capital in the UK Non Profit Funds has decreased from £2,138 million at 31 December 2010 to an estimated £1,024 million at 31 December 2011. The main cause of the decrease was the impact of capital transactions supporting the purchase of Clerical Medical by Scottish Widows in July 2011. This was partially offset by increases in available capital from changes in assumptions. It should be noted that the decrease in the Non Profit Fund from the purchase of Clerical Medical is largely compensated for by an increase in the available capital in the Shareholder Funds.

UK LIFE SHAREHOLDER FUNDS

Available capital in the UK Life Shareholder Funds has increased from £2,486 million at 31 December 2010 to an estimated £3,677 million at 31 December 2011. The main cause of the increase was the impact of capital transactions supporting the purchase of Clerical Medical by Scottish Widows.

OVERSEAS LIFE BUSINESS

Available capital has decreased during 2011 due to a significant dividend payment which was only 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 1.17: **Analysis of policyholder liabilities (unaudited)**

	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 2011					
With Profit Fund liabilities	**13,651**	**9,300**	**4**		**22,955**
Unit-linked business (excluding that accounted for as non-participating investment contracts)			**38,474**	**7,801**	**46,275**
Other life insurance business			**8,745**	**55**	**8,800**
Insurance and participating investment contract liabilities	**13,651**	**9,300**	**47,223**	**7,856**	**78,030**
Non-participating investment contract liabilities			**45,469**	**4,167**	**49,636**
Total policyholder liabilities	**13,651**	**9,300**	**92,692**	**12,023**	**127,666**
At 31 December 2010					
With Profit Fund liabilities	13,845	10,394	5		24,244
Unit-linked business (excluding that accounted for as non-participating investment contracts)			38,641	8,011	46,652
Other life insurance business			8,527	90	8,617
Insurance and participating investment contract liabilities	13,845	10,394	47,173	8,101	79,513
Non-participating investment contract liabilities			47,058	4,304	51,362
Total policyholder liabilities	13,845	10,394	94,231	12,405	130,875

CAPITAL SENSITIVITIES

SHAREHOLDERS FUNDS

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

WITH PROFIT FUNDS

The with-profit 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). Reinsurance arrangements are in place to reduce the Group s exposure to deteriorating mortality rates in respect of life insurance contracts. In addition, poor cost control would gradually reduce the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Assets held in excess of those backing reserves are invested predominantly in cash and cash like instruments. The investment strategy is determined in line with the policy of Lloyds Banking Group to minimise both the profit volatility and the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

OPTIONS AND GUARANTEES

The Group has sold insurance products that contain options and guarantees, both within the With Profit 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 2011 of £2.0 billion (2010: £1.8 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of 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 the UK gilt yield curve.

Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2011, the 10 year equity-implied at-the-money assumption was set at 27.2 per cent (31 December 2010: 26.1 per cent). The assumption for property volatility was 15 per cent (31 December 2010: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 19 per cent (31 December 2010: 15 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 £61 million (31 December 2010: £57 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £2 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £9 million.

FINANCIAL AND PRUDENTIAL REGULATORY REPORTING, DISCLOSURE AND TAX RISK

DEFINITION

The risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial, prudential regulatory and tax reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate information about the Group on a timely basis.

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 avoiding the need for restatement of publicly disclosed information.

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.

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;
- 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MONITORING

Financial reporting risk, prudential regulatory reporting risk, tax risk and disclosure risk are all 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 requirements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK

Definition

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

RISK APPETITE

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

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

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions, sovereigns and corporate clients. The credit risk exposures of the Group are set out in note 56 to the financial statements. Credit risk exposures are categorised as retail , arising primarily in the Retail and Wealth and International Divisions, commercial and corporate , financial institutions or Sovereigns arising in the Wholesale, Commercial and Wealth and International Divisions.

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 19 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2011. 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 56 to the financial statements.

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

Note 2(H) to the financial statements provides details of the Group s approach to the impairment of financial assets.

MEASUREMENT

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

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

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

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities (details of these rating scales are published in Lloyds Banking Group s Pillar III disclosure). Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale (Note 56 to the financial statements provides an analysis of the portfolio and page 92 provides details of the Credit risk portfolio).

The quality definition of both retail and non-retail counterparties/exposures is largely based on the outcomes of credit risk (probability of default PD) models. The Group operates a significant number of different rating models, typically developed internally using statistical analysis and may use management judgement retail models rely more on the former; non-retail models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data in model development, where appropriate. The models vary, inter alia, in the extent to which they are point in time versus through the cycle. The models are subject to rigorous validation and oversight/ governance, including where appropriate, benchmarking to external information.

In non-retail portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PD changes. The modelled PDs map to a (non-retail) master scale which enables the consolidation of credit risk information, and it is this that forms the basis for the IFRS credit quality characterisation.

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

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

MITIGATION

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

Internal control

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

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

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

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

(Unaudited)

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

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

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

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

Credit scoring: In its principal retail portfolios, the Group uses statistically based decisioning techniques (primarily credit scoring models). The Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. The most material changes are approved in accordance with the governance framework set by the 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, County Court Judgments and bankruptcies); and CRA data (for example, performance of credit lines with other lenders, 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 in Retail, 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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 who, 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.

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

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

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

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group s risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 21 to the financial statements provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group s large exposures are reported in accordance with regulatory reporting requirements.

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

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

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

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

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

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

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

Collateral

The principal collateral types for loans and advances are:

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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

Master netting agreements

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

Other credit risk transfers

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

MONITORING

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

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

INTENSIVE CARE OF CUSTOMERS IN DIFFICULTY

Retail Assets

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

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

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

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

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

- Forbearance a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments such as a temporary capital payment break.
- Financial distress assistance an account change for customers in financial distress where arrears accrue at the contractual payment such as a short-term arrangement to pay.
- Repair an account change used to repair a customer s position when they have emerged from financial difficulty, such as capitalisation of arrears when a payment track record has been re-established.

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

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

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

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

Wholesale Assets (including Commercial)

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

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

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

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

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

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

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

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

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

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

Concessions granted under forbearance would be classified in the Credit Risk Classification system according to the severity of the customer s financial distress. Management information is produced which gives a high level view of asset quality, with clearly defined parameters and features. Trends and warning signs are reported and advised to senior management promptly, which include issues not yet identified by rating models. A robust review and challenge process is applied to each credit if asset quality declines, initiating an appropriate and measured response. As the financial stress of a credit deteriorates the Credit Risk Classification helps to determine the route and management of the customer. Repeat transgressions of forbearance would be reflected in the strategy to manage the customer and an objective reassessment of any impairment will be undertaken on a regular basis. This is subject to independent review and sanctioning.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

The lending appeals process: If a lending application is declined, customers have the right to appeal that decision. The Group has committed to respond to 90 per cent of appeals with a decision within 15 working days.

The finance application checklist: Details of the type of information customers may be asked to provide in order to support their lending application.

Business mentoring: Businesses may benefit from the support of a business mentor. www.mentorsme.co.uk is a free online service that enables businesses to locate local independent mentoring organisations that suit their specific business needs.

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

The Group s accounting policy for loan renegotiations and forbearance is set out in note 2 to the financial statements.

CREDIT RISK PORTFOLIO IN 2011

Overview

The Group achieved a significant reduction in its impairment charge in 2011 to £9,787 million (from £13,181 million in 2010), due primarily to lower corporate real estate and real estate related charges in Wholesale, lower charges in the Irish portfolio together with strong Retail performance. All divisions experienced impairment charge reductions by over 20 per cent from 2010.

These lower charges were principally supported by the continued application of the prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK property prices, partly offset by weakening UK economic growth and rising unemployment.

Prudent credit policies and procedures are in place throughout the Group, focusing on development of enduring client relationships. As a result of this approach, the credit quality of new lending remains strong.

The Group s more difficult exposures are being managed successfully in the current challenging economic environment by the Wholesale Business Support Units and Retail Collection and Recovery Units. The Group s exposure to Ireland has been closely managed, with a dedicated UK-based business support team in place to manage the winding down of the Irish book.

The Group continues to proactively manage down sovereign as well as banking and trading book exposure to selected Eurozone countries.

Divestment strategy is focused on balance sheet reduction and disposal of higher risk positions.

Table 1.18: **Impairments on Group loans and advances (audited)**

	2011	2010	Change
	£m	£m	%
Retail	**1,970**	2,747	28
Wholesale	**2,901**	4,064	29
Commercial	**303**	382	21
Wealth and International	**4,610**	5,988	23
Central items	**3**		
Total impairment charge	**9,787**	13,181	26

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.19: **Impairment charge by division (audited)**

	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 2011					
Retail	**356,907**	**8,822**	**2.5**	**2,718**	**30.8**
Wholesale	**135,395**	**27,756**	**20.5**	**11,537**	**41.6**
Commercial	**29,681**	**2,915**	**9.8**	**880**	**30.2**
Wealth and International	**56,394**	**20,776**	**36.8**	**12,583**	**60.6**
Reverse repos and other items	**17,066**				
	595,443	**60,269**	**10.1**	**27,718**	**46.0**
Impairment provisions[1]	**(27,718)**				
Fair value adjustments[2]	**(2,087)**				
Total Group	**565,638**				
At 31 December 2010					
Retail	368,981	9,750	2.6	3,096	31.8
Wholesale	158,002	31,658	20.0	14,863	46.9
Commercial	29,649	2,856	9.6	992	34.7
Wealth and International	66,368	20,342	30.7	10,684	52.5
Reverse repos and other items	3,378				
	626,378	64,606	10.3	29,635	45.9
Impairment provisions[1]	(29,635)				
Fair value adjustments[2]	(4,146)				
Total Group	592,597				

1 Impairment provisions include collective unimpaired provisions.

2 The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Company s consolidated financial records at their fair value and took into account both the expected future impairment 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 useful 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). In 2011, a net credit of £1,943 million (2010: £3,118 million) relates to the unwind of HBOS acquisition fair value adjustments. Of that amount, £1,693 million (2010: £2,229 million) relates to impairment losses incurred which were expected at the date of acquisition. 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.

Table 1.20: **Total impairment charge (audited)**

	2011 £m	2010 £m	Change %
Total impairment losses on loans and advances to customers	**9,712**	12,958	25
Loans and advances to banks		(13)	
Debt securities classified as loans and receivables	**49**	57	14
Available-for-sale financial assets	**81**	115	30
Other credit risk provisions	**(55)**	64	
Total impairment charge	**9,787**	13,181	26

Pages 94 to 104 provide the credit risk divisional split.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OUTLOOK GROUP

The UK economy is fragile with a weak short-term economic outlook generally expected. Consumer and business confidence remains low, relatively high inflation has reduced consumer spending power and exports are falling.

In addition to the possibility of further economic deterioration, financial market instability represents an additional downside risk. Uncertainty over the best way forward for the highly indebted Eurozone persists and poses a serious threat to the global economic recovery, with political instability and contagion to other Eurozone countries increasing in the last quarter of 2011. Financial markets are expected to remain dislocated and volatile, with the risk of contagion unlikely to dissipate in the near term, and this continues to place strains on funding markets at a time when many financial institutions (in particular) have material ongoing funding needs.

The Group s Wholesale leveraged finance portfolios and its commercial real estate and real estate related property lending portfolios remain particularly vulnerable, especially in the significant secondary and tertiary asset lending book. The impact of further economic weakness will also be felt in the traditional lending portfolios in Corporate and Commercial. In addition, the Irish economic outlook remains challenging and the property market depressed, and both these factors could further adversely impact the wholesale and retail Irish portfolios.

However, despite the downside risks, against its base case economic assumptions, the Group expects the total impairment charge in 2012 to reduce by a similar percentage amount to the reduction in 2011, reflecting the stabilisation of its portfolios and proactive risk management activities.

CREDIT RISK RETAIL

Overview

The Retail impairment charge was £1,970 million in 2011, a decrease of £777 million, or 28 per cent, from 2010.

The decrease in the Retail impairment charge was driven by the unsecured portfolio as a result of the improved quality of new business and effective portfolio management. The Retail impairment charge for loans and advances to customers, as an annualised percentage of average loans and advances to customers, decreased to 0.54 per cent in 2011 from 0.74 per cent in 2010.

The overall value of assets entering arrears in 2011 were lower in both unsecured and secured lending compared to 2010.

Table 1.21: **Retail impairment charge (audited)**

	2011	2010	Change
	£m	£m	%
Secured	**463**	292	(59)
Unsecured	**1,507**	2,455	39
Total impairment charge	**1,970**	2,747	28

Impaired loans and provisions

Retail impaired loans decreased by £0.9 billion to £8.8 billion compared with 31 December 2010 and, as a percentage of closing loans and advances to customers, decreased to 2.5 per cent from 2.6 per cent at 31 December 2010. Impairment provisions, as a percentage of impaired loans, reduced to 30.8 per cent from 31.8 per cent at 31 December 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

Table 1.22: **Impairments on Retail loans and advances (audited)**

	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 %**
As at 31 December 2011					
Secured	**332,143**	**6,452**	**1.9**	**1,651**	**25.6**
Unsecured					
Collections		**1,233**	**5.0**	**1,067**	**86.5**
Recoveries[2]		**1,137**	**4.6**		
	24,764	**2,370**	**9.6**	**1,067**	
Total gross lending	**356,907**	**8,822**	**2.5**	**2,718**	**30.8**
Impairment provisions[1]	**(2,718)**				
Fair value adjustments	**(1,377)**				
	352,812				
As at 31 December 2010					
Secured	341,069	6,769	2.0	1,589	23.5
Unsecured					
Collections		1,826	6.6	1,507	82.5
Recoveries[2]		1,155	4.1		
	27,912	2,981	10.7	1,507	
Total gross lending	368,981	9,750	2.6	3,096	31.8
Impairment provisions[1]	(3,096)				
Fair value adjustments	(2,154)				
	363,731				

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.

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

Table 1.23: **Retail loans and advances to customers (audited)**

	2011 £m	2010 £m
Secured:		
Mainstream	**256,518**	265,368
Buy to let	**48,276**	46,356
Specialist	**27,349**	29,345
	332,143	341,069
Unsecured		
Credit cards	**10,192**	11,207
Personal loans	**11,970**	13,881
Bank accounts	**2,602**	2,624
Others		200
	24,764	27,912
Total Retail gross lending	**356,907**	368,981

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SECURED

Secured impairment charge

The impairment charge increased by £171 million, to £463 million in 2011 compared to the previous year. The impairment charge as a percentage of average loans and advances to customers, increased to 0.14 per cent from 0.09 per cent in 2010. The provision coverage increased reflecting a less certain outlook on house prices and appropriate provisioning against existing credit risks which have longer emergence periods due to current low interest rate environment, partially offset by underlying improvements in the quality of the portfolio.

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 whilst interest rates remain low. At December 2011, 1.2 per cent of loan balances were on a forbearance arrangement, compared to 1.3 per cent at 31 December 2010.

Secured impaired loans

Impaired loans decreased by £0.3 billion to £6.5 billion at 31 December 2011 and, as a percentage of closing loans and advances to customers, reduced to 1.9 per cent from 2.0 per cent at 31 December 2010. The number of customers going into arrears reduced throughout 2011 in comparison with 2010. Specialist lending remains closed to new business and this book has been in run-off since 2009.

Secured arrears

The percentage of mortgage cases greater than three months in arrears (excluding repossessions) remained stable at 2.3 per cent at 31 December 2011 compared to 31 December 2010 and 30 June 2011. The percentage of Specialist mortgage cases greater than three months in arrears (excluding repossessions) increased to 7.5 per cent at 31 December 2011 from 6.4 per cent at 31 December 2010 with the majority of this growth occurring in the first half of 2011.

Table 1.24: **Mortgages greater than three months in arrears (excluding repossessions) (unaudited)**

	Number of cases		**Total mortgage accounts %**	
	31 Dec 2011 Cases	31 Dec 2010 Cases	**31 Dec 2011 %**	31 Dec 2010 %
Greater than three months in arrears (excluding repossessions)				
Mainstream	**53,734**	55,675	**2.0**	2.1
Buy to let	**7,805**	7,577	**1.8**	1.8
Specialist	**13,677**	12,582	**7.5**	6.4
Total	**75,216**	75,834	**2.3**	2.3

	Value of debt[1]		**Total mortgage balances %**	
	31 Dec 2011 £m	31 Dec 2010 £m	**31 Dec 2011 %**	31 Dec 2010 %
Greater than three months in arrears (excluding repossessions)				
Mainstream	**5,988**	6,247	**2.3**	2.4
Buy to let	**1,145**	1,157	**2.4**	2.5
Specialist	**2,427**	2,262	**8.9**	7.7
Total	**9,560**	9,666	**2.9**	2.8

1 Value of debt represents total book value of mortgages in arrears.

The stock of repossession was stable with 3,043 cases at 31 December 2010 and 3,054 at 31 December 2011, and is broadly consistent with prior years and below the Council of Mortgage Lender s average.

Secured loan to value analysis

The average indexed loan-to-value (LTV) on the mortgage portfolio at 31 December 2011 was 55.9 per cent compared with 55.6 per cent at 31 December 2010. The average LTV for new mortgages and further advances written in 2011 was 62.1 per cent compared with 60.9 per cent for 2010. The tables below show LTVs across the principal mortgage portfolios.

The indexed LTV in excess of 100 per cent as a percentage of closing loans and advances ending 31 December 2011 reduced to 12.0 per cent (£39.7 billion), compared with 13.2 per cent (£44.9 billion) at 31 December 2010. This decrease in negative equity was driven by the regional mix of business being biased towards areas experiencing house price growth despite national house prices falling.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.25: **Actual and average LTVs across the Retail mortgage portfolios (audited)**

	Mainstream %	Buy to let %	Specialist[1] %	Total %
At 31 December 2011				
Less than 60%	**32.5**	**12.7**	**14.6**	**28.1**
60% to 70%	**12.7**	**13.0**	**10.1**	**12.5**
70% to 80%	**17.2**	**24.1**	**17.2**	**18.2**
80% to 90%	**16.0**	**17.3**	**19.3**	**16.5**
90% to 100%	**11.2**	**17.1**	**19.0**	**12.7**
Greater than 100%	**10.4**	**15.8**	**19.8**	**12.0**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan-to-value:[2]				
Stock of residential mortgages	**52.2**	**74.0**	**72.6**	**55.9**
New residential lending	**61.4**	**65.8**	**n/a**	**62.1**
Impaired mortgages	**72.0**	**99.8**	**88.0**	**78.4**
At 31 December 2010				
Less than 60%	33.0	11.4	14.0	28.5
60% to 70%	12.1	11.1	9.4	11.7
70% to 80%	16.1	21.9	15.9	16.8
80% to 90%	15.3	18.0	21.3	16.2
90% to 100%	11.9	19.1	20.0	13.6
Greater than 100%	11.6	18.5	19.4	13.2
Total	100.0	100.0	100.0	100.0
Average loan-to-value:[2]				
Stock of residential mortgages	51.9	75.6	72.9	55.6
New residential lending	60.0	66.5	n/a	60.9
Impaired mortgages	72.3	97.8	87.3	78.0

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 assigned to these loans and advances.

Unsecured

In 2011 the impairment charge on loans and advances to customers reduced by £948 million to £1,507 million compared with 2010. This reflected continued improving business quality and portfolio trends resulting from the Group s conservative risk appetite, with a focus on lending to existing customers.

A combination of the Group s risk appetite, reduced demand from customers for new unsecured borrowing and existing customers continuing to reduce their personal indebtedness contributed to loans and advances to customers reducing by £3.1 billion to £24.8 billion at 31 December 2011.

The impairment charge as a percentage of average loans and advances to customers decreased to 5.66 per cent in 2011 from 8.11 per cent in 2010, with the impairment charge reducing at a greater rate than the reduction in average loans and advances in 2011.

Impaired loans decreased by £0.6 billion to £2.4 billion which represented 9.6 per cent of closing loans and advances to customers at 31 December 2011, compared with 10.7 per cent at 31 December 2010. The reduction in impaired loans is a result of tightening credit policy across the credit lifecycle, including stronger controls on customer affordability. Retail s exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers changing financial circumstances. The portfolios show a level of early arrears for accounts acquired since 2009 which are at pre-recession levels, highlighting an underlying improvement in the risk profile of the business.

Impairment provisions decreased by £0.4 billion, compared with 31 December 2010, to £1.1 billion. This reduction was primarily a result of the movement of assets from Collections to Recoveries, at which point they are written down to the present value of future expected cash flows. The proportion of impaired loans that have been written down to the present value of future expected cash flows on these assets has increased to 48.0 per cent at 31 December 2011 from 38.7 per cent at 31 December 2010. Impairment provisions as a percentage of impaired loans in collections increased to 86.5 per cent at 31 December 2011 from 82.5 per cent at 31 December 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK WHOLESALE

Overview

Impairment losses for 2011 decreased significantly to £2,901 million, from £4,064 million for 2010.

The decrease in the underlying impairment charge during 2011 is primarily driven by lower impairment from the corporate real estate and real estate-related lending portfolios, partly offset mainly by higher impairment on leveraged acquisition finance exposures during 2011 where the dampened effect of UK economic conditions had the most impact.

Whilst subdued UK economic conditions and weaker consumer confidence is evident in a number of sectors, the reduction in the impairment charge also reflects continued strong risk management and the low interest rate environment, helping to maintain defaults at a lower level.

The Group has proactively managed down sovereign as well as banking and trading book exposures to selected European countries. Divestment strategy was focused on balance sheet reduction and disposing of higher risk positions.

A robust credit risk management and control framework is in place across the combined portfolios and a prudent risk appetite approach continues to be embedded across the division. Significant resources continue to be deployed into the Business Support Units, which focuses on key and vulnerable obligors and asset classes.

Table 1.26: **Wholesale impairment charge (unaudited)**

	2011	2010	Change
	£m	£m	%
Wholesale excluding Asset Finance	**2,701**	3,800	29
Asset Finance	**200**	264	24
Total impairment charge	**2,901**	4,064	29

Wholesale s impairment charge decreased £1,163 million, or 29 per cent, compared to £4,064 million during 2010. Despite a subdued UK economic environment in 2011, impairment charges have decreased substantially compared with 2010 due to robust proactive risk management, an appropriately impaired portfolio (against current economic assumptions) and a low interest rate environment helping to maintain defaults at a lower level. There has also been a stabilisation of commercial property prices in 2011. Impairment charges as an annualised percentage of average loans and advances to customers reduced to 1.95 per cent from 2.23 per cent in 2010.

Impaired loans and provisions

Wholesale s impaired loans reduced by £3,902 million to £27,756 million compared with 31 December 2010. The reduction is due to new impaired assets mainly in the Corporate Real Estate Business Support Unit being more than offset by write-offs on irrecoverable assets, the sale of previously impaired assets, net repayments and transfers back to good book. Furthermore, the flow of assets into impaired status reduced during the year compared to 2010. Impairment provisions also reduced as a result of write-offs and a lower impairment rate on newly impaired assets especially in the corporate real estate and real estate related portfolios. As a result of this, impairment provisions as a percentage of impaired loans reduced to 41.6 per cent from 46.9 per cent at 31 December 2010.

As a percentage of closing loans and advances to customers, impaired loans increased to 20.5 per cent from 20.0 per cent at 31 December 2010. This increase is a result of the reducing level of total loans and advances to customers as at 31 December 2011 compared with 31 December 2010. The Group continues to monitor vulnerable portfolios within Wholesale and, where appropriate, remedial risk mitigating actions are being undertaken.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.27: **Impairments on Wholesale loans and advances (audited)**

	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 %**
As at 31 December 2011					
Corporate	**68,772**	**5,631**	**8.2**	**3,051**	**54.2**
Corporate Real Estate BSU	**21,326**	**15,211**	**71.3**	**5,631**	**37.0**
Wholesale Equity	**113**	**113**	**100.0**	**100**	**88.5**
Wholesale Markets	**35,802**	**5,584**	**15.6**	**2,009**	**36.0**
Treasury and Trading	**2,220**				
Asset Finance	**7,162**	**1,217**	**17.0**	**746**	**61.3**
Total Wholesale	**135,395**	**27,756**	**20.5**	**11,537**	**41.6**
Reverse repos	**16,836**				
Impairment provisions	**(11,537)**				
Fair value adjustments	**(617)**				
Loans and advances to customers	**140,077**				
Loans and advances to banks	**8,443**				
Debt securities[2]	**12,489**				
Available-for-sale financial assets[3]	**12,554**				

1 Impairment provisions include collective unimpaired provisions.

2 Of which Wholesale Markets is £12,135 million, Wholesale Equity £195 million, Treasury and Trading £150 million, Asset Finance £7 million, and Corporate £2 million.

3 Of which Wholesale Markets is £7,798 million, Wholesale Equity £1,797 million, Treasury and Trading £2,922 million and Corporate £37 million.

	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 2010					
Corporate	80,670	6,635	8.2	3,629	54.7
Corporate Real Estate BSU	26,151	17,518	67.0	8,092	46.2
Wholesale Equity	140	108	77.1	107	99.1
Wholesale Markets	40,042	5,718	14.3	1,992	34.8
Treasury and Trading	1,050				
Asset Finance	9,949	1,679	16.9	1,043	62.1
Total Wholesale	158,002	31,658	20.0	14,863	46.9
Reverse repos	3,096				
Impairment provisions	(14,863)				
Fair value adjustments	(1,562)				
Loans and advances to customers	144,673				
Loans and advances to banks	12,401				
Debt securities[2]	25,779				
Available-for-sale financial assets[3]	29,458				

1 Impairment provisions include collective unimpaired provisions.

2 Of which Wholesale Markets is £25,120 million, Wholesale Equity £487 million, Treasury and Trading £163 million, Asset Finance £7 million, Corporate £2 million and Commercial £2 million.

3 Of which Wholesale Markets is £21,279 million, Wholesale Equity £2,109 million, Treasury and Trading £6,011 million and Corporate £59 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CORPORATE

The £68,772 million of loans and advances to customers in the Corporate portfolio is structured across a number of different portfolios and sectors as detailed below:

UK Corporate Major Corporate balance sheets remained relatively stable during the first half of 2011 with corporates continuing to reduce debt and build up liquidity reserves. Mergers and acquisition activity has been minimal and focus has been on refinancing existing facilities. In line with economic commentary, some consumer related sectors in the UK are now feeling the impact of a slowdown in spending. Commodity price volatility is a potential concern in terms of required funding and customer profitability.

Financial Institutions Continuing concerns over sovereign fiscal deficits and public sector debt levels have necessitated increased scrutiny and risk reduction to the European banking sector, in particular banks domiciled in the weaker Eurozone countries. Trading exposures are in large part either short term and/or collateralised and inter bank lending activity is mainly very short term with strong investment grade counterparties.

Mid-Markets Corporate Customers in this sector are predominantly UK-focused and mainly dependent on the performance of the domestic economy. Some clients trading has, unsurprisingly, proved challenging in a number of sectors in 2011, particularly those reliant on consumer discretionary expenditure. Retail, hotels, leisure and construction have all been vulnerable to the wider economic environment during the year, with the majority of impairments in the year arising in these sectors. The impact of public sector austerity measures has also been evident in some sectors, with these also contributing to the impairment charge in the year. The mid-markets segment of the UK Corporate market appears to have limited direct vulnerability to events in the weaker Eurozone countries, however the segment is more directly exposed to any flow-through effect on the UK economy resulting from weaker export demand.

US Corporate The business continues to be predominately investment grade focused and the balance sheets of US Major Corporates remain relatively strong, with good levels of liquidity. The reduction in the element of the corporate portfolio that is not central to the Group s strategy has continued through a combination of secondary sales, refinancings, and realisation of property assets. The year-end impairment position is one of modest net write backs with new impairments on existing cases more than offset by recoveries. Overall, portfolio asset quality remains strong.

Corporate Real Estate Outside of London and the South East, activity in the Corporate Real Estate market remains weak, in part due to declining values and the focus on only prime properties and prime tenants. Rental growth, where achievable by clients in the regions, is slow. Market demand 2 for debt is low, especially for new facilities from customers within the Group s risk appetite, despite messaging that the Group is open for business which meets its lending criteria. Customers are adopting a wait and see approach, de-gearing where they can, and conserving cash. In addition, with a significant proportion of its assets supporting property investments, tenant default is an area of continuing vulnerability especially where the lending is underpinned by secondary or tertiary assets. With a continuing high level of loan maturities due over the next few years, refinancing risk remains a market-wide issue. However, the Group s core portfolios are characterised by strong management teams with proven asset management skills and/or acceptable lease maturity profiles with borrowers meeting their interest cover and debt service obligations. New propositions are structured and priced in line with the Group s prudent risk appetite.

Corporate Real Estate Business Support Unit

The Corporate Real Estate Business Support Unit has continued to make strong progress executing on its active asset management programme for the complex portfolio of over 1800 cases it manages. This has resulted in a further fall in the impairment total to £1,273 million (2010: £2,427 million), after the peak experienced in 2009.
Despite capital values improving 17.8 per cent from their trough in 2009, the Group has seen the improving trend in the real estate market in 2011 weaken for all but prime or central London based real estate.

The management of the portfolio has focussed on continuing to support its long-term customers and at the same time reduce the exposure to real estate through managed sales, which has resulted in a realisation of over £4.8 billion of cash receipts in 2011 despite the worsening transactional market. In addition there has been over £5 billion of restructurings undertaken with longer term facilities put in place to support the customer base.

Over the past two years, a total of over £8.5 billion of asset sales through managed disposals has occurred which has resulted in an overall £14.6 billion reduction of gross loan exposure in the UK. The Group has also concluded one of the largest loan portfolio sales in the market in December which provided a significant £923 million deleveraging of its real estate exposure.

During the year a number of new initiatives have been introduced including the sale of assets specifically grouped under receivership, which is the first time such a sale has been achieved; and an arrangement with a publicly quoted asset manager to facilitate certain residential portfolios through the receivers. Such arrangements demonstrate the Group s desire to find solutions to ensure that it maximises the recovery from these loan positions or portfolios through managing for value the underlying real estate and it continues to seek innovative ways to achieve this aim.

Wholesale Equity

The Wholesale Equity portfolio (assets representing Equity Risk including ordinary equity, preference shares and debt securities) totals £4.9 billion (split £3.8 billion on balance sheet commitments and £1.1 billion as yet undrawn, the majority of which relates to Lloyds Development Capital and the Funds Investment business).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The overall size of the portfolio has shown a downward trend in the second half of 2011, in the main due to significant disposals of a number of assets from the Project Finance business. Continuing concerns around sovereign debt in the Eurozone and disappointing economic data from the major economies has resulted in ongoing volatility in equity markets.

Wholesale Markets

Loans and advances to customers of £35.8 billion largely comprise balances in the Structured Corporate Finance portfolio, which includes Acquisition Finance (leveraged lending), Project Finance and Asset Based Finance (Ship Finance, Aircraft Finance, Rail Capital and Corporate Asset Finance). The dampened effect of UK economic conditions has been felt in the Acquisition Finance portfolio resulting in a higher impairment charge on leveraged exposures during 2011 compared to 2010. However, a number of sectors remain vulnerable, especially retail, leisure and healthcare, and refinancing risk is also an issue, with significant loan maturities due in the next few years. In Ship Finance, the outlook for the container, tanker and dry bulk sectors is challenging. Wholesale Markets is also responsible for the Treasury Assets portfolio which mainly encompasses a portfolio of Asset-Backed Securities and financial institution Floating Rate Note positions. Portfolio credit quality remained relatively stable over the year and the portfolio size continues to be actively reduced through asset sales and from bond maturities. Further details of Wholesale Division s Asset-Backed Securities portfolio is provided in Note 56 to the financial statements.

Treasury and Trading

Treasury and Trading acts as the link between the wholesale markets and the Group s balance sheet management activities and provides pricing and risk management solutions to both internal and external clients.
The portfolio comprises £6.0 billion of loans and advances to banks, £2.9 billion of Available-for-Sale debt securities and £2.2 billion of loans and advances to customers (excluding reverse repos).

The majority of Treasury and Trading s funding and risk management activity is transacted with investment grade counterparties including Sovereign central banks and much of it is on a secured basis, such as repos facing a Central Counterparty (CCP). Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement. During the year Lloyds Banking Group became a member of LCH SwapClear as part of a move to reduce counterparty risk by clearing standardised derivative contracts through a CCP. Treasury and Trading has reduced the government bond portfolio in response to growing concern over market conditions in the Eurozone resulting in minimal exposure to weaker Eurozone sovereigns. The credit quality of the government bond portfolio is almost solely AAA/AA rated sovereign debt.

Asset Finance

There has been a marginal improvement in credit quality in relation to the retail portfolios during the year. Impairments remain lower than anticipated, particularly in the Personal Financial Services portfolios and the retail motor loans portfolio. Asset quality also continues to improve in response to the continuing strategy to enhance the quality of new business written (especially Motor Finance) and following the closure of Personal Financial Services to new business. The credit quality profile across the non-retail portfolios also remains relatively stable, and underlying impairment levels have reduced against 2010 levels, reflecting a material slow down in new default cases.

CREDIT RISK COMMERCIAL

Overview

- Impairment losses for 2011 decreased significantly to £303 million, from £382 million for 2010.
- The decrease reflects the continued application of the Group s prudent credit risk appetite approach and the benefits of the low interest rate environment which has helped maintain defaults at a lower level.
- Portfolio metrics including delinquencies and assets under close monitoring have generally remained steady or improved.
- Due to the continuing uncertainty regarding the economic outlook, the Group remains cautious. Downward pressures on consumer spending from a weakening labour market, still-high household indebtedness and rising Government budgetary pressures continue to imply vulnerability for a number of sectors, most notably retail, motor traders and restaurants.

Commercial continues to operate rigorous processes to enhance control and monitoring activities which play a crucial role in identifying customers showing early signs of financial distress and bringing them into the Group s support model.

Commercial s impairment charge decreased £79 million, or 21 per cent, compared to £382 million during 2010. This reflects the continued application of a prudent credit risk appetite for new business and a low interest rate environment helping to maintain defaults at a lower level. Impairment charges as an annualised percentage of average loans and advances to customers reduced to 1.06 per cent from 1.24 per cent in 2010. The majority of the business is based around full banking relationships. The relatively small portfolio of lending outside of the Group s risk appetite has continued to reduce throughout 2011.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impaired loans and provisions

Commercial s impaired loans increased by £59 million to £2,915 million compared with 31 December 2010. Despite this small increase, impairment provisions reduced. This is as a result of lower default rates at the smaller end of the portfolio and write-offs. As a result, impairment provisions as a percentage of impaired loans reduced to 30.2 per cent from 34.7 per cent at 31 December 2010. As a percentage of closing loans and advances to customers, impaired loans increased to 9.8 per cent from 9.6 per cent at 31 December 2010.

Table 1.28: **Impaired loans and provisions (audited)**

	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 2011					
Commercial	**29,681**	**2,915**	**9.8**	**880**	**30.2**
Impairment provisions	**(880)**				
Fair value adjustments	**(51)**				
Loans and advances to customers	**28,750**				
At 31 December 2010					
Commercial[2]	29,649	2,856	9.6	992	34.7
Impairment provisions	(992)				
Fair value adjustments	(103)				
Loans and advances to customers	28,554				

1 Impairment provisions include collective unimpaired provisions.
2010 figures have been restated for transfers from Corporate.

CREDIT RISK WEALTH AND INTERNATIONAL

Overview

In Wealth and International, impairment charges totalled £4,610 million, a decrease of 23 per cent from £5,988 million in 2010. The reduction predominantly reflects lower impairment charges in the Group s Irish portfolio where the rate of impaired loan migration has slowed.

Impairment coverage has increased in Ireland to 62 per cent from 54 per cent, primarily reflecting further falls in the commercial real estate market during 2011, and further vulnerability exists.

On the Irish Wholesale portfolio, 84 per cent of the portfolio is now impaired at a coverage ratio of 61 per cent.

On the Irish Retail portfolio, impairment provisions as a percentage of impaired loans has increased to 73 per cent against a backdrop of falling house prices and an increase in borrowers falling into arrears.

Further provisioning has been necessary in the Group s Australasian portfolio primarily reflecting geographical real estate concentrations where market conditions and asset valuations have remained weak in 2011.

The Group has also significantly reduced its exposure in its Australasian business by Aus $2.1 billion including the successful disposal of a £1 billion portfolio of impaired Australasian real estate loans in the last quarter of 2011. The levels of disposals during the year represent 40 per cent of the gross impaired portfolio.

The majority of Wealth and International s assets are not central to the Group s strategy and in run-off.

Table 1.29: **Wealth and International impairment charge (audited)**

	2011 £m	2010 £m	Change %
Wealth	**100**	46	(117)
International:			
Ireland	**3,187**	4,264	25
Australia	**1,034**	1,362	24
Wholesale Europe	**204**	210	3
Other International	**85**	106	20
	4,510	5,942	24
Total impairment charge	**4,610**	5,988	23

Wealth and International s impairment charge in 2011 almost entirely related to portfolios that are not central to the Group s strategy. The impairment charge decreased by £1,378 million to £4,610 million compared with 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 7.37 per cent from 8.9 per cent in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impaired loans and provisions

Total impaired loans increased by £434 million to £20,776 million compared with £20,342 million at 31 December 2010 and as a percentage of closing loans and advances to customers increased to 36.8 per cent from 30.7 per cent at 31 December 2010. The increase in impaired loans predominantly relates to the Group s book in Ireland where impaired loans increased during 2011 reflecting ongoing difficulties in the economy. This results in 66 per cent of the total Irish portfolio now being classified as impaired (84 per cent wholesale). Impaired loans in the Australasian book reduced by £1.4 billion driven by write offs and impaired asset disposals.

Impairment provisions as a percentage of impaired loans increased to 60.6 per cent from 52.5 per cent at 31 December 2010. The coverage ratio in the Group s Irish Portfolio has increased further reflecting continuing weakness in real estate markets where further vulnerability exists.

Table 1.30: **Impairments on Wealth and International loans and advances (audited)**

	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 2011					
Wealth	**8,781**	**399**	**4.5**	**162**	**40.6**
International:					
Ireland Retail	**7,036**	**1,415**	**20.1**	**1,034**	**73.1**
Ireland Wholesale	**17,737**	**14,945**	**84.3**	**9,133**	**61.1**
Australia	**9,745**	**2,780**	**28.5**	**1,609**	**57.9**
Wholesale Europe	**6,356**	**978**	**15.4**	**475**	**48.6**
Other	**6,739**	**259**	**3.8**	**170**	**65.6**
	47,613	**20,377**	**42.8**	**12,421**	**61.0**
Wealth and International	**56,394**	**20,776**	**36.8**	**12,583**	**60.6**
Impairment provisions	**(12,583)**				
Fair value adjustments	**(42)**				
Total Wealth and International	**43,769**				
At 31 December 2010					
Wealth	9,472	353	3.7	116	32.9
International:					
Ireland Retail	7,673	870	11.3	616	70.8
Ireland Wholesale	19,755	13,575	68.7	7,147	52.6
Australia	14,587	4,187	28.7	2,208	52.7
Wholesale Europe	7,322	1,007	13.8	420	41.7
Other	7,559	350	4.6	177	50.6
	56,896	19,989	35.1	10,568	52.9
Wealth and International	66,368	20,342	30.7	10,684	52.5
Impairment provisions	(10,684)				
Fair value adjustments	(327)				
Total Wealth and International	55,357				

1 Impairment provisions include collective unimpaired provisions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Wealth

Total impaired loans increased by £46 million, or 13 per cent to £399 million compared with £353 million at 31 December 2010 and as a percentage of closing loans and advances increased to 4.6 per cent from 3.7 per cent at 31 December 2010. Impairment charges increased by £54 million to £100 million compared with 2010 primarily due to increased charges in the Group s Spanish mortgage book reflecting a deteriorating housing market and economy in Spain. Impairment charges as a percentage of average loans and advances to customers increased to 1.1 per cent from 0.5 per cent in 2010.

Ireland

Total impaired loans increased by £1,915 million, or 13 per cent to £16,360 million compared with £14,445 million at 31 December 2010 and as a percentage of closing loans and advances increased to 66.0 per cent from 52.7 per cent at 31 December 2010. Impairment charges decreased by £1,077 million to £3,187 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 11.9 per cent from 15.4 per cent in 2010.
Continuing weakness in the Irish real estate markets resulted in a further increase in impaired wholesale loans and coverage in 2011. The majority of Irish retail provisions relate to a residential mortgage portfolio where impairment charges have increased in relation to 2010 due to a continued decline in residential property prices and higher arrears levels, including customers on a forbearance arrangement.

Table 1.31: **Impairments on Ireland loans and advances (audited)**

	2011			2010		
	Gross loans £m	**Impaired loans £m**	**Provisions £m**	Gross loans £m	Impaired loans £m	Provisions £m
Commercial Real Estate	**10,872**	**9,807**	**6,194**	11,685	9,232	4,791
Corporate	**6,865**	**5,138**	**2,939**	8,070	4,343	2,356
Retail	**7,036**	**1,415**	**1,034**	7,673	870	616
Total	**24,773**	**16,360**	**10,167**	27,428	14,445	7,763

The most significant contribution to impairment in Ireland is the Commercial Real Estate portfolio. Impairment provisions provide 63 per cent coverage on impaired commercial real estate loans. Mortgage lending at the year end comprised 99 per cent of the retail portfolio with impaired loans of £1.4 billion and impairment coverage of 70 per cent.

£2.6 billion of wholesale lending within the Commerical Real Estate and corporate portfolios relates to sterling loans secured on UK property.

Within the Commercial Real Estate portfolio, over 90 per cent of the portfolio is now impaired. The average impairment coverage ratio has increased in the year to 63 per cent (52 per cent 31 December 2010) reflecting the continued deteriorating Irish economic conditions and Irish commercial property market.

The Group has successfully started to reduce its exposure to Ireland with disposals in excess of 1 billion in the period broadly in line with current provisioning levels.

Australasia

Total impaired loans decreased by £1,407 million, or 34 per cent to £2,780 million compared with £4,187 million at 31 December 2010. The decrease in impaired loans in the period is as a result of impaired asset disposals and write offs partially offset by further migration of cases to impaired status. Total impaired loans as a percentage of closing loans and advances decreased to 28.5 per cent from 28.7 per cent at 31 December 2010.
Impairment charges decreased by £328 million to £1,034 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 8.2 per cent from 9.3 per cent in 2010.

Impairment on the Group s Commercial Real Estate portfolio in Australasia was the main contributor to the full year charge. This portfolio is exposed to Australian non-metropolitan real estate markets where market conditions and asset valuations in 2011 have remained weak. The Group has significantly reduced its remaining exposure to these markets following the successful disposal of a £1 billion portfolio of loans during the last quarter of 2011 in the Group s two most challenging markets (Gold Coast and New

Zealand). A specific charge of £70 million was also incurred in the period as a result of losses arising from the earthquake in New Zealand.

Wholesale Europe

Total impaired loans decreased by £29 million, or 3 per cent to £978 million compared with £1,007 million at 31 December 2010 and as a percentage of closing loans and advances increased to 15.4 per cent from 13.8 per cent at 31 December 2010. Impairment charges decreased by £5 million to £204 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers increased to 2.9 per cent compared to 2.8 per cent in 2010. Commercial real estate was the primary driver of the impairment charge in Wholesale Europe reflecting provisions on a small number of specific transactions.

Other International

Impairments mainly relate to the corporate business in Dubai and the Dutch mortgage business. Total impaired loans decreased by £91 million, or 26 per cent to £259 million compared with £350 million at 31 December 2010 and as a percentage of closing loans and advances decreased to 3.8 per cent from 4.6 per cent at 31 December 2010. Impaired loans predominantly relate to a limited number of corporate exposures and the reduction in impaired balances primarily reflects write offs in respect of two loans that have been exited in the period. Impairment charges decreased by £21 million to £85 million compared to 2010. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 1.2 per cent from 1.3 per cent in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EXPOSURES TO SELECTED EUROZONE COUNTRIES

The following section summarises the Group s direct exposure to certain European countries which have been identified on the basis of a Standard & Poor s rating of A or less, as at 31 December 2011. The exposures are shown at their balance sheet carrying values 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 and corporates. Indirect risk is taken into account, where it is determined that counterparties have material direct exposures to the selected countries.

The Group has established a Eurozone Instability Steering Group in order to monitor developments within the Eurozone on a daily basis, carry out stress testing through detailed scenario analysis and complete appropriate due diligence on the Group s exposures.

The following tables summarise exposures to the selected Eurozone countries by type of counterparty:

Table 1.32: **Eurozone exposure by counterparty (unaudited)**

	Greece	Ireland	Italy	Portugal	Spain	Total
	£m	£m	£m	£m	£m	£m
At 31 December 2011						
Direct sovereign exposure			**16**		**17**	**33**
Central Bank balances					**35**	**35**
Banks		**207**	**433**	**142**	**1,692**	**2,474**
Asset backed securities	**55**	**376**	**39**	**341**	**375**	**1,186**
Other financial institutions		**272**	**88**	**19**	**27**	**406**
Other corporate	**431**	**8,894**	**81**	**298**	**2,935**	**12,639**
Retail		**6,027**		**11**	**1,649**	**7,687**
Insurance assets		**68**	**47**		**39**	**154**
	486	**15,844**	**704**	**811**	**6,769**	**24,614**
At 31 December 2010						
Direct sovereign exposure			31		54	85
Central Bank balances					44	44
Banks		1,818	596	362	2,437	5,213
Asset backed securities	75	867	594	447	987	2,970
Other financial institutions		74	151	65	146	436
Other corporate	473	11,632	228	267	2,769	15,369
Retail		7,202		10	1,769	8,981
Insurance assets		107	294		110	511
	548	21,700	1,894	1,151	8,316	33,609

In addition to the above countries, the Group has total exposures with six other European countries which are rated A or below. No balance with one individual country exceeds £350 million. These balances primarily relate to corporate exposures.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Direct sovereign exposures The Group s sovereign exposures are primarily to the UK and 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. Total exposures to the selected countries are £33 million (December 2010: £85 million) and are primarily in respect of loans and advances held at amortised cost, with no impairments recognised. Direct sovereign exposures include those to the Export Credit Agencies for Italy and Spain. Since 2009, the Group has proactively managed and reduced limits and exposures to these countries. Derivatives with sovereigns and sovereign referenced credit default swaps are insignificant.

In addition to direct sovereign exposures, the Group maintains deposit balances with a number of European Central banks for regulatory and liquidity management purposes. For the selected countries, the Group has a central bank balance with Spain of £35 million (2010: £44 million).

Table 1.33: **Exposures to Banks (unaudited)**

	Greece £m	**Ireland £m**	**Italy £m**	**Portugal £m**	**Spain £m**	**Total £m**
At 31 December 2011						
Amortised cost		**46**	**41**	**17**	**33**	**137**
Available for sale:						
Cost		**193**	**194**	**198**	**1,848**	**2,433**
AFS reserve		**(57)**	**(14)**	**(74)**	**(300)**	**(445)**
		136	**180**	**124**	**1,548**	**1,988**
Net trading assets			**188**		**59**	**247**
Derivatives net CDS assets and liabilities						
Derivatives other		**25**	**24**	**1**	**52**	**102**
Total exposure		**207**	**433**	**142**	**1,692**	**2,474**
At 31 December 2010						
Amortised cost		42	59	62	52	215
Available for sale:						
Cost		923	512	362	2,586	4,383
AFS reserve		(82)	(9)	(62)	(265)	(418)
		841	503	300	2,321	3,965
Net trading assets		919	25		38	982
Derivatives net CDS assets and liabilities			9			9
Derivatives other		16			26	42
Total exposure		1,818	596	362	2,437	5,213

Included within exposures to banks and other financial institutions, and treated as available for sale assets, are Covered Bonds of £1.7 billion (2010: £2.0 billion). The covered bonds are ultimately secured on a pool of mortgage assets in the countries concerned and benefit from over-collaterisation, with an overall weighted maturity of approximately five years.

Remaining exposures to banks held at amortised cost are predominantly short-term and relate to general banking facilities, money market and repo facilities and fixed and floating rate notes. No impairments are held against these exposures. In addition there are unitilised and uncommitted money market lines and repo facilities of approximately £1.7 billion predominantly in respect of Spanish and Italian banks. Bank limits have been closely monitored with amounts and tenors reduced where appropriate.

Net trading assets relate to exposures within the credit trading market-making business. There has been a large reduction in trading assets in the year in line with the overall Group balance sheet.

Derivative balances are shown at fair value adjusted where master netting agreements exist and net of cash collateral of £155 million. There are credit default swap positions referenced to banking groups domiciled in Italy (net long of £1 million and net short of £4 million) and Spain (net short of £10 million).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.34: **Asset Backed Securities (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost	**32**	**221**	**26**	**208**	**211**	**698**
Available for sale:						
Cost	**44**	**268**	**14**	**219**	**213**	**758**
AFS reserve	**(21)**	**(113)**	**(1)**	**(86)**	**(49)**	**(270)**
	23	**155**	**13**	**133**	**164**	**488**
Total exposure	**55**	**376**	**39**	**341**	**375**	**1,186**
At 31 December 2010						
Amortised cost	37	558	467	241	600	1,903
Available for sale:						
Cost	51	417	149	261	471	1,349
AFS reserve	(13)	(108)	(22)	(55)	(84)	(282)
	38	309	127	206	387	1,067
Total exposure	75	867	594	447	987	2,970

Country of exposure for asset backed securities are based on the location of the underlying assets.

Within the asset backed securities exposures, the underlying assets are primarily residential mortgages. No impairments are held against these exposures. Significant exposure reductions were achieved during 2011, primarily through asset sales.

Table 1.35: **Other financial institutions (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost		**255**	**18**			**273**
Available for sale:						
Cost						
AFS reserve						
Net trading assets		**5**	**34**	**8**	**27**	**74**
Derivatives other		**12**	**36**	**11**		**59**
Total exposure		**272**	**88**	**19**	**27**	**406**
At 31 December 2010						
Amortised cost		33	43	58	77	211
Available for sale:						
Cost		23	4			27
AFS reserve						
		23	4			27
Net trading assets		17	99	5	68	189
Derivatives other		1	5	2	1	9
Total exposure		74	151	65	146	436

Exposures to other financial institutions primarily relate to balances held within insurance companies and funds. No impairments are held against these exposures.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.36: **Other Corporate Exposures (unaudited)**

	Greece £m	**Ireland £m**	**Italy £m**	**Portugal £m**	**Spain £m**	**Total £m**
At 31 December 2011						
Amortised cost:						
Gross exposure	**407**	**15,910**	**69**	**125**	**2,192**	**18,703**
Impairment allowances	**(43)**	**(7,961)**	**(1)**	**(25)**	**(149)**	**(8,179)**
	364	**7,949**	**68**	**100**	**2,043**	**10,524**
Net trading assets						
Derivatives other	**19**	**31**		**2**	**167**	**219**
On balance sheet exposures	**383**	**7,980**	**68**	**102**	**2,210**	**10,743**
Off balance sheet exposures	**48**	**914**	**13**	**196**	**725**	**1,896**
Total exposure	**431**	**8,894**	**81**	**298**	**2,935**	**12,639**
At 31 December 2010						
Amortised cost:						
Gross exposure	384	17,512	135	130	1,849	20,010
Impairment allowances	(19)	(6,561)	(7)	(2)	(111)	(6,700)
	365	10,951	128	128	1,738	13,310
Net trading assets		47				47
Derivatives other	6	36	2		38	82
On balance sheet exposures	371	11,034	130	128	1,776	13,439
Off balance sheet exposures	102	598	98	139	993	1,930
Total exposure	473	11,632	228	267	2,769	15,369

Other Corporate balances within individual countries comprise:

Greece The exposures in Greece principally relate to shipping loans to Greek shipping companies where the assets are generally secured and the vessels operate in international waters; repayment is mainly dependent on international trade and the industry is less sensitive to the Greek economy.

Ireland see page 104 for further details on Irish exposures.

Italy and Portugal exposures comprise lending to corporates, including a small amount of commercial real estate exposure.

Spain The corporate exposure in Spain is mainly local lending (90 per cent of the total Spanish exposures) comprising corporate loans and project finance facilities (81 per cent) and commercial real estate portfolio (19 per cent).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.37: **Retail Exposures (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011						
Amortised cost:						
Gross exposure		**7,061**		**11**	**1,685**	**8,757**
Impairment allowances		**(1,034)**			**(70)**	**(1,104)**
On balance sheet exposures		**6,027**		**11**	**1,615**	**7,653**
Off balance sheet exposures					**34**	**34**
Total exposure		**6,027**		**11**	**1,649**	**7,687**
At 31 December 2010						
Amortised cost:						
Gross exposure		7,818		10	1,712	9,540
Impairment allowances		(616)			(35)	(651)
On balance sheet exposures		7,202		10	1,677	8,889
Off balance sheet exposures					92	92
Total exposure		7,202		10	1,769	8,981

Retail exposures within Spain are predominantly secured residential mortgages, where about half of the borrowers are expatriates. Impaired lending represents 6 per cent (December 2010: 6 per cent) of the portfolio, with a coverage ratio of 49 per cent (December 2010: 31 per cent). See page 104 for further details on Irish exposures.

Table 1.38: **Insurance Assets (unaudited)**

	Greece £m	Ireland £m	Italy £m	Portugal £m	Spain £m	Total £m
At 31 December 2011		**68**	**47**		**39**	**154**
At 31 December 2010		107	294		110	511

Assets held by the Insurance Business are held outside the with profits and unit linked funds. Approximately £127 million of these exposures relate to direct investments where the issuer is resident in Spain, Italy or Ireland and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. The remaining exposures relate to interests in two funds administered by SWIP (the Global Liquidity Fund and the Short Term Fund) where in line with the investment mandates, cash is invested in the money markets. For these funds, which are domiciled in Ireland, the exposure is analysed on a look through basis to the underlying assets held and the Insurance business s pro rata share of these assets rather than treating all the holding in the fund as exposure to Ireland. Within the above exposures there are no sovereign exposures.

Table 1.39: **Other European Exposures (unaudited)**

The Group has the following exposures to sovereigns, banks, asset backed securities and other financial institutions in the following European countries:

	Austria £m	Belgium £m	France £m	Germany £m	Luxembourg £m	Netherlands £m	Switzerland £m
At 31 December 2011							
Direct sovereign exposure	**2**	**74**	**217**	**656**	**2**		

Central Bank balances		**4**		**203**	**3**	**9,594**	**125**
Banks	**202**	**404**	**1,517**	**1,291**	**4**	**712**	**937**
Asset backed securities			**525**	**703**		**176**	
Other financial institutions	**5**	**11**	**143**	**100**	**14**	**173**	**77**
At 31 December 2010							
Direct sovereign exposure		78	842	1,837	153	2	
Central Bank balances		3	4	70	4	10,846	297
Banks	762	1,009	1,675	3,007	35	1,342	1,072
Asset backed securities	-	75	806	1,678	7	1,319	
Other financial institutions	289	21	308	313	34	788	74

Banks and Financial Institutions in the above countries may have exposures to other European countries that have Standard and Poor s rating of A or lower.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 now 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.

(unaudited)	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Loans and advances to banks	**32,620**	30,292	35,510	38,868	34,845
Loans and advances to customers:					
Mortgages	**348,210**	356,261	362,667	114,643	102,739
Other personal lending	**30,014**	36,967	42,958	25,318	22,988
Agriculture, forestry and fishing	**5,198**	5,558	5,130	3,969	3,226
Energy and water supply	**4,013**	3,576	3,031	2,598	2,102
Manufacturing	**10,061**	11,495	14,912	12,057	8,385
Construction	**9,722**	7,904	10,830	3,016	2,871
Transport, distribution and hotels	**32,882**	34,176	31,820	14,664	11,573
Postal and telecommunications	**1,896**	1,908	1,662	1,060	946
Financial, business and other services	**64,046**	59,363	66,923	33,319	29,707
Property companies	**64,752**	78,263	83,820	23,318	17,576
Lease financing	**7,800**	8,291	9,307	4,546	4,686
Hire purchase	**5,776**	7,208	8,710	5,295	5,423
Total loans	**616,990**	641,262	677,280	282,671	247,067
Allowance for impairment losses	**(18,746)**	(18,393)	(14,950)	(3,594)	(2,408)
Total loans and advances net of allowance for impairment losses	**598,244**	622,869	662,330	279,077	244,659

The analysis of loans and advances as at 31 December 2011, 2010 and 2009 between domestic and international offices is as follows:

(unaudited)	2011 £m	2010 £m	2009 £m
Domestic			
Loans and advances to banks	**31,852**	28,544	29,475
Loans and advances to customers:			
Mortgages	**331,715**	334,531	344,151
Other personal lending	**28,244**	34,610	40,790
Agriculture, forestry and fishing	**5,010**	5,429	4,829
Energy and water supply	**1,689**	1,583	1,141
Manufacturing	**8,055**	9,599	11,480
Construction	**7,885**	6,814	6,554
Transport, distribution and hotels	**27,232**	26,156	22,713
Postal and telecommunications	**1,491**	1,391	973
Financial, business and other services	**56,721**	49,931	58,132

Property companies	**49,561**	59,163	64,069
Lease financing	**6,792**	7,351	8,426
Hire purchase	**5,237**	6,319	7,671
Total loans	**561,484**	571,421	600,404
Allowance for impairment losses	**(8,025)**	(9,786)	(9,995)
Total loans and advances net of allowance for impairment losses	**553,459**	561,635	590,409

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

(unaudited)	2011 £m	2010 £m	2009 £m
International			
Loans and advances to banks	**768**	1,748	6,035
Loans and advances to customers:			
Mortgages	**16,495**	21,730	18,516
Other personal lending	**1,770**	2,357	2,168
Agriculture, forestry and fishing	**188**	129	301
Energy and water supply	**2,324**	1,993	1,890
Manufacturing	**2,006**	1,896	3,432
Construction	**1,837**	1,090	4,276
Transport, distribution and hotels	**5,650**	8,020	9,107
Postal and telecommunications	**405**	517	689
Financial, business and other services	**7,325**	9,432	8,791
Property companies	**15,191**	19,100	19,751
Lease financing	**1,008**	940	881
Hire purchase	**539**	889	1,039
Total loans	**55,506**	69,841	76,876
Allowance for impairment losses	**(10,721)**	(8,607)	(4,955)
Total loans and advances net of allowance for impairment losses	**44,785**	61,234	71,921

(unaudited)	2011 £m	2010 £m	2009 £m
Total			
Loans and advances to banks	**32,620**	30,292	35,510
Loans and advances to customers:			
Mortgages	**348,210**	356,261	362,667
Other personal lending	**30,014**	36,967	42,958
Agriculture, forestry and fishing	**5,198**	5,558	5,130
Energy and water supply	**4,013**	3,576	3,031
Manufacturing	**10,061**	11,495	14,912
Construction	**9,722**	7,904	10,830
Transport, distribution and hotels	**32,882**	34,176	31,820
Postal and telecommunications	**1,896**	1,908	1,662
Financial, business and other services	**64,046**	59,363	66,923
Property companies	**64,752**	78,263	83,820
Lease financing	**7,800**	8,291	9,307
Hire purchase	**5,776**	7,208	8,710
Total loans	**616,990**	641,262	677,280
Allowance for impairment losses	**(18,746)**	(18,393)	(14,950)
Total loans and advances net of allowance for impairment losses	**598,244**	622,869	662,330

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

(unaudited)	**2011 £m**	2010 £m	2009 £m	2008 £m	2007 £m
Balance at beginning of year	**18,393**	14,950	3,594	2,408	2,194
Exchange and other adjustments	**(369)**	(7)	112	43	2
Advances written off:					
Loans and advances to customers:					
Mortgages	**(86)**	(145)	(77)	(23)	(25)
Other personal lending	**(2,617)**	(3,344)	(3,063)	(1,206)	(1,256)
Agriculture, forestry and fishing	**(11)**	(47)	(5)	(2)	(1)
Energy and water supply	**(48)**	(36)	(28)	(24)	(11)
Manufacturing	**(137)**	(385)	(148)	(34)	(13)
Construction	**(92)**	(365)	(336)	(11)	(4)
Transport, distribution and hotels	**(329)**	(742)	(80)	(50)	(24)
Postal and telecommunications	**(1)**		(9)		
Financial, business and other services	**(1,120)**	(881)	(308)	(169)	(95)
Property companies	**(2,630)**	(846)	(51)	(6)	
Lease financing	**(224)**	(15)	(26)	(2)	(26)
Hire purchase	**(192)**	(160)	(69)	(59)	(87)
Loans and advances to banks	**(6)**	(111)			
Total advances written off	**(7,493)**	(7,077)	(4,200)	(1,586)	(1,542)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	**26**	12	1	1	2
Other personal lending	**326**	176	107	102	121
Energy and water supply		4			
Manufacturing		2			1
Construction		1			
Transport, distribution and hotels	**1**	4		1	1
Financial, business and other services		1	2	3	3
Property companies		16			
Hire purchase	**68**			5	9
Total recoveries of advances written off	**421**	216	110	112	137
Total net advances written off	**(7,072)**	(6,861)	(4,090)	(1,474)	(1,405)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

(unaudited)	**2011 £m**	2010 £m	2009 £m	2008 £m	2007 £m
Effect of unwinding of discount recognised through interest income	**(226)**	(403)	(446)	(102)	(104)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	**444**	196	343	171	18
Other personal lending	**1,669**	3,431	4,314	1,455	1,313
Agriculture, forestry and fishing	**27**	20	29	2	4
Energy and water supply	**105**	17	105	35	18
Manufacturing	**206**	203	747	122	19
Construction	**350**	463	842	61	8
Transport, distribution and hotels	**884**	800	1,553	66	39
Postal and telecommunications	**15**	32	24		
Financial, business and other services	**1,464**	1,293	1,913	491	151
Property companies	**2,776**	4,114	5,418	73	1
Lease financing	**60**	57	261	1	35
Hire purchase	**20**	101	234	107	116
Loans and advances to banks		(13)	(3)	135	(1)
Total allowances for impairment losses charged against income for the year	**8,020**	10,714	15,780	2,719	1,721
Total balance at end of year	**18,746**	18,393	14,950	3,594	2,408
Ratio of net write-offs during the year to average loans outstanding during the year	**1.2%**	1.1%	0.6%	0.6%	0.7%

The Group s impairment allowances in respect of loans and advances to banks and customers increased by £353 million, or 2 per cent, from £18,393 million at 31 December 2010 to £18,746 million at 31 December 2011. This increase resulted from a charge to the income statement of £8,020 million partly offset by net advances written off of £7,072 million (advances written off of £7,493 million less recoveries of £421 million). Of the total charge to the income statement of £8,020 million, £3,935 million arose in the UK and £4,085 million related to the Group s international businesses, dominated by continuing credit losses suffered in Ireland and Australia following the particular deterioration in economic conditions in those countries in recent years; although in both cases there was some reduction in the level of charges compared to 2010. By category of lending, the most significant elements of the charge to the income statement were £2,776 million in respect of property companies and £1,669 million in respect of other personal lending. The largest element of the domestic charge was £1,670 million in respect of other personal lending which arose mainly in the Retail division and was lower than in 2010 following improved arrears experience as a result of the Group s approach to credit risk, its focus on lending to existing customers, lower interest rates and lower overall balances. The charge in respect of property lending arose mainly overseas and again reflects losses in Ireland and Australia where much of the Group s credit exposure is in the commercial property sectors. Of the net advances written off of £7,072 million, £5,358 million arose in the UK and £1,714 million overseas; by category of lending £2,291 million related to other personal lending, £1,120 million related to financial, business and other services and £2,630 million to property companies. The continuing high level of write-offs reflects the progress of the impaired lending against which the Group has made significant allowances in recent years.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the years ended 31 December 2011, 2010 and 2009 between domestic and international offices is as follows:

	2011			2010			2009		
(unaudited)	**Domestic £m**	**Foreign £m**	**Total £m**	Domestic £m	Foreign £m	Total £m	Domestic £m	Foreign £m	Total £m
Balance at beginning of year	**9,786**	**8,607**	**18,393**	10,785	4,165	14,950	3,575	19	3,594
Exchange and other adjustments	**68**	**(437)**	**(369)**	42	(49)	(7)	171	(59)	112
Advances written off:									
Loans and advances to customers:									
Mortgages	**(56)**	**(30)**	**(86)**	(130)	(15)	(145)	(77)		(77)
Other personal lending	**(2,605)**	**(12)**	**(2,617)**	(3,322)	(22)	(3,344)	(3,062)	(1)	(3,063)
Agriculture, forestry and fishing	**(8)**	**(3)**	**(11)**	(8)	(39)	(47)	(5)		(5)
Energy and water supply	**(48)**		**(48)**	(16)	(20)	(36)	(28)		(28)
Manufacturing	**(105)**	**(32)**	**(137)**	(196)	(189)	(385)	(147)	(1)	(148)
Construction	**(38)**	**(54)**	**(92)**	(192)	(173)	(365)	(336)		(336)
Transport, distribution and hotels	**(247)**	**(82)**	**(329)**	(234)	(508)	(742)	(80)		(80)
Postal and telecommunications	**(1)**		**(1)**				(9)		(9)
Financial, business and other services	**(894)**	**(226)**	**(1,120)**	(827)	(54)	(881)	(308)		(308)
Property companies	**(1,594)**	**(1,036)**	**(2,630)**	(740)	(106)	(846)	(51)		(51)
Lease financing	**(120)**	**(104)**	**(224)**	(15)		(15)	(25)	(1)	(26)
Hire purchase	**(57)**	**(135)**	**(192)**	(160)		(160)	(69)		(69)
Loans and advances to banks	**(6)**		**(6)**	(111)		(111)			
Total advances written off	**(5,779)**	**(1,714)**	**(7,493)**	(5,951)	(1,126)	(7,077)	(4,197)	(3)	(4,200)
Recoveries of advances written off:									
Loans and advances to customers:									
Mortgages	**26**		**26**	12		12	1		1
Other personal lending	**326**		**326**	176		176	107		107
Agriculture, forestry and fishing									
Energy and water supply					4	4			
Manufacturing					2	2			
Construction					1	1			
Transport, distribution and hotels	**1**		**1**		4	4			
Postal and telecommunications									
Financial, business and other services					1	1	1	1	2
Property companies				12	4	16			
Hire purchase	**68**		**68**						
Total recoveries of advances written off	**421**		**421**	200	16	216	109	1	110
Total net advances written off	**(5,358)**	**(1,714)**	**(7,072)**	(5,751)	(1,110)	(6,861)	(4,088)	(2)	(4,090)

114

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

(unaudited)	2011 Domestic £m	2011 Foreign £m	2011 Total £m	2010 Domestic £m	2010 Foreign £m	2010 Total £m	2009 Domestic £m	2009 Foreign £m	2009 Total £m
Effect of unwinding of discount recognised through interest income	**(406)**	**180**	**(226)**	(474)	71	(403)	(446)		(446)
Allowances for impairment losses charged against income for the year:									
Loans and advances to customers:									
Mortgages	**24**	**420**	**444**	(27)	223	196	275	68	343
Other personal lending	**1,670**	**(1)**	**1,669**	2,690	741	3,431	3,714	600	4,314
Agriculture, forestry and fishing	**19**	**8**	**27**	5	15	20	2	27	29
Energy and water supply	**130**	**(25)**	**105**	30	(13)	17	24	81	105
Manufacturing	**110**	**96**	**206**	78	125	203	544	203	747
Construction	**168**	**182**	**350**	318	145	463	593	249	842
Transport, distribution and hotels	**298**	**586**	**884**	217	583	800	717	836	1,553
Postal and telecommunications	**(8)**	**23**	**15**	31	1	32	19	5	24
Financial, business and other services	**1,188**	**276**	**1,464**	696	597	1,293	1,670	243	1,913
Property companies	**287**	**2,489**	**2,776**	1,059	3,055	4,114	3,685	1,733	5,418
Lease financing	**48**	**12**	**60**	26	31	57	198	63	261
Hire purchase	**1**	**19**	**20**	74	27	101	135	99	234
Loans and advances to banks				(13)		(13)	(3)		(3)
Total allowances for impairment losses charged against income for the year	**3,935**	**4,085**	**8,020**	5,184	5,530	10,714	11,573	4,207	15,780
Total balance at end of year	**8,025**	**10,721**	**18,746**	9,786	8,607	18,393	10,785	4,165	14,950

The following table analyses the coverage of the allowance for loan losses by category of loans.

(unaudited)	**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 %	2008 Allowance £m	2008 Percentage of loans in each category to total loans %	2007 Allowance £m	2007 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	**14**	**5.3**	20	4.7	149	5.2	135	13.8		14.1
Loans and advances to customers:										
Mortgages	**948**	**56.4**	526	55.5	464	53.6	186	40.5	37	41.5
Other personal lending	**1,895**	**4.9**	3,541	5.8	3,419	6.3	2,047	9.0	1,795	9.3
Agriculture, forestry and fishing	**51**	**0.8**	16	0.9	33	0.8	5	1.4	5	1.3
Energy and water supply	**165**	**0.7**	108	0.6	120	0.4	33	0.9	22	0.9
Manufacturing	**475**	**1.6**	540	1.8	709	2.2	119	4.3	29	3.4
Construction	**898**	**1.6**	588	1.2	527	1.6	60	1.1	10	1.2
Transport, distribution and hotels	**2,117**	**5.3**	1,400	5.3	1,391	4.7	75	5.2	58	4.7
Postal and telecommunications	**62**	**0.3**	50	0.3	15	0.2		0.4		0.4
Financial, business and other services	**3,075**	**10.4**	2,451	9.3	2,108	9.9	596	11.7	232	12.0

Property companies	**8,710**	**10.5**	8,546	12.2	5,394	12.4	70	8.2	4	7.1
Lease financing	**92**	**1.3**	287	1.3	244	1.4	15	1.6	16	1.9
Hire purchase	**244**	**0.9**	320	1.1	377	1.3	253	1.9	200	2.2
Total balance at year end	**18,746**	**100.0**	18,393	100.0	14,950	100.0	3,594	100.0	2,408	100.0

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of the coverage of the allowance for loan losses at 31 December 2011, 2010 and 2009 between domestic and international offices is as follows:

	Domestic		**Foreign**		**Total**	
(unaudited) 2011	**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**

	Domestic		Foreign		Total	
(unaudited) 2010	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	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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

(unaudited) 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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 advances to customers				
(audited)	**Loans and advances to banks £m**	**Retail mortgages £m**	**Retail other £m**	**Wholesale £m**	**Total £m**	**Loans and advances designated at fair value through profit or loss £m**
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
31 December 2008						
Neither past due nor impaired	38,716	110,148	33,571	86,707	230,426	608
Past due but not impaired	17	3,134	1,146	555	4,835	

Impaired no provision required		479	150	1,253	1,882	
provision held	135	882	4,327	1,451	6,660	
Gross	38,868	114,643	39,194	89,966	243,803	608
31 December 2007						
Neither past due nor impaired	34,845	99,828	29,850	73,475	203,153	1,189
Past due but not impaired		2,153	966	639	3,758	
Impaired no provision required		415	100	293	808	
provision held		343	3,600	560	4,503	
Gross	34,845	102,739	34,516	74,967	212,222	1,189

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

		Loans and advances to customers				
(audited)	**Loans and advances to banks £m**	**Retail mortgages £m**	**Retail other £m**	**Wholesale £m**	**Total £m**	**Loans and advances designated at fair value through profit or loss £m**
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	
31 December 2008						
0-30 days		1,527	853	289	2,669	
30-60 days		633	259	90	982	
60-90 days	17	424	32	70	526	
90-180 days		549	2	77	628	
Over 180 days		1		29	30	
Total	17	3,134	1,146	555	4,835	
31 December 2007						
0-30 days		1,123	781	266	2,170	
30-60 days		445	155	107	707	
60-90 days		260	29	129	418	
90-180 days		325	1	67	393	
Over 180 days				70	70	
Total		2,153	966	639	3,758	

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

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.

		Loans and advances to customers				
(audited)	**Loans and advances to banks £m**	**Retail mortgages £m**	**Retail other £m**	**Wholesale £m**	**Total £m**	**Loans and advances designated at fair value through profit or loss £m**
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
31 December 2008						
Good quality	38,283	109,815	21,373	49,349		129
Satisfactory quality	215	264	9,192	31,042		411
Lower quality	204		900	5,831		56
Below standard, but not impaired	14	69	2,106	485		12
Total	38,716	110,148	33,571	86,707	230,426	608
31 December 2007						
Good quality	34,647	99,407	18,157	46,240		191
Satisfactory quality	190	378	8,964	25,013		670
Lower quality	7	1	665	2,034		327
Below standard, but not impaired	1	42	2,064	188		1

Total	34,845	99,828	29,850	73,475	203,153	1,189

For further details see pages F-120 to F-126.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

(unaudited)	**2011 £m**
Interest income that would have been recognised under original contract terms	**2,819**
Interest income included in profit	**(1,405)**
Interest foregone	**1,414**

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 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.

As disclosed in note 56 to the financial statements loans that were renegotiated during the year and that would otherwise have been past due or impaired at the year end (2011: £2,505 million; 2010: £5,475 million; 2009: £3,919 million; 2008: £144 million; 2007: £579 million); see also page F-126.

The lending renegotiated in 2010 and 2011 is analysed as follows:

(audited)	**2011 £m**	2010 £m
Capitalisation of arrears	**1,677**	2,804
Interest rate adjustment	**28**	337
Payment holidays	**172**	221
Interest capitalisation	**269**	10
Forbearance of principal	**359**	2,103
Total	**2,505**	5,475

FORBEARANCE

Forbearance or repayment arrangements allow a mortgage customer to repay a monthly amount which is lower than their contractual monthly payment for a short period. This period is usually for no more than 12 months and is negotiated with the customer by the mortgage collectors. During the period of forbearance, there is no clearing down of arrears such that unless the customer is paying more than their contractual minimum payment, arrears balances will remain. When customers come to the end of their arrangement period they will continue to be managed as a mainstream collections case and if unable to recover then will move toward possession.

Customers can have their arrears balance capitalised once they have demonstrated they can pay the original contractual minimum payment, but are unable to clear their arrears. This is usually demonstrated by the customer making six consecutive contractual monthly payments. Customers are not however able to capitalise more than twice in a five year period. Capitalised mortgages will return to the non-impaired book and will be managed in accordance with the recapitalised terms of the mortgage.

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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

(unaudited)	% of assets	Total £m	Governments and official institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m
As at 31 December 2011:					
United States of America	**4.3**	**42,215**	**7,686**	**20,509**	**14,020**
Republic of Ireland[1]	**1.6**	**15,966**	**80**	**738**	**15,148**
As at 31 December 2010:					
United States of America	4.1	40,246	8,304	12,022	19,920
Republic of Ireland[1]	2.5	24,459	10	1,744	22,705
Germany	1.4	14,156	2,488	6,715	4,953
France	1.1	10,708	1,409	4,368	4,931
As at 31 December 2009:					
United States of America	1.9	19,033	3,266	2,548	13,219
France	1.4	14,126	768	2,932	10,426

1 Following the merger of Bank of Scotland (Ireland) Limited into Bank of Scotland plc, the Group s lending in Ireland is now held on the balance sheet of Bank of Scotland plc in the UK and constitutes a cross-border outstanding.

As at 31 December 2011, United States of America had commitments of £15,624 million and Republic of Ireland had commitments of £1,216 million.

As 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.

As at 31 December 2010 the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £15,714 million in total were Australia and the Netherlands. As at 31 December 2009, there were no countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Environmental risk management

The Group s businesses work in line with Group policies and procedures to manage the environmental impact of their lending activities. The Group wide Credit Risk Policy requires all business loans to be assessed for material environmental risks as part of the credit sanctioning process.

In 2011, the Group launched an electronic environmental risk screening system, which is the primary mechanism for assessing environmental risk in Wholesale. This provides real time screening of location specific and sector based risks that may be present in a transaction. Where a risk is identified, the transaction is referred to the Group s expert in-house Environmental Risk team for further review and assessment, as outlined below. Additional support is provided by the Group s panel of environmental consultants as required.

Table 1.40: **Environmental risk management approach**

Colleagues are trained in environmental risk management as part of the standard credit risk training course, and the team provides bespoke training to teams upon request. Supporting this training, a range of documents are provided to all colleagues online including environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Project Finance: Equator Principles

Lloyds Banking Group is a signatory to the Equator Principles. These support the approach to assessing and managing environmental and social issues in project finance. Project finance is often used to fund the development and construction of major infrastructure and industrial projects. The Equator Principles are applicable to project finance transactions above USD 10 million and provide a framework to support responsible decision-making.

The Group has a robust, groupwide approach to assess, monitor and report Equator Principle transactions. The Group also provides ongoing training for lending officers; information on the Equator Principles is included in all training and the Group offers more in-depth training for staff working in project finance.

Projects are categorised depending on the level of perceived risk and magnitude of impact they pose, in relation to a set of criteria issued by the International Finance Corporation (IFC).

The categories are as follows:

Category A Projects with potential significant adverse social or environmental impacts that are diverse, irreversible or unprecedented;

Category B Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible and readily addressed through mitigation measures; and

Category C Projects with minimal or no social or environmental impacts.

Lending officers are responsible for undertaking initial classification of transactions that qualify under the Equator Principles. Their assessments are subject to further review by the Group s in-house Environmental Risk team, and for higher risk transactions by the Equator Principles Review Group, comprising experts from both the Risk and Project Finance teams. This ensures that each transaction is compliant and is consistent with the environmental risk policy. The Group provides a range of training and support materials to its risk and transactional staff to ensure that they are familiar with the requirements of the Principles.

In 2011, the Group participated in the Equator Principles Strategic Review process which examined the scope of application, transparency, implementation and governance of the Principles. It is the first step of a longer term process to determine the future direction of the Principles and ensure they are fit for purpose. The Group believes that the collective effort of financial institutions will ensure that the Equator Principles continue to play an industry leading role and will continue to engage in the update process.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.41: **Status of Categorised Projects (unaudited)**

	A	B	C	Total
Completed		15	10	25
In Progress	1	4	4	9
Not Completed		2	4	6
	1	21	18	40

Table 1.58: **Status of Projects by Industry (unaudited)**

	Renewables	Infrastructure	Energy and Utilities	Total
Completed	16	4	5	25
In Progress	5	3	1	9
Not Completed	2	4		6
	23	11	6	40

Throughout 2011, the Group continued to provide finance for a wide range of projects within the renewables, energy & utilities and infrastructure sectors that have the capability to deliver positive social and environmental outcomes. This year saw a 56 per cent increase in the value of renewables projects that the Group provided finance for compared to 2010. When completed, renewable projects within the UK funded during 2011 will provide over 540,000 homes with renewable energy, avoiding tens of thousands of tonnes of CO_2 emissions each year.

Table 1.42: **Industry of Completed Transactions (unaudited)**

	No.	£m
Renewables	16	611
Infrastructure	5	316
Energy & Utilities	4	123
	25	1,050

Table 1.43: **Geography of Completed Transactions (unaudited)**

	A	B	C	Total
UK		5	4	9
Americas		7	5	12
Europe		1		1
Australasia		2	1	3
		15	10	25

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MARKET RISK

DEFINITION

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

RISK APPETITE

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

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

EXPOSURES

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

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

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

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

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

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

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders expectations and this involves the mismatch of assets and liabilities.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in Force, see note 30 to the financial statements.)
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in four portfolios: (a) in the long-term funds of Scottish Widows plc and its subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group s defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 43 to the financial statements.

MEASUREMENT

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

- Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used
- Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening
- Bespoke Extreme Stress Scenarios: e.g. stock market crash

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

TRADING ASSETS AND OTHER TREASURY POSITIONS

Based on the 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2011 and 2010 based on the Group s global trading positions as detailed in table 1.44.

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

Table 1.44: **VaR trading assets and other treasury positions (see Measurement page 125) (audited)**

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

NON-TRADING

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

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

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

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

Table 1.45: **Non-trading (audited)**

	2011		2010	
	Up 25bps £m	**Down 25bps £m**	Up 25bps £m	Down 25bps £m
Sterling	**(53.1)**	**54.7**	(86.9)	88.4
US Dollar	**(0.4)**	**0.3**	11.1	(11.4)
Euro	**(15.7)**	**15.9**	8.9	(9.0)

Australian Dollar	**(1.8)**	**1.8**	(1.2)	1.2
Other	**(1.4)**	**1.3**	(3.0)	3.1
	(72.4)	**74.0**	(71.1)	72.3

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

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

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

PENSION SCHEMES

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE PORTFOLIOS

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

Table 1.46: **Insurance portfolios (audited)**

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

MITIGATION

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

BANKING NON-TRADING ACTIVITIES

Interest rate risk arising from the different repricing characteristics of the Group s non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the Non-Traded Market Risk Appetite.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled within the Trading Risk Appetite and any residual risk is hedged in the market.

INSURANCE ACTIVITIES

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

MONITORING

The Group Asset and Liability Committee and the Group Market Risk Committee regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored by Risk Division and where appropriate, escalation procedures are in place.

BANKING ACTIVITIES

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

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

INSURANCE ACTIVITIES

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group s overall risk appetite and regularly reviewed by the Group Market Risk Committee:

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATIONAL RISK

DEFINITION

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, or from people related or external events.

There are a number of categories of operational risk:

REGULATORY

Regulatory risk is the risk of reductions in earnings and/or value, through financial or reputational loss, from failing to comply with the applicable laws, regulations or codes.

CUSTOMER TREATMENT

The risk of regulatory censure and/or a reduction in earnings/value through financial or reputational loss, from inappropriate or poor customer treatment.

PEOPLE

The risk of reductions in earnings or value through financial or reputational loss arising from ineffectively leading colleagues responsibly and proficiently, managing people resource, supporting and developing colleague talent, or meeting regulatory obligations related to people.

SUPPLIER MANAGEMENT

The risk of reductions in earnings and/or value through financial or reputational loss from services with outsourced partners or third-party suppliers.

CUSTOMER PROCESSES

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor externally facing business processes. Customer process risk includes customer transaction and processing errors due to incorrect capturing of customer information and/or system failure.

FINANCIAL CRIME

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related regulatory obligations, these losses may include censure, fines or the cost of litigation. This includes risks associated with fraud and bribery.

MONEY LAUNDERING AND SANCTIONS

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with failure to comply with prevailing regulatory obligations on activities related to money laundering, sanctions and counter terrorism, these losses may include censure, fines or the cost of litigation.

SECURITY

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group s assets, the loss, corruption, misuse or theft of the Group s information assets or threats or actual harm to the Group s people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

IT SYSTEMS

The risk of reductions in earnings and/or value through financial or reputational loss resulting from the failure to develop, deliver or maintain effective IT solutions.

CHANGE

The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

ORGANISATIONAL INFRASTRUCTURE

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from poor internally facing business processes at group, divisional or business unit level. Organisational infrastructure in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

RISK APPETITE

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group s reputation.

The Group has zero risk appetite for regulatory breaches or systemic unfair outcomes for customers. To achieve this, the Group encourages and maintains an appropriately balanced regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

EXPOSURES

By its very nature, operational risks can arise from a wide range of the Group s activities that involve people, processes and systems. The Group s principal operational risks relate to the Group s ability to attract, retain and motivate its people, the rate and scale of change arising from the Group s strategic review programme, the way in which the Group treats its customers and the regulatory environment in which it operates.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group continues to face risks relating to its ability to attract, retain, and develop high calibre talent, as a result of challenges arising from ongoing regulatory and public interest in remuneration practices. In addition there is uncertainty from EU state aid requirements and Independent Commission on Banking proposals on banking reform.

The breadth of the strategic review programme is such that all parts of the Group are impacted to a degree. The risks associated with the programme, including implementation and delivery, are the subject of rigorous oversight by business areas and Risk Division, with challenges by Internal Audit, commensurate to the scale of the change. Customer treatment and how the Group manages its customer relationships affect all aspects of the Group s operations and are closely aligned with achievement of the Group s strategic aim to be the best bank for customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies (see note 54 to the financial statements Contingent Liabilities and Commitments).

Regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

MEASUREMENT

Operational risks are measured against a set of risk appetite metrics, with appropriate limits and triggers, which have been approved by the Board.

MITIGATION

The Group s operational risk management framework consists of the following key components:

Identification and categorisation of the key operational risks facing a business area, including defining risk appetite.

Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.

Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.

Loss and incident management, capturing actions to manage any losses facing a business area.

The development of Key Risk Indicators for management reporting, including the monitoring of risk appetite.

Oversight and assurance of the risk management framework in businesses.

Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

MONITORING

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report is discussed at the monthly Group Operational Risk Committee and Compliance & Conduct Committee. These committees can escalate matters to the Chief Risk Officer, or higher committees, if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group s senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE RISK

DEFINITION

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

RISK APPETITE

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the Group s risk preferences. It takes account of the need for each entity in the Group to maintain solvency in excess of the minimum level required by the entity s jurisdictional legal or regulatory requirements.

The Group&