Lloyds Banking Group plc
Form 20-F
March 09, 2018

As filed with the Securities and Exchange Commission on 9 March 2018

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 2017
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)

Malcolm Wood, Company Secretary
Tel +44 (0) 20 7356 1274, Fax +44 (0) 20 7356 1808
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
$1,500,000,000 4.344% Subordinated Securities due in 2048	The New York Stock Exchange
$824,033,000 5.3% Subordinated Securities due 2045	The New York Stock Exchange
$1,750,000,000 3.574% Senior Notes due in 2028 (callable in 2027)	The New York Stock Exchange
$1,250,000,000 3.75% Senior Notes due 2027	The New York Stock Exchange
$1,500,000,000 4.65% Subordinated Securities due 2026	The New York Stock Exchange
$1,327,685,000 4.582% Subordinated Securities due 2025	The New York Stock Exchange
$1,250,000,000 3.5% Senior Notes due 2025	The New York Stock Exchange
$1,000,000,000 4.5% Subordinated Securities due 2024	The New York Stock Exchange
$2,250,000,000 2.907% Senior Notes due 2023 (callable in 2022)	The New York Stock Exchange
$1,500,000,000 3.0% Senior Notes due 2022	The New York Stock Exchange
$1,000,000,000 3.1% Senior Notes due 2021	The New York Stock Exchange
$2,500,000,000 6.375% Senior Notes due 2021	The New York Stock Exchange
$1,000,000,000 2.7% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.4% Senior Notes due 2020	The New York Stock Exchange
$1,000,000,000 2.35% Senior Notes due 2019	The New York Stock Exchange
$750,000,000 2.05% Senior Notes due 2019	The New York Stock Exchange
$450,000,000 Floating Rate Notes due 2019	The New York Stock Exchange
$1,000,000,000 2.3% Senior Notes due 2018	The New York Stock Exchange
$700,000,000 2% Senior Notes due 2018	The New York Stock Exchange
$300,000,000 Floating Rate Notes due 2018	The New York Stock Exchange
$1,250,000,000 1.75% Senior Notes due 2018	The New York Stock Exchange
$400,000,000 Floating Rate Notes due 2018	The New York Stock Exchange
$1,000,000,000 1.75% Senior Notes due 2018	The New York Stock Exchange
$500,000,000 Floating Rate Notes due 2018	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:
7.50% Fixed Rate Reset Additional Tier 1 Perpetual Subordinated Contingent Convertible Securities

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2017 was:

Ordinary shares, nominal value 10 pence each	71,972,949,589
Preference shares, nominal value 25 pence each	412,204,151
Preference shares, nominal value 25 cents each	809,160
Preference shares, nominal value 25 euro cents each	Nil

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

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, a non-accelerated filer, or an emerging growth company. See definitions of "large accelerated filer", "accelerated filer," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer o Non-Accelerated filer o Emerging Growth Company o

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards[†]provided pursuant to Section 13(a) of the Exchange Act.
Yes o No 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

† The term "new or revised financial accounting standard" refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

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PRESENTATION OF INFORMATION

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (‘pounds sterling’, ‘sterling’ or ‘£’), the lawful currency of the UK. In this annual report, references to ‘pence’ and ‘p’ are to one-hundredth of one pound sterling; references to ‘US dollars’, ‘US$’ or ‘$’ are to the lawful currency of the United States (the US); references to ‘cent’ or ‘c’ are to one-hundredth of one US dollar; references to ‘euro’ or ‘€’ are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to ‘euro cent’ are to one-hundredth of one euro; and references to ‘Japanese yen’, ‘Japanese ¥’ or ‘¥’ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2017, which was $1.3529 = £1.00. The Noon Buying Rate on 31 December 2017 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 provider of financial services to individual and business customers in the UK. At 31 December 2017, total Lloyds Banking Group assets were £812,109 million and Lloyds Banking Group had 67,905 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was £48,985 million. The Group reported a profit before tax for the 12 months to 31 December 2017 of £5,625 million, and its capital ratios at that date were 21.2 per cent for total capital, 17.2 per cent for tier 1 capital and 14.1 per cent for common equity tier 1 capital.

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

	2017 £m	2016 £m	2015 £m
Net interest income	10,912	9,274	11,318
Other income	23,325	30,337	11,832
Total income	34,237	39,611	23,150
Insurance claims	(15,578)	(22,344)	(5,729)
Total income, net of insurance claims	18,659	17,267	17,421
Operating expenses	(12,346)	(12,627)	(15,387)
Trading surplus	6,313	4,640	2,034
Impairment	(688)	(752)	(390)
Profit before tax	5,625	3,888	1,644

Lloyds Banking Group's main business activities are retail and commercial banking and long-term savings, protection and investment and it operates primarily in the UK. Services are offered through a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows, and through a range of distribution channels including the largest branch network and digital bank in the UK.

At 31 December 2017, the Group's three primary operating divisions, which are also reporting segments, were: Retail; Commercial Banking; and Insurance and Wealth. Retail provides banking, mortgages, personal loans, motor finance, credit cards and other financial services to personal and small business customers. Commercial Banking provides banking and related services to business clients, from SMEs to large corporates. Insurance and Wealth provides long-term savings, protection and investment products as well as general insurance products.

Profit before tax is analysed on pages 13 to 22 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 24 to 32 on an underlying basis. The key principles adopted in the preparation of this basis of reporting are described on page 24. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources; this reporting is on an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax. Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. The table below shows the results of Lloyds Banking Group's segments in the last three fiscal years, and their aggregation. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission's Regulation G are set out on pages F-18 to F-21.

	2017	2016[1]	2015[1]
	£m	£m	£m
Retail	4,403	4,058	4,255
Commercial Banking	2,489	2,379	2,383
Insurance and Wealth	939	973	1,090
Other	662	457	384
Profit before tax – underlying basis	8,493	7,867	8,112

1 Segmental analysis restated, as explained on page 24.

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

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SELECTED CONSOLIDATED FINANCIAL DATA

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

	2017	2016	2015	2014	2013
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	18,659	17,267	17,421	16,399	18,478
Operating expenses	(12,346)	(12,627)	(15,387)	(13,885)	(15,322)
Trading surplus	6,313	4,640	2,034	2,514	3,156
Impairment losses	(688)	(752)	(390)	(752)	(2,741)
Profit before tax	5,625	3,888	1,644	1,762	415
Profit (loss) for the year	3,897	2,164	956	1,499	(802)
Profit (loss) for the year attributable to ordinary shareholders	3,392	1,651	466	1,125	(838)
Dividends for the year[1,2]	2,195	2,175	1,962	535	–
Balance sheet data at 31 December (£m)					
Share capital	7,197	7,146	7,146	7,146	7,145
Shareholders' equity	43,551	42,670	41,234	43,335	38,989
Other equity instruments	5,355	5,355	5,355	5,355	–
Customer deposits	418,124	415,460	418,326	447,067	439,467
Subordinated liabilities	17,922	19,831	23,312	26,042	32,312
Loans and advances to customers	472,498	457,958	455,175	482,704	492,952
Total assets	812,109	817,793	806,688	854,896	842,380
Share information					
Basic earnings (loss) per ordinary share	4.9p	2.4p	0.8p	1.7p	(1.2)p
Diluted earnings (loss) per ordinary share	4.8p	2.4p	0.8p	1.6p	(1.2)p
Net asset value per ordinary share	60.5p	59.8p	57.9p	60.7p	54.6p
Dividends per ordinary share[1,3]	3.05p	3.05p	2.75p	0.75p	–
Equivalent cents per share[1,3,4]	4.21c	3.95c	4.03c	1.16c	–
Market price per ordinary share (year end)	68.1p	62.5p	73.1p	75.8p	78.9p
Number of shareholders (thousands)	2,450	2,510	2,563	2,626	2,681
Number of ordinary shares in issue (millions)[5]	71,973	71,374	71,374	71,374	71,368
Financial ratios (%)[6]					
Dividend payout ratio[7]	62.8	124.9	359.3	45.1	–
Post-tax return on average shareholders' equity	8.0	4.1	1.3	2.9	(2.0)
Post-tax return on average assets	0.48	0.26	0.11	0.17	(0.09)
Average shareholders' equity to average assets	5.3	5.2	5.1	4.7	4.7
Cost:income ratio[8]	66.2	73.1	88.3	84.7	82.9
Capital ratios (%)[9,10]					
Total capital	21.2	21.2	21.5	22.0	20.8
Tier 1 capital	17.2	16.8	16.4	16.5	14.5
Common equity tier 1 capital/Core tier 1 capital	14.1	13.4	12.8	12.8	14.0

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Annual dividends comprise both interim and estimated 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.

2 Dividends for the year in 2016 included a special dividend totalling £356 million; (2015: £357 million).

3 Dividends per ordinary share in 2016 included a recommended special dividend of 0.5 pence; (2015: 0.5 pence).

4 Translated into US dollars at the Noon Buying Rate on the date each payment was made, with the exception of the final dividend in respect of 2017, which has been translated at the Noon Buying Rate on 23 February 2018.

5 For 2016 and previous years, this figure excluded the limited voting ordinary shares owned by the Lloyds Bank Foundations. The limited voting ordinary shares were redesignated as ordinary shares on 1 July 2017.

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

7 Total dividend for the year divided by earnings attributable to ordinary shareholders adjusted for tax relief on distributions to other equity holders.

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

9 Capital ratios for 2013 are in accordance with the modified Basel II framework as implemented by the PRA.

10 Capital ratios for 2014 and later years are in accordance with the CRD IV rules implemented by the PRA on 1 January 2014.

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EXCHANGE RATES

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

	2018 January	**2017 December**	**2017 November**	**2017 October**	**2017 September**	**2017 August**
US dollars per pound sterling:						
High	**1.43**	**1.35**	**1.35**	**1.33**	**1.36**	1.32
Low	**1.35**	**1.33**	**1.31**	**1.31**	**1.30**	1.28

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:

	2017	2016	2015	2014	2013
US dollars per pound sterling:					
Average	**1.30**	1.34	1.53	1.65	1.57

On 23 February 2018, the latest practicable date, the US dollar Noon Buying Rate was $1.3979 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

BUSINESS

HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company's issued ordinary share capital. Following sales of shares in September 2013 and March 2014 and the completion of trading plans with Morgan Stanley & Co. International plc (Morgan Stanley), the UK Government completed the sale of its shares in May 2017, returning the Group to full private ownership.

Pursuant to its decision approving state aid to the Group, the European Commission required the Group to dispose of a retail banking business meeting minimum requirements for the number of branches, share of the UK personal current accounts market and proportion of the Group's mortgage assets. Following disposals in 2014, the Group sold its remaining interest in TSB to Banco de Sabadell (Sabadell) in 2015, and all EC state aid requirements were met by 30 June 2017.

On 1 June 2017, following the receipt of competition and regulatory approval, the Group acquired 100 per cent of the ordinary share capital of MBNA Limited, which together with its subsidiaries operates a UK consumer credit card business, from FIA Jersey Holdings Limited, a wholly-owned subsidiary of Bank of America.

BUSINESS

STRATEGY OF LLOYDS BANKING GROUP

The Group is a leading provider of financial services to individual and business customers in the UK. The Group's main business activities are retail and commercial banking, and long-term savings, protection and investment. Services are provided through a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows and through a range of distribution channels, including the largest branch network and digital bank in the UK.

In 2017 the Group successfully completed the second phase of its strategic plan, which focussed on creating the best customer experience, becoming simpler and more efficient and delivering sustainable growth.

As the Group looks to the future, it sees the external environment evolving rapidly. Changing customer behaviours, the pace of technological evolution and changes in regulation all present opportunities. Given the Group's strong capabilities and the significant progress made in recent years the Group believes it is in a unique position to compete and win in this environment by developing additional competitive advantages. The Group will continue to transform itself to succeed in this digital world and the next phase of its strategy will ensure the Group has the capabilities to deliver future success.

STRATEGIC PRIORITIES

The Group has identified four strategic priorities focused on the financial needs and behaviours of the customer of the future: further enhancing the Group's leading customer experience; further digitising the Group; maximising Group capabilities; and transforming ways of working. The Group will invest more than £3 billion in these strategic initiatives through the plan period that will drive the Group's transformation into a digitised, simple, low risk, customer focused UK financial services provider.

Delivering a leading customer experience

The Group will drive stronger customer relationships through best in class propositions while continuing to provide the Group's customers with brilliant servicing and a seamless experience across all channels. This will include:

– remaining the number 1 digital bank in the UK with open banking functionality;

– unrivalled reach with UK's largest branch network serving complex needs; and

– data-driven and personalised customer propositions.

Digitising the Group

The Group will deploy new technology to drive additional operational efficiencies that will make banking simple and easier for customers whilst reducing operating costs, pursuing the following initiatives:

– deeper end-to-end transformation targeting over 70 per cent of cost base;

– simplification and progressive modernisation of our data and IT infrastructure; and

– technology enabled productivity improvements across the business.

Maximising the Group's capabilities

The Group will deepen customer relationships, grow in targeted segments and better address our customers' banking and insurance needs as an integrated financial services provider. This will include:

– increasing Financial Planning and Retirement (FP&R) open book assets by more than £50 billion by 2020 with more than 1 million new pension customers;

– implementing an integrated FP&R proposition with single customer view; and

– start-up, SME and Mid Market net lending growth (more than £6 billion in the plan period).

Transforming ways of working

The Group is making its biggest ever investment in people, increasing colleague training and development by 50 per cent to 4.4 million hours per annum and embracing new technology to drive better customer outcomes. The hard work, commitment and expertise of the Group's colleagues has enabled it to deliver to date and the Group will further invest in capabilities and agile working practices. The Group has already restructured the business and reorganised the leadership team to ensure effective implementation of the new strategy.

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

As part of a Group restructuring during 2017 the Consumer Finance division has now become part of Retail; the Group's UK wealth business, previously part of Retail, has been transferred to the Insurance division, now renamed Insurance and Wealth; the Group's International wealth business, previously part of Retail, has been transferred to the Commercial Banking division; and the Group's venture capital business, previously part of Commercial Banking, has been transferred to Other.

Following this restructuring, the Group's activities are now organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

Further information on the Group's segments is set out on pages 24 to 32 and in note 4 to the financial statements.

MATERIAL CONTRACTS

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

ENVIRONMENTAL MATTERS

A sustainable and responsible approach is integral to how the Group operates.

The Group needs to use scarce natural resources more sustainably, manage its environmental impacts and support its customers by financing opportunities created by the transition to a low carbon economy.

MANAGING ENVIRONMENTAL IMPACTS

Delivering the science-based carbon reduction and climate resilience targets set out in the Paris Agreement will have significant structural implications for the economy and the businesses and communities the Group serves. That is why the Group is evolving its Group-wide sustainability strategy.

This year, overall carbon emissions were 292,848 tonnes of CO_2e, a decrease of 14 per cent year-on-year and of 48 per cent against the 2009 baseline. This is mainly attributable to the reduction in consumption of gas and electricity, which make up the largest proportion of the Group's emissions, as a result of its extensive energy management programme. In 2017, the Group also reduced the CO_2e related to its business travel by promoting 'No Travel Week', encouraging travel alternatives and the successful roll out of 'WebEx', Group-wide.

CO_2E EMISSIONS

	Oct 16 - Sept 17	Oct 15 - Sept 16[1,2]	Oct 14 - Sept 15[1,2]
Total CO_2 e	**292,848**	340,382	395,543
Total Scope 1	**52,160**	53,026	58,851
Total Scope 2	**166,617**	202,414	239,709
Total Scope 3	**74,071**	84,943	96,983

1 Restated 2014/2015 and 2015/2016 emissions data to improve the accuracy of reporting, using actual data to replace estimates.

2 Restated all historic years to reflect improved methodology in assigning road travel between reporting scopes.

Emissions in tonnes CO2 e in line with the GHG Protocol Corporate Standard (2004). The Group is in the process of transitioning to the revised Scope 2 guidance. Criteria used to measure and report Scope 1, 2, 3 emissions is provided in the Lloyds Banking Group Reporting Criteria statement available online at www.lloydsbankinggroup.com/responsible-business.

Scope 1 emissions include mobile and stationary combustion of fuel and operation of facilities.

Scope 2 emissions have been calculated using a location based methodology, as set out by the GHG Protocol.

Indicator is subject to Limited ISAE3000 (revised) assurance by Deloitte LLP for the 2017 Annual Responsible Business Reporting. Deloitte's 2017 assurance statement and the 2017 Reporting Criteria are available online at www.lloydsbankinggroup.com/rbdownloads

SUPPORTING THE LOW CARBON ECONOMY

The Group is helping more of its commercial clients to understand and manage their sustainability risks and the Group completes an environmental risk assessment at the start of every new client relationship. The Group is currently exploring ways to build sustainability considerations into its policies and risk management processes. The Group offers customers products and services that help them embrace sustainability. In 2016, the Group launched an innovative £1 billion Green Loan Initiative to incentivise commercial real estate to become more energy efficient and this year exceeded its target to help 2 million square feet of real estate.

At the end of 2017, the Group's UK team had financed renewable projects with a combined capacity of over 2.75GW (2016: 1.78GW) and internationally the Group's existing investments in renewables exceed 8.9GW (2016: 7.4GW). In 2017 Lloyds Bank played an important part in Macquarie's acquisition of the Green Investment Bank (now Green Investment Group), providing financing for a significant portfolio of operational offshore wind farms including Sheringham Shoal, Gwynt y Mor, Rhyl Flats and projects in construction, including Galloper and Rampion offshore wind farms. Together the projects have a total capacity of approximately 2.4GW, which is enough to power over 1.7 million homes and they will support a significant number of jobs across the UK through the supply chain and maintenance of the wind farms.

THE IMPACT OF CLIMATE RISK

The Group welcomes the recommendations of the Financial Stability Board Taskforce on Climate-related Financial Disclosures (TCFD) and has mapped its approach to them. The Group is developing a strategy and implementing processes to:

Assess the materiality of climate risk across its business
Identify and define a range of scenarios, including relevant physical and transition risk
Evaluate the business impacts
Identify potential responses to manage the risks and opportunities

The Group will address a number of these and will disclose further information on its work in this important area.

CLIMATE RELATED FINANCIAL DISCLOSURES

Strategy

In 2017, the Group reviewed how it integrates environmental sustainability into its strategy and risk management processes, taking advice from external advisors and working with all parts of the business to understand work already in plan and where it needs to do more. The Group is committed to supporting the transition to a low carbon economy through its financial products and services, including renewable energy services.

Governance of climate change

The Responsible Business Committee, a sub-committee of the Board, will take overall responsibility for the Group's climate-related impacts and risks from 2018. It is chaired by an Independent Director, Sara Weller, and meets regularly throughout the year. The Group has refocused its executive-level Responsible Business Management Committee to become its Sustainability Committee and will ensure that staff with operational responsibilities across the Group's key divisions are actively involved in the development and implementation of a comprehensive environmental sustainability strategy. Discussions involving these Committees and the Commercial Banking leadership team were held in 2017 to start to examine the strategic implications of environmental challenges, including climate change.

BUSINESS

Risk management

The Sustainability Committee will oversee the assessment of the Group's climate-related risks, escalating to the Responsible Business Committee and the Board Risk Committee as appropriate. The Group's divisions are each exposed to different levels of climate risk. For example, as a large home insurer, the Group is aware that global warming is projected to increase the risk of flooding and consequently weather-related insurance claims. It is important that the Group continues to work with its customers, industry peers and government to ensure this risk is minimised and mitigated to keep flood insurance affordable.

Metrics and targets

The Group is working to develop strategic commitments and targets in response to climate-related risks and opportunities, with different parts of the business feeding into this target setting process. This builds on its work to reduce the environmental impact of its own operations.

The target is to reduce the Group's overall CO_2e by 60 per cent by 2030 and 80 per cent by 2050, in line with the UK's emission reduction targets. This follows a science-based target setting methodology. As part of its Green Loan Initiative, the Group's target is to fund 5 million square feet of commercial real estate to become more energy efficient by 2020, the equivalent of five London Shards. The Group has set a new target to help provide power for 5 million homes through its investment in renewable energy by 2020.

The Group will also consider the supplementary industry specific recommendations for the financial sector.

PROPERTIES

At 31 December 2017, Lloyds Banking Group occupied 2,021 properties in the UK. Of these, 429 were held as freeholds and 1,592 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations – London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 169 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.

LEGAL ACTIONS AND REGULATORY MATTERS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory reviews and investigations both in the UK and overseas. Set out below is a summary of the more significant matters.

PAYMENT PROTECTION INSURANCE (EXCLUDING MBNA)

The Group increased the provision for PPI costs by a further £1,300 million in 2017, of which £600 million was in the fourth quarter, bringing the total amount provided to £18,675 million. The remaining provision is consistent with an average of 11,000 complaints per week (previously 9,000) through to the industry deadline of August 2019, in line with the average experience over the last nine months.

The higher volume of complaints received has been driven by increased claims management company (CMC) marketing activity and the Financial Conduct Authority (FCA) advertising campaign.

At 31 December 2017, a provision of £2,438 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £1,470 million during the year to 31 December 2017.

SENSITIVITIES

The Group estimates that it has sold approximately 16 million PPI policies since 2000. These include policies that were not mis-sold and those that have been successfully claimed upon. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 53 per cent of the policies sold since 2000.

The total amount provided for PPI represents the Group’s best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ from the Group’s estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the regulatory changes, FCA media campaign and Claims Management Company and customer activity.

For every additional 1,000 reactive complaints per week above 11,000 on average through to the industry deadline of August 2019, the Group would expect an additional charge of £200 million.

PAYMENT PROTECTION INSURANCE (MBNA)

With regard to MBNA, as announced in December 2016, the Group's exposure is capped at £240 million already provided for, through an indemnity received from Bank of America.

OTHER PROVISIONS FOR LEGAL ACTIONS AND REGULATORY MATTERS

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2017 the Group charged a further £865 million in respect of legal actions and other regulatory matters, the unutilised balance at 31 December 2017 was £1,292 million (31 December 2016: £1,339 million). The most significant items are as follows.

ARREARS HANDLING RELATED ACTIVITIES

The Group has provided an additional £245 million (bringing the total provided to date to £642 million), for the costs of identifying and rectifying certain arrears management fees and activities. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and has made good progress in reimbursing mortgage arrears fees to the 590,000 impacted customers.

PACKAGED BANK ACCOUNTS

In 2017 the Group provided an additional £245 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £750 million. A number of risks and uncertainties remain in particular with respect to future volumes.

CUSTOMER CLAIMS IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY

The Group continues to receive claims in Germany from customers relating to policies issued by Clerical Medical Investment Group Limited (subsequently renamed Scottish Widows Limited). The German industry-wide issue regarding notification of contractual 'cooling off' periods continued to lead to an increasing number of claims in 2016 and 2017. Up to 31 December 2016 the Group had provided a total of £639 million and no further amounts have been provided to 31 December 2017. The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will be known only once all relevant claims have been resolved.

HBOS READING – CUSTOMER REVIEW

The Group is undertaking a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Group in 2009. The Group has provided £100 million in the year to 31 December 2017 and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. The review is ongoing and at 12 February 2018, the Group had made offers to 57 customers, which represents more than 80 per cent of the customers in review.

INTERCHANGE FEES

With respect to multi-lateral interchange fees (MIFs), the Group is not directly involved in the ongoing investigations and litigation (as described below) which involve card schemes such as Visa and MasterCard. However, the Group is a member of Visa and MasterCard and other card schemes.

– The European Commission continues to pursue competition investigations against MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA.

– Litigation brought by retailers continues in the English Courts against both Visa and MasterCard.

Any ultimate impact on the Group of the above investigations and litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. As part of this transaction, the Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Group may be subject under the LSA is capped at the cash consideration which was received by the Group at completion. Visa Inc may also have recourse to a general indemnity, previously in place under Visa Europe’s Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR AND OTHER TRADING RATES

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

Certain Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. Certain of the plaintiffs’ claims, including those in connection with USD and JPY LIBOR, have been dismissed by the US Federal

Court for Southern District of New York, and decisions are awaited on the Group's motions to dismiss the Sterling LIBOR and BBSW claims. The decisions leading to the Group's dismissal from the USD LIBOR claims are subject to two appeals; the first took place on 25 September 2017 and a decision is expected in the first quarter of 2018, and the second is expected to take place in the first half of 2018. The decisions leading to the Group's dismissal from the JPY LIBOR claims are not presently subject to appeal.

Certain Group companies are also named as defendants in: (i) UK based claims; and (ii) in a Dutch class action, each raising LIBOR manipulation allegations. A number of the claims against the Group in relation to the alleged mis-sale of Interest Rate Hedging Products also include allegations of LIBOR manipulation.

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

UK SHAREHOLDER LITIGATION

In August 2014, the Group and a number of former directors were named as defendants in a claim by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. The defendants refute all claims made. A trial commenced in the English High Court on 18 October 2017 and is scheduled to conclude in the first quarter of 2018 with judgment to follow. It is currently not possible to determine the ultimate impact on the Group (if any).

FINANCIAL SERVICES COMPENSATION SCHEME

Following the default of a number of deposit takers in 2008, the Financial Services Compensation Scheme (FSCS) borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. In June 2017, the FSCS announced that following the sale of certain Bradford & Bingley mortgage assets, the principal balance outstanding on the HM Treasury loan was £4,678 million (31 December 2016: £15,655 million). Although it is anticipated that the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants, including the Group, of the FSCS. The amount of future levies payable by the Group depends on a number of factors, principally, the amounts recovered by the FSCS from asset sales.

TAX AUTHORITIES

The Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Group that their interpretation of the UK rules which allow the offset of such losses denies the claim. If HMRC’s position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £650 million (including interest) and a reduction in the Group’s deferred tax asset of approximately £350 million. The Group does not agree with HMRC’s position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. There are a number of other open matters on which the Group is in discussion with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc), none of which is expected to have a material impact on the financial position of the Group.

RESIDENTIAL MORTGAGE REPOSSESSIONS

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Group’s practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations and has published Guidance on the treatment of customers with mortgage payment shortfalls. The Guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers’ monthly mortgage instalments. The Group is now determining its detailed approach to implementation of the Guidance and will contact affected customers during 2018.

MORTGAGE ARREARS HANDLING ACTIVITIES

On 26 May 2016, the Group was informed that an enforcement team at the FCA had commenced an investigation in connection with the Group's mortgage arrears handling activities. This investigation is ongoing and it is currently not possible to make a reliable assessment of the liability, if any, that may result from the investigation.

CONTINGENT LIABILITIES RELATING TO OTHER LEGAL ACTIONS AND REGULATORY MATTERS

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

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COMPETITIVE ENVIRONMENT

The Group provides financial services to individual and business customers, predominantly in the UK but also overseas. The main business activities of the Group are retail and commercial banking and long-term savings, protection and investment.

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 along with emerging forms of lending in the commercial banking markets and with bancassurance, life assurance and general insurance companies in the UK insurance market.

The markets for UK financial services, and the other markets within which the Group operates, are competitive, and management expects such competition to continue or intensify in response to competitor behaviour, including non-traditional competitors, consumer demand, technological changes such as the growth of digital banking, and the impact of regulatory actions and other factors.

For more information see "*Risk Factors – Business and economic risks – The Group's businesses are conducted in competitive environments, with increased competition scrutiny, and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures.*"

RECENT DEVELOPMENTS

On 8 March 2018 the Group announced that it was launching a share buyback programme to repurchase up to £1 billion of its outstanding ordinary shares, as previously announced on 21 February 2018.

The Group has entered into an agreement with UBS AG, London Branch ("UBS") to conduct the share buyback programme on its behalf and to make trading decisions under the programme independently of the Group. Under the terms of the programme, the maximum consideration is £1 billion. The programme commenced on 8 March 2018 and will end no later than 4 February 2019. The sole purpose of the programme is to reduce the outstanding ordinary share capital of the Group.

UBS will purchase the Group's ordinary shares as principal and sell them on to the Group in accordance with the terms of their engagement. The Group intends to cancel the shares that it purchases through the programme.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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Given the Group's UK focus, its prospects are closely linked to the strength of the UK economy
Despite near-term uncertainties about the future relationship with the EU, the UK economy is expected to remain resilient in 2018, growing at a similar pace to 2017. Longer term growth potential is still expected to be faster than the Eurozone and similar to the US
Interest rates are expected to remain low, with gradual rises beneficial to the Group's savings customers and the Group

OVERVIEW

As a UK focused financial services provider, the Group's prospects are closely aligned to the strength of and outlook for the UK economy. In the period following the decision to leave the EU, the UK economy has remained resilient. Growth has slowed only a little below its trend rate, unemployment has continued to fall to a 40-year low, and property prices have continued to rise slowly. In the absence of any sudden shocks to business or consumer confidence, this recent resilience is expected to continue in 2018 and the next few years. In common with many other countries, the biggest uncertainty for longer term growth is the degree to which productivity growth improves from its weak rate of the past decade.

OPPORTUNITIES

The economy's resilience bodes well for the Group and its customers. While interest rates are expected to increase only gradually, the Bank of England's first increase in Bank Rate in over 10 years has benefited savers, many of whom will have dealt with low rates for a prolonged period, and will support banking margins. In recent years, low interest rates and the Group's low risk approach have been reflected in low and falling levels of impairments against the Group's lending balances.

Looking ahead, impairments are expected to remain at benign levels at an industry level, with contributing factors including the slow pace of expected interest rate increases, unemployment remaining close to its current 40-year low, and the benefit of both continuing to support property prices. Meanwhile, business confidence has to date held up well in the face of global and domestic uncertainties. Manufacturers and exporters have been aided by sterling's depreciation since late 2015, and businesses generally are benefiting from low debt service costs.

CHALLENGES

Households' spending power has been squeezed over the past year as the rise in inflation to 3 per cent by the end of 2017 has outpaced growth in pay that has remained subdued in a broadly 2-2.5 per cent range over the year, partly reflecting weak productivity growth. While inflation is expected to slow, it is likely to trend towards 2 per cent only gradually through the next three year chapter of the Group's strategy, and whilst the Group expects wage growth to improve and end the spending power squeeze, it is uncertain how quickly this will happen. Meanwhile, the economy is more reliant than normal on business investment and exports to drive growth.

Business investment is likely to have been impacted by the uncertainty around the UK's future trading relationship with the EU but as negotiations progress and that relationship becomes clearer, investment spending should be supported. Operational impacts of the UK's exit from the EU present risks for some of the Group's customers' businesses, although the UK's continued competitive advantages in innovation and high value services, and the flexible labour market should enable the economy to prosper longer term in growing world markets.

OUTLOOK

Barring unexpected sudden shocks to consumer or business confidence, the near-term outlook for both the UK economy and the Group remains relatively benign. A tight labour market and gradual productivity improvements should over time underpin quickening wage growth, whilst inflation is expected to start falling through 2018, the combination gradually ending the squeeze on households' spending power. With unemployment remaining close to its current 40-year lows, Bank Rate is expected to continue to rise, but only slowly. House prices are expected to rise marginally, with the affordability impact of slightly higher interest rates offset by improving disposable incomes.

The Group is not immune to the challenges facing the near-term and medium-term economic outlook, but its UK focus means that the current benign conditions and resilience of the UK economy will be supportive to the Group's performance through the delivery of the next chapter of its strategy. Direct operational impacts from EU exit are also limited.

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 set out in note 3 to the financial statements.

FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group's IFRS reporting are discussed in note 54 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS – 2017, 2016 AND 2015

SUMMARY

	2017 £m	2016 £m	2015 £m
Net interest income	10,912	9,274	11,318
Other income	23,325	30,337	11,832
Total income	34,237	39,611	23,150
Insurance claims	(15,578)	(22,344)	(5,729)
Total income, net of insurance claims	18,659	17,267	17,421
Operating expenses	(12,346)	(12,627)	(15,387)
Trading surplus	6,313	4,640	2,034
Impairment	(688)	(752)	(390)
Profit before tax	5,625	3,888	1,644
Tax expense	(1,728)	(1,724)	(688)
Profit for the year	3,897	2,164	956
Profit attributable to ordinary shareholders	3,392	1,651	466
Profit attributable to other equity holders[1]	415	412	394
Profit attributable to equity holders	3,807	2,063	860
Profit attributable to non-controlling interests	90	101	96
Profit for the year	3,897	2,164	956

1 The profit after tax attributable to other equity holders of £415 million (2016: £412 million; 2015: £394 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £102 million (2016: £91 million; 2015: £80 million).

2017 COMPARED WITH 2016

During the year ended 31 December 2017, the Group recorded a profit before tax of £5,625 million compared with a profit before tax in 2016 of £3,888 million.

Total income decreased by £5,374 million, or 14 per cent, to £34,237 million in 2017 compared with £39,611 million in 2016, comprising a £7,012 million decrease in other income only partly offset by an increase of £1,638 million in net interest income.

Net interest income was £10,912 million in 2017; an increase of £1,638 million, or 18 per cent compared to £9,274 million in 2016. There was a positive impact of £622 million in 2017 from a decrease in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group, reflecting different levels of investment returns on the assets held by the OEICs; the change in population of consolidated OEICs in 2017 compared to 2016 did not have a significant impact. After adjusting for this, net interest income was £1,016 million, or 9 per cent higher. Average interest-earning assets fell as a result of decreases in average UK mortgage balances, lending to global corporates and in the portfolio of assets which are outside of the Group's risk appetite, more than offsetting the impact of the acquisition of MBNA. Net interest margin improved, excluding the impact of amounts payable to OEIC unitholders, as a result of lower deposit and wholesale funding costs and a positive impact from the acquisition of MBNA, more than offsetting continued pressure on asset margins.

Other income was £7,012 million, or 23 per cent, lower at £23,325 million in 2017 compared to £30,337 million in 2016. Fee and commission income was £80 million or 3 per cent, lower at £2,965 million compared to £3,045 million in 2016 as increased levels of card fees, reflecting both the acquisition of MBNA and higher levels of card usage, were more than offset by lower current account fees, reflecting reduced volumes of added-value accounts and changes in pricing structure, and lower levels of other fees receivable. Fee and commission expense increased by £26 million, or 2 per cent, to £1,382 million compared with £1,356 million in 2016. Net trading income decreased by £6,728 million, or 36 per cent, to £11,817 million in 2017 compared to £18,545 million in 2016; this decrease reflected a reduction of £6,630 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2017 relative to those in 2016. Insurance premium income was £138 million, or 2 per cent, lower at £7,930 million in 2017 compared with £8,068 million in 2016; there was a decrease of £23 million in life insurance premiums and a £115 million decrease in general insurance premiums. The decrease in life insurance premiums reflects the fact that good growth in corporate pensions business has been offset by a lower level of bulk annuity deals, compared to the activity in 2016. General insurance premiums decreased as a result of market conditions and the continued run-off of closed books. Other operating income was £40 million, or 2 per cent, lower at £1,995 million in 2017 compared to £2,035 million in 2016.

Insurance claims expense was £6,766 million, or 30 per cent, lower at £15,578 million in 2017 compared to £22,344 million in 2016. The insurance claims expense in respect of life and pensions business was £6,737 million lower at £15,241 million in 2017 compared to £21,978 million in 2016; this decrease was matched by a similar reduction in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £29 million or 8 per cent, lower at £337 million in 2017 compared to £366 million in 2016 as a result of the continued run-down of closed books and relatively benign weather conditions in 2017 compared to 2016.

Operating expenses decreased by £281 million, or 2 per cent to £12,346 million in 2017 compared with £12,627 million in 2016; the main reason for this decrease being the £209 million reduction in charges for redress payments to customers in respect of PPI and other conduct related matters from £2,374 million in 2016 to £2,165 million in 2017. Excluding these charges from both years, operating expenses were £72 million, or 1 per cent, lower at £10,181 million in 2017 compared to £10,253 million in 2016 as operating expenses of £172 million arising in MBNA since acquisition have been more than offset by the impact of underlying cost reductions. Staff costs were £207 million, or 4 per cent, lower at £4,610 million in 2017 compared with £4,817 million in 2016; increases in pension charges being more than offset by headcount related reductions in salaries and lower levels of severance costs. Premises and equipment costs were £58 million or 9 per cent, higher at £730 million in 2017 compared with £672 million in 2016. Other expenses were £79 million, or 3 per cent, higher at £2,463 million in 2017 compared with £2,384 million in 2016. Depreciation and amortisation costs were £10 million lower at £2,370 million in 2017 compared to £2,380 million in 2016, as increased charges in respect of property, plant and equipment were more than offset by reduced charges relating to intangible assets.

Impairment losses decreased by £64 million, or 9 per cent, to £688 million in 2017 compared with £752 million in 2016; this reflects the fact that in 2016 there was an impairment charge of £173 million in respect of certain equity investments in the Group's available-for-sale portfolio which was not repeated in 2017. Impairment losses in respect of loans and advances to customers were £105 million, or 18 per cent, higher at £697 million in 2017 compared with £592 million in 2016; this includes a charge of £118 million in the MBNA business since acquisition and there were lower levels of releases and write-backs than in 2016. There was a credit of £9 million in respect of undrawn commitments in 2017, compared to a credit of £13 million in 2016.

In 2017, the Group recorded a tax expense of £1,728 million compared to a tax expense of £1,724 million in 2016, an effective tax rate of 31 per cent, compared to the standard UK corporation tax rate of 19.25 per cent, principally as a result of the banking surcharge and restrictions on the deductibility of conduct provisions.

Total assets were £5,684 million, or 1 per cent, lower at £812,109 million at 31 December 2017 compared to £817,793 million at 31 December 2016. Trading and other financial assets at fair value through profit or loss were £11,704 million, or 8 per cent, higher at £162,878 million compared to £151,174 million at 31 December 2016 due to the inclusion of a number of investments in OEICs which were de-consolidated during the year. However, loans and advances to banks were £20,291 million, or 75 per cent, lower at £6,611 million compared to £26,902 million at 31 December 2016 following the de-consolidation of these OEICs. Derivative assets were £10,304 million, or 29 per cent, lower at £25,834 million at 31 December 2017 compared to £36,138 million at 31 December 2016, largely as a result of exchange rate movements. Loans and advances to customers were £14,540 million, or 3 per cent, higher at £472,498 million at 31 December 2017 compared to £457,958 million at 31 December 2016; the addition of £8,144 million of lending following the acquisition of MBNA and an £8,528 million increase in reverse repurchase agreement balances together with the impact of the reacquisition of a portfolio of mortgages from TSB and growth in consumer finance and SME lending have more than offset reductions in the larger corporate sector, as the Group focuses on optimising capital and returns, and in closed mortgage books. Available-for-sale financial assets were £14,426 million, or 26 per cent, lower at £42,098 million at 31 December 2017 compared to £56,524 million at 31 December 2016 reflecting reductions in the Group's holdings of UK government securities.

Total liabilities were £6,362 million, or 1 per cent, lower at £762,966 million at 31 December 2017 compared to £769,328 million at 31 December 2016. Deposits from banks were £13,420 million, or 82 per cent, higher at £29,804 million at 31 December 2017 compared to £16,384 million at 31 December 2016 as a result of an increase of £15,896 million in repurchase agreements. Customer deposits were £2,664 million, or 1 per cent, higher at £418,124 million compared to £415,460 million at 31 December 2016 as reductions in non-relationship deposit balances were more than offset by strong inflows from Commercial clients. Derivative liabilities were £8,800 million, or 25 per cent, lower at £26,124 million at 31 December 2017 compared to £34,924 million at 31 December 2016, largely as a result of exchange rate movements. Debt securities in issue were £3,864 million, or 5 per cent, lower at £72,450 million at 31 December 2017 compared to £76,314 million at 31 December 2016 following maturities of some tranches of securitisation notes and covered bonds. Other liabilities were £8,463 million, or 29 per cent, lower at £20,730 million at 31 December 2017 compared to £29,193 million at 31 December 2016 reflecting the deconsolidation of a number of OEICs. Subordinated liabilities were £1,909 million, or 10 per cent, lower at £17,922 million at 31 December 2017 compared to £19,831 million at 31 December 2016 reflecting redemptions in the year.

Total equity was £678 million, or 1 per cent, higher at £49,143 million at 31 December 2017 compared to £48,465 million at 31 December 2016 as retained profits for the year have more than offset the Group's dividend payments, distributions on its AT1 securities and other reserve movements.

The Group has strengthened its capital position, with a common equity tier 1 ratio of 14.1 per cent (31 December 2016: 13.4 per cent), largely driven by the increase in equity, offset in part by the increase in the deduction for goodwill and other intangible assets following the acquisition of MBNA, and a reduction in risk-weighted assets. The total capital ratio was unchanged at 21.2 per cent.

Risk-weighted assets reduced by £4,527 million, or 2 per cent, to £210,919 million at 31 December 2017 compared to £215,446 million at 31 December 2016, largely relating to updates made to both mortgage and unsecured retail Internal Ratings Based (IRB) models, continued active portfolio management, foreign exchange movements, disposals and capital efficient securitisation activity, partly offset by targeted growth in key customer segments and the acquisition of MBNA.

The Group's liquidity surplus exceeds the regulatory minimum and internal risk appetite with a Liquidity Coverage Ratio of 127 per cent based on EU Delegated Act at 31 December 2017. Wholesale funding reduced by 9 per cent to £101 billion compared with £111 billion at 31 December 2016. In addition, the Group made use of central bank funding schemes and by the end of 2017 the Group had fully utilised its £20 billion capacity from the Bank of England's Term Funding Scheme.

The Group has recommended a final ordinary dividend of 2.05 pence per share. This is in addition to the interim ordinary dividend of 1.0 pence per share that was paid in September 2017. The total ordinary dividend per share for 2017 of 3.05 pence per share has increased by 20 per cent, from 2.55 pence in 2016.

The Group continues to give due consideration at each year end to the return of any surplus capital and for 2017, intends to implement a share buyback of up to £1 billion. This represents the return of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties. The share buyback programme will commence in March 2018 and is expected to be completed during the next twelve months.

2016 COMPARED WITH 2015

During the year ended 31 December 2016, the Group recorded a profit before tax of £3,888 million compared with a profit before tax in 2015 of £1,644 million. The result in 2016 included provisions in respect of redress to customers (together with the related administrative costs) associated with both past sales of Payment Protection Insurance and other matters of £2,435 million (of which £2,374 million is charged within operating expenses and £61 million against income) compared to a charge of £4,837 million in the year ended 31 December 2015. Excluding these charges from both years, profit before tax was £158 million, or 2 per cent, lower at £6,323 million in the year ended 31 December 2016 compared to £6,481 million in the previous year. The comparison of results for 2016 to 2015 was also impacted by the sale of TSB Banking Group plc (TSB), which ceased to be consolidated in March 2015, with the sale of the Group's remaining holding becoming unconditional on 30 June 2015. The Group recognised a net loss of £660 million in 2015, relating to both the disposal of its shareholding and commitments under agreements entered into with TSB. After taking this item into account there was a reduction in profit before tax of £818 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Total income increased by £16,461 million, or 71 per cent, to £39,611 million in 2016 compared with £23,150 million in 2015, comprising an £18,505 million increase in other income partly offset by a decrease of £2,044 million in net interest income.

Net interest income was £9,274 million in 2016; a decrease of £2,044 million, or 18 per cent compared to £11,318 million in 2015. There was a negative impact of £1,813 million in 2016 from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group, reflecting different levels of investment returns on the assets held by the OEICs; the change in population of consolidated OEICs in 2016 compared to 2015 did not have a significant impact. After adjusting for this, net interest income was £231 million, or 2 per cent lower, of which £592 million related to TSB which was sold in 2015. Average interest-earning assets fell as a result of decreases in average UK mortgage balances and in the portfolio of assets which are outside of the Group's risk appetite, as well as a reduction of some £5 billion as result of the sale of TSB, more than offsetting growth in small business and unsecured personal lending. Net interest margin improved, excluding the impact of amounts payable to OEIC unitholders.

Other income was £18,505 million higher at £30,337 million in 2016 compared to £11,832 million in 2015. Fee and commission income was £207 million, or 6 per cent, lower at £3,045 million compared to £3,252 million in 2015. Fee and commission expense decreased by £86 million, or 6 per cent, to £1,356 million compared with £1,442 million in 2015. The decrease in net fee and commission income largely reflects lower levels of current account and credit and debit card fees as well as reduced income from commercial banking activities. Net trading income increased by £14,831 million to £18,545 million in 2016 compared to £3,714 million in 2015; this increase reflected an improvement of £14,797 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2016 relative to those in 2015. Insurance premium income was £3,276 million, or 68 per cent, higher at £8,068 million in 2016 compared with £4,792 million in 2015; there was an increase of £3,289 million in life insurance premiums and a £13 million decrease in general insurance premiums. Premium income in 2015 had been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group; excluding this item life insurance premium income was £1,330 million, or 23 per cent, higher at £7,210 million in 2016 compared to £5,880 million in 2015, principally reflecting growth in bulk annuity business. Other operating income was £519 million higher at £2,035 million in 2016 compared to £1,516 million in 2015 as a gain of £484 million on sale of the Group's investment in VISA Europe and an improvement in income from the value of in-force insurance business more than offset a loss on redemption of the Group's Enhanced Capital Notes.

Insurance claims expense was £16,615 million higher at £22,344 million in 2016 compared to £5,729 million in 2015. The insurance claims expense in respect of life and pensions business was £16,619 million higher at £21,978 million in 2016 compared to £5,359 million in 2015; this increase was matched by a similar improvement in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £4 million or 1 per cent, lower at £366 million in 2016 compared to £370 million in 2015.

Operating expenses decreased by £2,760 million, or 18 per cent to £12,627 million in 2016 compared with £15,387 million in 2015; the main reason for the decrease being the £2,463 million reduction in charges for redress payments to customers in respect of PPI and other conduct related matters from £4,837 million in 2015 to £2,374 million in 2016 and a charge of £665 million in 2015 in relation to the disposal of TSB. Excluding these items from both years, operating expenses were £368 million, or 4 per cent, higher at £10,253 million in 2016 compared to £9,885 million in 2015. Staff costs were £140 million, or 3 per cent, higher at £4,817 million in 2016 compared with £4,677 million in 2015; although annual pay rises have been more than offset by the impact of headcount reductions resulting from the sale of TSB and the Group's rationalisation programmes, there has been an increase in severance costs in relation to restructuring initiatives. Premises and equipment costs were £43 million or 6 per cent, lower at £672 million in 2016 compared with £715 million in 2015. Other expenses, excluding the charge relating to the TSB disposal, were £3 million higher at £2,384 million in 2016 compared with £2,381 million in 2015. Depreciation and amortisation costs were £268 million, or 13 per cent, higher at £2,380 million in 2016 compared to £2,112 million in 2015, in line with increased asset balances, particularly operating lease assets and capitalised software.

Impairment losses increased by £362 million, or 93 per cent, to £752 million in 2016 compared with £390 million in 2015. Impairment losses in respect of loans and advances to customers were £149 million, or 34 per cent, higher at £592 million in 2016 compared with £443 million in 2015; this reflects a lower level of releases and recoveries rather than a deterioration in quality of the underlying portfolio. There was a credit of £13 million in respect of undrawn commitments in 2016, compared to a credit of £55 million in 2015. In addition there was an impairment charge of £173 million in respect of certain equity investments in the Group's available-for-sale portfolio.

In 2016, the Group recorded a tax expense of £1,724 million compared to a tax expense of £688 million in 2015, an effective tax rate of 44 per cent, compared to the standard UK corporation tax rate of 20 per cent, principally as a result of the banking surcharge, restrictions on the deductibility of conduct provisions and the negative impact on the net deferred tax asset of both the change in corporation tax rate and the expected utilisation by the life business.

Total assets were £11,105 million, or 1 per cent, higher at £817,793 million at 31 December 2016 compared to £806,688 million at 31 December 2015. Cash and balances at central banks were £10,965 million, or 19 per cent, lower at £47,452 million compared to £58,417 million at 31 December 2015, reflecting fewer opportunities for the favourable placement of funds and trading and other assets at fair value through profit or loss were £10,638 million, or 8 per cent, higher at £151,174 million compared to £140,536 million at 31 December 2015, principally due to increases in the long-term insurance and investment funds. Loans and advances to customers were £2,783 million, or 1 per cent, higher at £457,958 million at 31 December 2016 compared to £455,175 million at 31 December 2015; the continued reduction in the portfolio of assets which are outside of the Group's risk appetite and lower UK mortgage balances, as the Group concentrates on protecting margin in the current market, were more than offset by an £8,304 million increase in reverse repurchase agreement balances together with growth in SME lending and the UK consumer finance business. Available-for-sale financial assets were £23,492 million, or 71 per cent, higher at £56,524 million compared to £33,032 million at 31 December 2015; during 2016, the Group reviewed its holding of government securities classified as held-to-maturity (£19,808 million at 31 December 2015) in light of the prevailing low interest rate environment and they have been reclassified as available-for-sale. Total liabilities were £9,620 million, or 1 per cent, higher at £769,328 million at 31 December 2016 compared to £759,708 million at 31 December 2015. Debt securities in issue were £5,742 million, or 7 per cent, lower at £76,314 million compared to £82,056 million at 31 December 2015, reflecting reduced funding requirements; however Insurance and investment contract liabilities were, together, £11,431 million, or 11 per cent, higher at £114,502 million, compared to £103,071 million at 31 December 2015, in line with the increase in investment assets. Subordinated liabilities were

£3,481 million or 15 per cent, lower at £19,831 million compared to £23,312 million at 31 December 2015 as a result of redemptions during the year, including the Group's Enhanced Capital Notes. Total equity was £1,485 million, or 3 per cent, higher at £48,465 million at 31 December 2016 compared to £46,980 million at 31 December 2015; this reflected positive revaluation movements in the available-for-sale and cash flow hedging reserves.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group strengthened its capital position, with a common equity tier 1 ratio of 13.4 per cent (31 December 2015: 12.8 per cent), largely driven by the increase in profits and a reduction in risk-weighted assets. The total capital ratio reduced to 21.2 per cent (31 December 2015: 21.5 per cent) primarily reflecting managed reductions in Tier 2 loan stock, largely through calls and redemptions, offset by the increase in common equity tier 1 capital and the reduction in risk-weighted assets.

Risk-weighted assets reduced by £7,399 million, or 3 per cent, to £215,446 million at 31 December 2016 compared to £222,845 million at 31 December 2015, largely relating to active portfolio management, disposals, an improvement in credit quality and capital efficient securitisation activity, partially offset by model updates related to UK mortgage portfolios and foreign exchange movements reflecting the depreciation in Sterling.

The Group's liquidity position remained good, with liquidity coverage ratio (LCR) eligible assets of £121 billion. LCR eligible assets represented over 8 times the Group's money-market funding with a maturity of less than one year and were in excess of total wholesale funding at 31 December 2016. The Group's LCR ratio continued to exceed regulatory requirements.

The Group recommended a final ordinary dividend of 1.70 pence per share, together with a capital distribution in the form of a special dividend of 0.5 pence per share. This was in addition to the interim ordinary dividend of 0.85 pence per share that was paid in September 2016.

The total ordinary dividend per share for 2016 of 2.55 pence per share had increased by 13 per cent, from 2.25 pence in 2015.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2017	2016	2015
Net interest income £m	10,912	9,274	11,318
Average interest-earning assets £m	585,374	600,435	614,917
Average rates:			
Gross yield on interest-earning assets %[1]	2.73	2.77	2.86
Interest spread %[2]	1.67	1.33	1.67
Net interest margin %[3]	1.86	1.54	1.84

1 Gross yield is the rate of interest earned on average interest-earning assets.

2 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.

3 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.

2017 COMPARED WITH 2016

Net interest income was £10,912 million in 2017, an increase of £1,638 million, or 18 per cent, compared to £9,274 million in 2016. Net interest income in 2017 includes a charge of £1,435 million in respect of amounts attributable to third party investors in respect of its consolidated Open-Ended Investment Companies (OEICs) compared to a charge in 2016 of £2,057 million as a result of positive market movements in the year, with gains ranging from (1.0) per cent to 37.2 per cent in UK and global equity markets as well as in fixed income indices. The change in population of consolidated OEICs in 2017 compared to 2016 did not have a significant impact on this figure, contributing a net decrease of £65 million attributable to third party investors. After adjusting for the amounts payable to unitholders, net interest income was £1,016 million, or 9 per cent, higher at £12,347 million in 2017 compared to £11,331 million in 2016.

Average interest-earning assets were £15,061 million, or 3 per cent, lower at £585,374 million in 2017 compared to £600,435 million in 2016. The decrease reflected the impact of reductions in closed mortgage books, lending to global corporates and in the portfolio of assets which are outside of the Group’s risk appetite, more than offsetting the impact of the acquisition of MBNA.

The net interest margin was 32 basis points higher at 1.86 per cent in 2017 compared to 1.54 per cent in 2016, and adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 22 basis points higher at 2.11 per cent in 2017 compared to 1.89 per cent in 2016. The improvement in net interest margin reflected lower deposit and wholesale funding costs and a positive impact from the acquisition of MBNA, more than offsetting continued pressure on asset margins. Margins in Retail improved as a result of deposit repricing in the first quarter of 2017 and the positive impact of the acquisition of MBNA. Margins on relationship lending and similar interest-earning assets in Commercial Banking also improved as a result of the lower funding costs.

2016 COMPARED WITH 2015

Net interest income was £9,274 million in 2016, a decrease of £2,044 million, or 18 per cent, compared to £11,318 million in 2015. Net interest income in 2016 includes a charge of £2,057 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2015 of £244 million. The increase reflects more favourable market conditions; the change in population of consolidated OEICs in 2016 compared to 2015 did not have a significant impact. After adjusting for the amounts payable to unitholders, net interest income was £231 million, or 2 per cent, lower at £11,331 million in 2016 compared to £11,562 million in 2015.

Average interest-earning assets were £14,482 million, or 2 per cent, lower at £600,435 million in 2016 compared to £614,917 million in 2015. The reduction reflected the impact of the sale of TSB part-way through 2015, the continuing run-off of assets which are outside of the Group’s risk appetite and a reduction in UK mortgage balances, reflecting the focus on protecting margins, partly offset by increased SME lending and unsecured personal lending.

The net interest margin was 30 basis points lower at 1.54 per cent in 2016 compared to 1.84 per cent in 2015, however adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 1 basis point higher at 1.89 per cent in 2016 compared to 1.88 per cent in 2015. Margins in Retail fell only slightly despite the challenges of the continuing low interest rate environment; due to the focus on high quality, lower margin business, with the margin also impacted by lower Euribor and planned reductions in deposits. Margins on relationship lending and similar interest-earning assets in Commercial Banking grew, supported by high quality deposit growth, disciplined deposit pricing and reduced funding costs.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2017 £m	2016 £m	2015 £m
Fee and commission income:			
Current account fees	712	752	804
Credit and debit card fees	953	875	918
Other	1,300	1,418	1,530
	2,965	3,045	3,252
Fee and commission expense	(1,382)	(1,356)	(1,442)
Net fee and commission income	1,583	1,689	1,810
Net trading income	11,817	18,545	3,714
Insurance premium income	7,930	8,068	4,792
Gains on sale of available-for-sale financial assets	446	575	51
Liability management	(14)	(598)	(28)
Other	1,563	2,058	1,493
Other operating income	1,995	2,035	1,516
Total other income	23,325	30,337	11,832

2017 COMPARED WITH 2016

Other income was £7,012 million, or 23 per cent, lower at £23,325 million in 2017 compared to £30,337 million in 2016.

Fee and commission income was £80 million, or 3 per cent, lower at £2,965 million in 2017 compared with £3,045 million in 2016. Current account fees were £40 million, or 5 per cent, lower at £712 million in 2017 compared to £752 million in 2016, due to lower volumes of added-value accounts and changes in pricing structure. An increase of £78 million, or 9 per cent, in credit and debit card fees from £875 million in 2016 to £953 million in 2017 resulted from the acquisition of MBNA and higher levels of card usage. Other fees and commissions receivable were £118 million, or 8 per cent, lower at £1,300 million in 2017 compared with £1,418 million in 2016.

Fee and commission expense was £26 million, or 2 per cent, higher at £1,382 million in 2017 compared to £1,356 million in 2016 as increased fees payable in card services, in part reflecting the acquisition of MBNA, have more than offset reductions on other fees payable.

Net trading income was £6,728 million, or 36 per cent, lower at £11,817 million in 2017 compared with £18,545 million in 2016. Net trading income within the insurance businesses was £6,630 million, or 38 per cent, lower at £10,941 million in 2017 compared to £17,571 million in 2016, which reflects reduced market gains over 2017 compared to 2016 in both debt security and equity investments. Net trading income within the Group’s banking activities was £98 million, or 10 per cent, lower at £876 million in 2017 compared to £974 million in 2016, reflecting the change in fair value of interest rate derivatives and foreign exchange contracts in the banking book not mitigated through hedge accounting.

Insurance premium income was £7,930 million in 2017 compared with £8,068 million in 2016; a decrease of £138 million, or 2 per cent. Earned premiums in respect of the Group's long-term life and pensions business were £23 million lower at £7,187 million in 2017 compared to £7,210 million in 2016 reflecting the fact that good growth in corporate pensions business has been offset by a lower level of bulk annuity deals, compared to the activity in 2016. General insurance earned premiums were £115 million, or 13 per cent, lower at £743 million in 2017 compared with £858 million in 2016 as a result of market conditions and the continued run-off of closed books.

Other operating income was £40 million, or 2 per cent, lower at £1,995 million in 2017 compared to £2,035 million in 2016. In 2016 there was a loss of £721 million arising on the Group's tender offers and redemptions in respect of its Enhanced Capital Notes which completed in March 2016; in 2017 there has been a reduction of £637 million in the movement in value of in-force business from a gain of £472 million in the year ended 31 December 2016 to a charge of £165 million in 2017. The reduction in the movement in value of in-force business reflected the negative impact of assumption changes and experience variances. Gains on sales of available-for-sale financial assets in 2017 included a gain of £146 million on the sale of the Group's investment in Vocalink and £274 million (2016: £112 million) from the sale of UK government securities; 2016 included a gain of £484 million on sale of the Group's investment in VISA Europe.

2016 COMPARED WITH 2015

Other income was £18,505 million higher at £30,337 million in 2016 compared to £11,832 million in 2015.

Fee and commission income was £207 million, or 6 per cent, lower at £3,045 million in 2016 compared with £3,252 million in 2015. Current account fees were £52 million, or 6 per cent, lower at £752 million in 2016 compared to £804 million in 2015, due to the disposal of TSB part-way through 2015 and lower levels of added-value account fees as a result of changing customer preferences. A decrease of £43 million, or 5 per cent, in credit and debit card fees from £918 million in 2015 to £875 million in 2016 resulted from reduced interchange income due to a market-wide cap on fees. Other fees and commissions receivable were £112 million, or 7 per cent lower at £1,418 million in 2016 compared with £1,530 million in 2015 again reflecting the disposal of TSB and reduced income in the Insurance and Commercial divisions and as the portfolio of assets which are outside of the Group's risk appetite continues to run down.

Fee and commission expense was £86 million, or 6 per cent, lower at £1,356 million in 2016 compared to £1,442 million in 2015 in part due to the disposal of TSB during 2015 but also reflecting reduced activity in the mortgage market and lower fees payable following the changes in interchange regulation.

Net trading income was £14,831 million higher at £18,545 million in 2016 compared with £3,714 million in 2015. Net trading income within the insurance businesses was £14,797 million higher at £17,571 million in 2016 compared to £2,774 million in 2015, which reflects higher levels of returns on policyholder investments as a result of more favourable market conditions over 2016. However this increase, along with the increase in long-term insurance premium income, was largely offset by the increase in insurance claims expense and the £1,813 million increase in the amounts payable to unit holders in those Open-Ended Investment Companies consolidated into the Group's results within net interest income. Net trading income within the Group's banking activities was £34 million, or 4 per cent, higher at £974 million in 2016 compared to £940 million in 2015.

Insurance premium income was £8,068 million in 2016 compared with £4,792 million in 2015; an increase of £3,276 million, or 68 per cent. Premium income in 2015 had been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group. Excluding this item earned premiums in respect of the Group's long-term life and pensions business were £1,330 million, or 23 per cent, higher at £7,210 million in 2016 compared to £5,880 million in 2015 reflecting significant new bulk annuities business, more than offsetting reductions in protection and corporate pensions business. General insurance earned premiums were little changed, £13 million, or 1 per cent, lower at £858 million in 2016 compared with £871 million in 2015 as a result of the continuing run-off of closed business.

Other operating income was £519 million higher at £2,035 million in 2016 compared to £1,516 million in 2015 despite a net loss of £721 million arising on the Group's tender offers and redemptions in respect of its Enhanced Capital Notes which completed in March 2016. Excluding this item, other operating income was £1,240 million, or 82 per cent, higher at £2,756 million in 2016 compared to £1,516 million in 2015; this reflected a £634 million improvement in the movement in value of in-force insurance business, reflecting business growth and positive economic variance, and a £524 million increase in gains on disposal of available-for-sale financial assets, from £51 million in 2015 to £575 million in 2016, of which £484 million related to the sale of the Group's investment in Visa Europe.

OPERATING EXPENSES

	2017 £m	2016 £m	2015 £m
Administrative expenses:			
Staff:			
Salaries	2,679	2,750	2,808
Performance-based compensation	473	475	409
Social security costs	361	363	349
Pensions and other post-retirement benefit schemes	625	555	548
Restructuring costs	24	241	104
Other staff costs	448	433	459
	4,610	4,817	4,677
Premises and equipment:			
Rent and rates	365	365	368
Repairs and maintenance	231	187	173
Other	134	120	174
	730	672	715
Other expenses:			
Communications and data processing	882	848	893
Advertising and promotion	208	198	253
Professional fees	328	265	262
UK bank levy	231	200	270
TSB disposal	–	–	665
Other	814	873	703
	2,463	2,384	3,046
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,944	1,761	1,534
Amortisation of acquired value of in-force non-participating investment contracts	34	37	41
Amortisation of other intangible assets	392	582	537
	2,370	2,380	2,112
Goodwill impairment	8	–	–
Total operating expenses, excluding regulatory provisions	10,181	10,253	10,550
Regulatory provisions:			
Payment protection insurance provision	1,300	1,350	4,000
Other regulatory provisions[1]	865	1,024	837
	2,165	2,374	4,837
Total operating expenses	12,346	12,627	15,387
Cost:income ratio (%)[2]	66.2	73.1	88.3

1 In 2016, regulatory provisions of £61 million (2017: £nil; 2015: £nil) were charged against income.

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

2017 COMPARED WITH 2016

Operating expenses decreased by £281 million, or 2 per cent, to £12,346 million in 2017 compared with £12,627 million in 2016. This decrease principally reflects the fact that 2017 includes a regulatory provisions charge of £2,165 million, which was £209 million, or 9 per cent, lower than the charge of £2,374 million in 2016.

Staff costs were £207 million, or 4 per cent, lower in 2017 at £4,610 million compared to £4,817 million in 2016, reflecting, in particular, the impact of reduced headcount. On a full-time equivalent basis, the Group had 67,905 employees at the end of 2017, a reduction of 2,528 from 70,433 employees at 31 December 2016; and this represents an underlying reduction of 4,231 employees offset by an increase of 1,703 employees as a result of the acquisition of MBNA. Salaries were £71 million, or 3 per cent, lower at £2,679 million in 2017 compared with £2,750 million in 2016. Pension costs were £70 million, or 13 per cent, higher at £625 million in 2017 compared to £555 million in 2016; social security costs were £2 million, or 1 per cent, lower at £361 million in 2017 compared with £363 million in 2016; and other staff costs were £15 million, or 3 per cent, higher at £448 million in 2017 compared with £433 million in 2016.

Premises and equipment costs were £58 million, or 9 per cent, higher at £730 million in 2017 compared to £672 million in 2016. Rent and rates were unchanged at £365 million; repairs and maintenance costs were £44 million, or 24 per cent, higher at £231 million in 2017 compared to £187 million in 2016, as a result of charges relating to property rationalisation, and other premises and equipment costs increased by £14 million, or 12 per cent, from £120 million in 2016 to £134 million in 2017.

Other expenses, excluding the regulatory provisions charges, were 79 million, or 3 per cent, higher at £2,463 million in 2017 compared with £2,384 million in 2016. Communications and data processing costs were £34 million, or 4 per cent, higher at £882 million in 2017 compared with

£848 million in 2016 as a result of the acquisition of MBNA and project costs; professional fees were £63 million, or 24 per cent, higher at £328 million in 2017 compared to £265 million in 2016 as a result of costs in relation to regulatory developments such as ring-fencing; and advertising and promotion costs were £10 million, or 5 per cent, higher at £208 million in 2017 compared with £198 million in 2016, in part reflecting the acquisition of MBNA. The cost of the Bank levy was £31 million, or 16 per cent, higher at £231 million in 2017 compared to £200 million in 2016. Other costs were £59 million, or 7 per cent, lower at £814 million in 2017 compared with £873 million in 2016.

Depreciation and amortisation costs were £10 million lower at £2,370 million in 2017 compared with £2,380 million in 2016. Charges for the depreciation of tangible fixed assets were £183 million, or 10 per cent, higher at £1,944 million in 2017 compared to £1,761 million in 2016, in line with increased operating lease asset balances. The charge for the amortisation of intangible assets was £190 million, or 33 per cent, lower at £392 million in 2017 compared to £582 million in 2016, reflecting the fact that the core deposit intangible arising from the HBOS acquisition became fully amortised in the early part of 2017, only partly offset by charges relating to the purchased credit card receivable established on the MBNA acquisition and to software.

The Group incurred a regulatory provisions charge in operating expenses of £2,165 million in 2017 compared to £2,374 million in 2016 (in addition there was £61 million in the year ended 31 December 2016 which was charged against income) of which £1,300 million (2016: £1,350 million) related to payment protection insurance.

2016 COMPARED WITH 2015

Operating expenses decreased by £2,760 million, or 18 per cent, to £12,627 million in 2016 compared with £15,387 million in 2015. This decrease principally reflects the fact that 2016 includes a regulatory provisions charge of £2,374 million, which was £2,463 million, or 51 per cent, lower than the charge of £4,837 million in 2015.

Staff costs were £140 million, or 3 per cent, higher in 2016 at £4,817 million compared to £4,677 million in 2015, reflecting, in particular, increased expenditure in relation to the Group’s restructuring programmes. Salaries were £58 million, or 2 per cent, lower at £2,750 million in 2016 compared with £2,808 million in 2015, as the impact of headcount reductions, including the sale of TSB, has more than offset annual pay rises; pension costs were £7 million, or 1 per cent, higher at £555 million in 2016 compared to £548 million in 2015; social security costs were £14 million, or 4 per cent, higher at £363 million in 2016 compared with £349 million in 2015; and other staff costs were £26 million, or 6 per cent, lower at £433 million in 2016 compared with £459 million in 2015, in part due to lower levels of agency staff costs.

Premises and equipment costs were £43 million, or 6 per cent, lower at £672 million in 2016 compared to £715 million in 2015. Rent and rates was £3 million, or 1 per cent, lower at £365 million in 2016 compared to £368 million in 2015, in part due to charges in respect of onerous lease contracts as the Group rationalises its property portfolio; repairs and maintenance costs were £14 million, or 8 per cent, higher at £187 million in 2016 compared to £173 million in 2015 and other premises and equipment costs decreased by £54 million, or 31 per cent, from £174 million in 2015 to £120 million in 2016, partly reflecting gains on disposal of property, plant and equipment.

Other expenses, excluding the regulatory provisions charges, were £662 million, or 22 per cent, lower at £2,384 million in 2016 compared with £3,046 million in 2015. The Group had incurred a charge of £665 million in 2015 relating to the disposal of TSB, which was not repeated in 2016; excluding this charge, other expenses of £2,384 million in 2016 were £3 million higher than £2,381 million in 2015. Communications and data processing costs were £45 million, or 5 per cent, lower at £848 million in 2016 compared with £893 million in 2015 as a result of the sale of TSB and efficiency initiatives; professional fees were £3 million, or 1 per cent, higher at £265 million in 2016 compared to £262 million in 2015 as reduced costs following the sale of TSB have been offset by costs in relation to regulatory developments such as ring-fencing; and advertising and promotion costs were £55 million, or 22 per cent, lower at £198 million in 2016 compared with £253 million in 2015 as a result of the sale of TSB and reduced spend on certain marketing initiatives. The cost of the Bank levy was £70 million, or 26 per cent, lower at £200 million in 2016 compared to £270 million in 2015, as a result of reduced levels of chargeable liabilities. Other costs were £170 million, or 24 per cent, higher at £873 million in 2016 compared with £703 million in 2015.

Depreciation and amortisation costs were £268 million, or 13 per cent, higher at £2,380 million in 2016 compared with £2,112 million in 2015. Charges for the depreciation of tangible fixed assets were £227 million, or 15 per cent, higher at £1,761 million in 2016 compared to £1,534 million in 2015, in line with increased asset balances, in particular operating lease assets. The charge for the amortisation of other intangible assets was £45 million, or 8 per cent, higher at £582 million in 2016 compared to £537 million in 2015, reflecting increased capitalised software balances.

The Group incurred a regulatory provisions charge in operating expenses of £2,374 million in 2016 compared to £4,837 million in 2015 (in addition to £61 million, 2015: £nil, charged against income) of which £1,350 million (2015: £4,000 million) related to payment protection insurance.

IMPAIRMENT

	2017 £m	2016 £m	2015 £m
Impairment losses on loans and receivables:			
Loans and advances to customers	697	592	443
Debt securities classified as loans and receivables	(6)	–	(2)
Total impairment losses on loans and receivables	691	592	441
Impairment of available-for-sale financial assets	6	173	4
Other credit risk provisions	(9)	(13)	(55)
Total impairment charged to the income statement	688	752	390

2017 COMPARED WITH 2016

Impairment losses decreased by £64 million, or 9 per cent, to £688 million in 2017 compared to £752 million in 2016, as a charge of £118 million in the MBNA business since acquisition has offset the impact of the charge in respect of available-for-sale financial assets in 2016 which was not repeated in 2017.

The impairment charge in respect of loans and advances to customers was £105 million, or 18 per cent, higher at £697 million in 2017 compared to £592 million in 2016. In Retail, overall credit performance in the mortgage book remains stable. The average indexed loan to value (LTV) improved to 43.6 per cent (31 December 2016: 44.0 per cent) while the percentage of lending with an indexed LTV of greater than 100 per cent fell to 0.6 per cent (31 December 2016: 0.7 per cent). The UK Motor Finance book continues to benefit from conservative residual values and prudent provisioning and impaired loans as a percentage of closing advances were stable. The credit card book also continued to perform strongly with reductions in persistent debt while the MBNA portfolio performed in line with both the Group’s expectations and the existing credit card book. Impaired credit card balances as a percentage of closing advances improved. Increased charges in Commercial Banking were driven by a lower level of releases and recoveries rather than a deterioration in the underlying portfolio, both 2016 and 2017 included material charges against a single customer (2016: oil and gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low. The Commercial Banking portfolio continues to benefit from effective risk management, a relatively benign economic environment and continued low interest rates. The impairment charge relating to assets which are outside of the Group’s risk appetite increased.

The impairment charge in respect of available-for-sale financial assets was £6 million in 2017, compared to £173 million in 2016, as a result of a charge in 2016 in respect of certain equity investments; and there was a credit of £9 million (2016: credit of £13 million) in respect of other credit risk provisions.

2016 COMPARED WITH 2015

Impairment losses increased by £362 million, or 93 per cent, to £752 million in 2016 compared to £390 million in 2015, largely due to lower levels of releases and write-backs and a charge in respect of available-for-sale financial assets.

The impairment charge in respect of loans and advances to customers was £149 million, or 34 per cent, higher at £592 million in 2016 compared to £443 million in 2015. In Retail, increased charges reflected a lower level of benefit from improvements in house prices in the secured book. The increased charges in Commercial Banking were driven by lower levels of releases and recoveries as well as overall growth in the consumer finance book and the non-recurrence of a favourable one-off release in 2015. The impairment charge relating to assets which are outside of the Group's risk appetite reduced, reflecting the continued run down of the portfolio.

The impairment charge in respect of available-for-sale financial assets was £173 million in 2016, compared to £4 million in 2015, as a result of a charge in respect of certain equity investments; and there was a credit of £13 million (2015: credit of £55 million) in respect of other credit risk provisions, in both years reflecting improved credit quality in a number of corporate relationships.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

TAXATION

	2017 £m	2016 £m	2015 £m
UK corporation tax:			
Current tax on profits for the year	(1,346)	(1,010)	(485)
Adjustments in respect of prior years	126	156	(90)
	(1,220)	(854)	(575)
Foreign tax:			
Current tax on profits for the year	(40)	(20)	(24)
Adjustments in respect of prior years	10	2	27
	(30)	(18)	3
Current tax (charge) credit	(1,250)	(872)	(572)
Deferred tax	(478)	(852)	(116)
Tax expense	(1,728)	(1,724)	(688)

2017 COMPARED WITH 2016

In 2017, a tax expense of £1,728 million arose on the profit before tax of £5,625 million and in 2016 a tax expense of £1,724 million arose on the profit before tax of £3,888 million. The statutory corporation tax rates were 19.25 per cent for 2017 and 20 per cent for 2016.

The tax expense for 2017 represents an effective tax rate of 31 per cent; the high effective tax rate in 2017 was largely due to the banking surcharge, and restrictions on the deductibility of conduct provisions.

2016 COMPARED WITH 2015

In 2016, a tax expense of £1,724 million arose on the profit before tax of £3,888 million and in 2015 a tax expense of £688 million arose on the profit before tax of £1,644 million. The statutory corporation tax rates were 20 per cent for 2016 and 20.25 per cent for 2015.

The tax expense for 2016 represented an effective tax rate of 44 per cent; the high effective tax rate in 2016 was largely due to the banking surcharge, restrictions on the deductibility of conduct provisions and the negative impact on the net deferred tax asset of both the change in corporation tax rate and the expected utilisation by the life assurance business.

LINE OF BUSINESS INFORMATION

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

The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources.

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

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

As part of a Group restructuring during 2017:

- the Consumer Finance division has now become part of Retail;
- the Group's UK wealth business, previously part of Retail, has been transferred to the Insurance division, now renamed Insurance and Wealth;
- the Group's International wealth business, previously part of Retail, has been transferred to the Commercial Banking division; and

– the Group’s venture capital business, previously part of Commercial Banking, has been transferred to Other.

Comparatives have been restated accordingly. Following this restructuring, the Group’s activities are now organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

Comparisons of results on a historical consolidated statutory basis are impacted by a number of items. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on an ‘underlying’ basis. The following items are excluded in arriving at underlying profit:

– losses on redemption of the Enhanced Capital Notes and the volatility in the value of the embedded equity conversion feature;

– market volatility and asset sales, which includes the effects of certain asset sales, the volatility relating to the Group’s own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up;

– the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets;

– restructuring costs comprising costs relating to the Simplification programme and the costs of implementing regulatory reform and ring fencing, rationalisation of the non-branch property portfolio and the integration of MBNA;

– TSB build and dual running costs and the loss relating to the TSB sale in 2015; and

– payment protection insurance and other conduct provisions,

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

	2017 **£m**	2016[1] £m	2015[1] £m
Retail	4,403	4,058	4,255
Commercial Banking	2,489	2,379	2,383
Insurance and Wealth	939	973	1,090
Other	662	457	384
Underlying profit before tax	8,493	7,867	8,112

1 Segmental analysis restated, as explained above.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Reconciliation of underlying profit to statutory profit before tax for the year

	Note	2017 £m	2016 £m	2015 £m
Underlying profit before tax		8,493	7,867	8,112
Enhanced Capital Notes	1	–	(790)	(101)
Market volatility and asset sales	2	279	439	(81)
Amortisation of purchased intangibles	3	(91)	(340)	(342)
Restructuring and TSB dual running costs	4	(621)	(622)	(255)
Charge relating to TSB disposal	5	–	–	(660)
Fair value unwind and other items	6	(270)	(231)	(192)
Payment protection insurance provision	7	(1,300)	(1,350)	(4,000)
Other conduct provisions	8	(865)	(1,085)	(837)
Statutory profit before tax		5,625	3,888	1,644

1. Enhanced Capital Notes

The Group completed tender offers and redemptions in respect of its Enhanced Capital Notes (ECNs) in March 2016, resulting in a net loss to the Group of £721 million in the year ended 31 December 2016, principally comprising the write-off of the embedded equity conversion feature and premiums paid under the terms of the transaction. In addition there was a charge of £69 million reflecting the change in fair value of the embedded equity conversion feature in the period prior to the transaction.

In the year ended 31 December 2015, a charge of £101 million arose from the change in fair value of the embedded equity conversion feature.

2. Market volatility and asset sales

Market volatility and asset sales of £279 million included positive volatility in the insurance business of £286 million. The credit of £439 million in 2016 included the gain on sale of Visa Europe of £484 million partly offset by negative volatility in the insurance business of £91 million.

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

In 2017, the Group's statutory result before tax included positive insurance and policyholder interests volatility totalling £286 million compared to negative volatility of £91 million in 2016 and negative volatility of £105 million in 2015.

Volatility comprises the following:

	2017	2016	2015
	£m	£m	£m
Insurance volatility	196	(152)	(303)
Policyholder interests volatility	190	241	87
Insurance hedging arrangements	(100)	(180)	111
Total	286	(91)	(105)

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

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

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

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

Management compensates for the limitations above by:

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

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

Insurance volatility

The Group's insurance business has policyholder liabilities that are supported by substantial holdings of investments. IFRS requires that the changes in both the value of the liabilities and investments are reflected within the income statement. The value of the liabilities does not move exactly in line with changes in the value of the investments. As the investments are substantial, movements in their value can have a significant impact on the profitability of the Group. Management believes that it is appropriate to disclose the division's results on the basis of an expected return in addition to results based on the actual return. The impact of the actual return on these investments differing from the expected return is included within insurance volatility.

The expected gross investment returns used to determine the underlying profit of the business are based on prevailing market rates and published research into historical investment return differentials for the range of assets held. The basis for calculating these expected returns reflects an average of the 15 year swap rate over the preceding 12 months updated throughout the year to reflect changing market conditions. The positive insurance volatility during 2017 of £196 million primarily reflects positive returns on equities.

Policyholder interests volatility

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

Accounting standards require that tax on policyholder investment returns relating to life products should be included in the Group's tax expense rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the expected approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. In 2017, the statutory profit before tax included a credit to other income which relates to policyholder interests volatility totalling £190 million reflecting movements in equity, bond and gilt returns relating to life products.

Insurance hedging arrangements

The Group purchased put option contracts in 2017 to protect against deterioration in equity market conditions and the consequent negative impact on the value of in-force business on the Group balance sheet. These were financed by selling some upside potential from equity market movements. A loss of £100 million was recognised in relation to these contracts in 2017, which was less than the gain from the underlying exposure.

3. Amortisation of purchased intangibles

The Group incurred a charge for the amortisation of intangible assets, principally those recognised on the acquisition of HBOS in 2009, of £91 million (2016: £340 million; 2015: £342 million); the lower charge in 2017 reflects the fact that the core deposit intangible arising from the HBOS acquisition is now fully amortised.

4. Restructuring costs and TSB build and dual-running costs

Restructuring costs in 2017 were £621 million and comprised severance costs relating to the Simplification programme, the rationalisation of the non-branch property portfolio, the integration of MBNA and the work on implementing the ring-fencing requirements.

Restructuring costs were £622 million in 2016 and comprised costs relating to the Simplification programme, the announced rationalisation of the non-branch property portfolio and the work on implementing the ring-fencing requirements. Restructuring costs of £170 million in 2015 related to the next phase of Simplification announced in October 2014.

During 2015, the Group completed the European Commission (EC) mandated business disposal of TSB. TSB dual-running costs in the year ended 31 December 2015 totalled £85 million. The dual-running costs included the costs of TSB's standalone treasury, finance, human resources and other head office functions.

5. Charge relating to TSB disposal

The Group completed the sale of a 9.99 per cent interest in TSB Banking Group plc (TSB) to Banco de Sabadell S.A. (Sabadell) on 24 March 2015, reducing the Group's holding in TSB to 40.01 per cent; this sale led to a loss of control and the deconsolidation of TSB. The Group's residual investment in 40.01 per cent of TSB was then recorded at fair value, as an asset held for sale. The Group recognised a loss of £660 million reflecting the net costs of the Transitional Service Agreement between Lloyds and TSB, the contribution to be provided by Lloyds to TSB in moving to alternative IT provision and the net result on sale of the 9.99 per cent interest and fair valuation of the residual investment.

The Group announced on 30 June 2015 that all relevant regulatory clearances for the sale of its remaining 40.01 per cent holding in TSB to Sabadell had been received and that the sale was therefore unconditional in all respects; the proceeds were received on 10 July 2015.

6. Fair value unwind and other items

The statutory (IFRS) results include the impact of the acquisition-related fair value adjustments, principally those arising from the acquisition of HBOS in 2009; these adjustments affect a number of line items.

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

7. Payment protection insurance provision

There was a charge of £1,300 million (2016: £1,350 million; 2015: £4,000 million) in respect of Payment Protection Insurance (PPI), claim levels having increased as expected in the third quarter of 2017 following the FCA advertising campaign and increased marketing activity from claims management companies (CMCs). The remaining provision is consistent with an average of 11,000 complaints per week (higher than the Group's previously assumed run-rate of about 9,000 per week) through to the industry deadline of August 2019.

8. Other conduct provisions

Other conduct provisions of £865 million (2016: £1,085 million; 2015: £837 million) cover a number of items including £245 million in relation to packaged bank accounts and £245 million in respect of arrears handling. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and has made good progress in reimbursing mortgage arrears fees to the 590,000 impacted customers. The Group is also currently undertaking a review of the HBOS Reading fraud and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. A provision of £100 million was taken and reflects the estimated compensation costs for HBOS Reading.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

DIVISIONAL RESULTS

RETAIL

Retail offers a broad range of financial service products, including current accounts, savings, mortgages, credit cards, motor finance and unsecured loans to personal and business banking customers. Its aim is to be the best bank for customers in the UK, by building deep and enduring relationships that deliver value to customers, and by providing them with greater choice and flexibility. Retail operates a multi-brand and multi-channel strategy and continues to simplify the business and provide more transparent products, helping to improve service levels and reduce conduct risks, whilst working within a prudent risk appetite.

	2017	2016[1]	2015[1]
	£m	£m	£m
Net interest income	8,706	8,073	8,253
Other income	2,217	2,162	2,263
Total income	10,923	10,235	10,516
Operating lease depreciation	(946)	(775)	(720)
Net income	9,977	9,460	9,796
Operating expenses	(4,857)	(4,748)	(4,958)
Impairment	(717)	(654)	(583)
Underlying profit	4,403	4,058	4,255

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Underlying profit increased by £345 million, or 9 per cent, to £4,403 million in 2017 compared to £4,058 million in 2016, including MBNA which was acquired on 1 June 2017.

Net interest income increased by £633 million, or 8 per cent, to £8,706 million in 2017 compared to £8,073 million in 2016, reflecting the acquisition of MBNA and driven by deposit repricing offsetting mortgage margin pressures.

Other income increased £55 million, or 3 per cent, to £2,217 million in 2017 compared to £2,162 million in 2016, driven by continued fleet growth in Lex Autolease.

Operating lease depreciation increased £171 million, or 22 per cent, to £946 million in 2017 compared to £775 million in 2016, again driven by continued fleet growth in Lex Autolease and increased conservatism in residual value management.

Operating expenses increased by £109 million, or 2 per cent, to £4,857 million in 2017 compared to £4,748 million in 2016 mainly due to the inclusion of MBNA as well as increased investment spend and pay-related growth, partly offset by underlying efficiency savings.

Impairment increased by £63 million, or 10 per cent, to £717 million in 2017 compared to £654 million in 2016, largely due to the addition of MBNA, partly offset by a lower charge reflecting the resilient economic environment.

2016 COMPARED WITH 2015

Underlying profit decreased by £197 million, or 5 per cent, to £4,058 million in 2016 compared to £4,255 million in 2015, reflecting the challenging interest rate environment and continued pressure on other operating income.

Net interest income decreased by £180 million, or 2 per cent, to £8,073 million in 2016 compared to £8,253 million in 2015, largely due to a reduction in mortgage balances following the focus on maximising margins as well as lower hedge income partly offset by continued growth in Black Horse.

Other income decreased £101 million, or 4 per cent, to £2,162 million in 2016 compared to £2,263 million in 2015, driven by changing customer behaviour and improvements to the customer propositions along with market-wide reduction in credit card interchange fees, partly offset by continued fleet growth in Lex Autolease.

Operating lease depreciation increased £55 million, or 8 per cent, to £775 million in 2016 compared to £720 million in 2015, driven by the continued fleet growth in Lex Autolease.

Operating expenses decreased by £210 million, or 4 per cent, to £4,748 million in 2016 compared to £4,958 million in 2015 with continued investment in the business more than offset by underlying efficiency savings.

Impairment increased by £71 million, or 12 per cent, to £654 million in 2016 compared to £583 million in 2015. Underlying credit quality remained stable.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL BANKING

Commercial Banking has a client-led, low risk, capital efficient strategy, helping UK-based clients and international clients with a link to the UK. Through its four client facing segments – SME, Mid Markets, Global Corporates and Financial Institutions – it provides clients with a range of products and services such as lending, transactional banking, working capital management, risk management and debt capital markets services.

	2017	2016[1]	2015[1]
	£m	£m	£m
Net interest income	3,086	2,934	2,774
Other income	1,761	1,756	1,842
Total income	4,847	4,690	4,616
Operating lease depreciation	(44)	(105)	(30)
Net income	4,803	4,585	4,586
Operating expenses	(2,199)	(2,189)	(2,225)
Impairment	(115)	(17)	22
Underlying profit	2,489	2,379	2,383

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Commercial Banking underlying profit increased by £110 million, to £2,489 million in 2017 compared to £2,379 million in 2016 due to income growth and active cost management.

Net interest income increased by £152 million, or 5 per cent, to £3,086 million in 2017 compared to £2,934 million in 2016 with an improvement in net interest margin supported by broad based franchise growth and increased net asset margin.

Other income increased by £5 million to £1,761 million in 2017 compared to £1,756 million in 2016 despite fewer significant transactions in the second half and reduced client activity.

Operating lease depreciation decreased by £61 million to £44 million in 2017 compared to £105 million in 2016 due to lower accelerated charges.

Operating expenses increased by £10 million to £2,199 million in 2017 compared to £2,189 million in 2016.

Impairments increased by £98 million, to £115 million charge in 2017 compared to £17 million in 2016, driven by a lower level of releases and recoveries rather than a deterioration in the underlying portfolio; both 2016 and 2017 included material charges against a single customer (2016: oil and gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low.

2016 COMPARED WITH 2015

Commercial Banking underlying profit decreased by £4 million, to £2,379 million in 2016 compared to £2,383 million in 2015 due to additional charges relating to certain leasing assets partially offset by total income growth.

Net interest income increased by £160 million, or 6 per cent, to £2,934 million in 2016 compared to £2,774 million in 2015 with an improvement in net interest margin supported by high quality deposit growth, disciplined deposit pricing and reduced funding costs.

Other income decreased by £86 million, or 5 per cent, to £1,756 million in 2016 compared to £1,842 million in 2015 driven by non-recurring income recognised in 2015, relating to refinancing support of Global Corporates clients.

Operating lease depreciation increased by £75 million to £105 million in 2016 compared to £30 million in 2015 due to additional charges relating to certain leasing assets.

Operating expenses decreased by £36 million to £2,189 million in 2016 compared to £2,225 million in 2015.

Impairments increased by £39 million, to a charge of £17 million in 2016 compared to a release of £22 million in 2015.

INSURANCE AND WEALTH

Insurance and Wealth offers insurance, investment and wealth management products and services. It supports over 9 million customers with total customer assets under management of £145 billion and annualised annuity payments to customers in retirement of approximately £1 billion. The division's strategic aim is to be the best insurer and wealth management business in the UK. It is committed to providing trusted, value for money products and services to meet the needs of its customers.

	2017	2016 [1]	2015 [1]
	£m	£m	£m
Net interest income	133	80	59
Other income	1,846	1,939	1,986
Total income, net of insurance claims	1,979	2,019	2,045
Operating expenses	(1,040)	(1,046)	(954)
Impairment	–	–	(1)
Underlying profit	939	973	1,090

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

Underlying profit from Insurance and Wealth was £34 million, or 3 per cent lower at £939 million compared to £973 million in 2016 as a result of lower Wealth income. Income in insurance and overall costs remained flat, with higher investment costs offset by lower business as usual costs.

Net interest income increased by £53 million, or 66 per cent, to £133 million from £80 million in 2016 due to a lower net interest expense within Insurance reflecting reduced funding costs.

Other income decreased by £93 million, or 5 per cent, to £1,846 million from £1,939 million in 2016 reflecting lower margins in Insurance as a result of the competitive environment, strengthening of underlying assumptions and lower bulk annuity sales. General insurance income fell due to the continued competitiveness of the home insurance marketplace.

Total costs were £6 million lower, with higher investment costs offset by lower business as usual costs.

2016 COMPARED WITH 2015

Underlying profit from Insurance and Wealth was £117 million, or 11 per cent lower at £973 million compared to £1,090 million in 2015. A 17 per cent increase in insurance new business income was more than offset by adverse economics impacting insurance existing business income together with increased investment costs.

Net interest income increased by £21 million, or 35 per cent, to £80 million from £59 million in 2015 due to a lower net interest expense within Insurance from lower interest rates. Net interest income within Wealth remained steady.

Other income decreased by £47 million, or 2 per cent, to £1,939 million from £1,986 million in 2015. The decrease was driven by adverse economics impacting existing business income partly offset by the four bulk annuity deals completed in the year. General insurance income net of claims increased as a result of lower weather related claims.

Total costs were £92 million higher reflecting increased investment and £28 million annual levy associated with the Flood Re scheme.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INCOME BY PRODUCT GROUP

	2017			2016[1]			2015[1]		
	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m
Workplace	107	96	203	123	103	226	140	134	274
Planning and retirement	95	91	186	109	95	204	40	94	134
Bulk annuities	54	26	80	121	16	137	125	–	125
Protection	13	20	33	19	17	36	12	19	31
Longstanding life, pensions and investments	12	440	452	9	441	450	9	526	535
	281	673	954	381	672	1,053	326	773	1,099
Life and pensions experience and other items			358			202			242
General Insurance			298			354			323
			1,610			1,609			1,664
Wealth			369			410			381
Total income			1,979			2,019			2,045

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

New business income has decreased by £100 million to £281 million. Excluding bulk annuities and 2016 with profits fund annuity transfer within planning and retirement, new business income remains stable.

Existing business income has increased by £1 million to £673 million, with positive impact of economics offset by legacy products run-off.

Experience and other items contributed a net benefit of £358 million, including benefits as a result of changes to longevity assumptions. These include both experience in the annuity portfolio and the adoption of a new industry model reflecting an updated view of future life expectancy.

2016 COMPARED WITH 2015

New business income has increased by £55 million to £381 million driven by growth in planning and retirement and protection propositions. This has more than offset lower income from workplace.

Existing business income has decreased by £101 million, primarily driven by adverse economics.

There was a net benefit of £202 million as a result of experience and other items. This included one off benefits following an update to the methodology for calculating the illiquidity premium and the addition of a new death benefit to legacy pension contracts, to align terms with other pensions products. These were partly offset by the effect of recent reforms on activity within the pensions market.

OTHER

Other comprises Run-off, the results of TSB up until loss of control in March 2015 and Central items.

Run-off

Run-off comprises assets classified as outside the Group's risk appetite.

	2017 £m	2016 £m	2015 £m
Net interest expense	(91)	(110)	(88)
Other income	42	120	145
Total income	(49)	10	57
Operating lease depreciation	(63)	(15)	(14)
Net income	(112)	(5)	43
Operating expenses	(54)	(77)	(150)
Impairment release (charge)	41	26	(8)
Underlying loss	(125)	(56)	(115)

2017 COMPARED WITH 2016

The underlying loss deteriorated by £69 million to £125 million in 2017 compared to £56 million in 2016, with reduced income and operating costs both reflecting further reductions in these portfolios of lending which are outside of the Group's risk appetite.

Net interest expense improved by £19 million, or 17 per cent, to £91 million in 2017 compared to £110 million in 2016, however other income reduced by £78 million, or 65 per cent, to £42 million in 2017 compared to £120 million in 2016.

There was an increase of £48 million in the charge for operating lease depreciation, net of profits on sale of operating lease assets, from £15 million in 2016 to £63 million in 2017.

Operating costs were £23 million, or 30 per cent, lower at £54 million in 2017 compared to £77 million in 2016 and there was an increased impairment release of £41 million which was £15 million, or 58 per cent, higher than the release of £26 million in 2016.

2016 COMPARED WITH 2015

The underlying loss of £56 million was an improvement of £59 million compared to the loss of £115 million in 2015.

Total income decreased by £47 million to £10 million in 2016 compared to £57 million in 2015, in particular reflecting reduced fee and other income as the portfolio continues to run off.

Operating expenses were £73 million, or 49 per cent, lower at £77 million compared to £150 million in 2015 reflecting the reducing costs of managing the portfolio as it runs down.

Impairment was a credit of £26 million compared to a charge of £8 million in 2015, in particular reflecting a credit in 2016 compared to a charge in 2015 in relation to Irish lending.

Central items

Central items includes income and expenditure not attributed to divisions, including the costs of certain central and head office functions and the Group's private equity business, Lloyds Development Capital.

	2017	2016[1]	2015[1]
	£m	£m	£m
Total income	825	546	403
Operating expenses	(34)	(33)	(24)
Impairment (charge) release	(4)	–	2
Underlying profit	787	513	381

1 Restated, as explained on page 24.

2017 COMPARED WITH 2016

The underlying profit in Central items was £274 million, or 53 per cent, higher at £787 million in 2017 compared to £513 million in 2016.

Total income increased by £279 million, or 51 per cent, from £546 million in 2016 to £825 million in 2017 largely as a result of the gain of £146 million on the sale of the Group's interest in Vocalink and the gains on sales of liquid assets, including gilts, of £ 274 million (2016: £112 million).

Operating expenses were £1 million, or 3 per cent, higher at £34 million in 2017 compared to £33 million in 2016.

There was a small impairment charge of £4 million in 2017 (2016: £nil).

2016 COMPARED WITH 2015

The underlying profit in Central items was £132 million, or 35 per cent, higher at £513 million in 2016 compared to £381 million in 2015.

Total income increased by £143 million, or 35 per cent, from £403 million in 2015 to £546 million in 2016, largely as a result of sales of liquid assets including gilts, and the timing of dividends from the Group's strategic investments.

Operating expenses were £9 million, or 38 per cent, higher at £33 million in 2016 compared to £24 million in 2015.

There was a small impairment credit of £2 million in 2015 but this was not repeated in 2016.

TSB

TSB served retail and small business customers; providing a full range of retail banking products. The Group sold its controlling interest in TSB in March 2015 and ceased to consolidate TSB's results at that point.

	2017	2016	2015
	£m	£m	£m
Net interest income	–	–	192
Other income	–	–	31
Total income	–	–	223
Operating expenses	–	–	(86)
Impairment	–	–	(19)
Underlying profit	–	–	118

TSB results are shown on a Lloyds Banking Group reporting basis. The costs of TSB's head office functions are excluded from underlying profit.

2016 COMPARED WITH 2015

Because TSB was sold during 2015, no results were consolidated in 2016, this compared to a profit of £118 million in 2015, for the period up to sale in March 2015.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2017			2016			2015		
	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	67,049	271	0.40	82,409	381	0.46	94,543	397	0.42
Loans and advances to customers	464,944	14,712	3.16	457,622	15,190	3.32	464,012	16,256	3.50
Debt securities	3,332	43	1.29	3,797	56	1.47	2,139	40	1.87
Available-for-sale financial assets	50,049	980	1.96	40,604	762	1.88	40,967	725	1.77
Held-to-maturity investments	–	–	–	16,003	231	1.44	13,256	197	1.49
Total interest-earning assets of banking book	585,374	16,006	2.73	600,435	16,620	2.77	614,917	17,615	2.86
Total interest-earning trading securities and other financial assets at fair value through profit or loss	79,754	1,772	2.22	81,961	1,594	1.94	87,583	1,955	2.23
Total interest-earning assets	665,128	17,778	2.67	682,396	18,214	2.67	702,500	19,570	2.79
Allowance for impairment losses on loans and receivables	(2,161)			(2,536)			(4,729)		
Non-interest earning assets	155,853			148,965			145,224		
Total average assets and interest income	818,820	17,778	2.17	828,825	18,214	2.20	842,995	19,570	2.32

	2017			2016			2015		
	Average interest earning assets £m	**Net interest income £m**	**Net interest margin %**	Average interest earning assets £m	Net interest income £m	Net interest margin %	Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	585,374	10,912	1.86	600,435	9,274	1.54	614,917	11,318	1.84
	79,754	1,294	1.62	81,961	1,060	1.29	87,583	1,205	1.38

Trading securities and other financial assets at fair value through profit or loss	665,128	12,206	1.84	682,396	10,334	1.51	702,500	12,523	1.78

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2017			2016			2015		
	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	6,758	80	1.18	10,540	68	0.65	10,442	43	0.41
Customer deposits	348,683	1,722	0.49	366,178	2,520	0.69	380,137	3,299	0.87
Liabilities to banks and customers under sale and repurchase agreements	18,943	110	0.58	8,342	38	0.46	5,960	34	0.57
Debt securities in issue[1]	72,762	266	0.37	85,030	799	0.94	85,462	586	0.69
Amounts payable to unitholders in consolidated open-ended investment vehicles	15,675	1,435	9.15	18,961	2,057	10.85	21,059	244	1.16
Subordinated liabilities	18,674	1,481	7.93	22,330	1,864	8.35	24,975	2,091	8.37
Total interest-bearing liabilities of banking book	481,495	5,094	1.06	511,381	7,346	1.44	528,035	6,297	1.19
Total interest-bearing liabilities of trading book	55,288	478	0.86	50,700	534	1.05	61,560	750	1.22
Total interest-bearing liabilities	536,783	5,572	1.04	562,081	7,880	1.40	589,595	7,047	1.20
Interest-free liabilities									
Non-interest bearing customer accounts	66,276			54,379			45,294		
Other interest-free liabilities	166,403			163,688			158,852		
Non-controlling interests and shareholders' funds	49,358			48,677			49,254		
Total average liabilities and interest expense	818,820	5,572	0.68	828,825	7,880	0.95	842,995	7,047	0.84

1 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.43 per cent (2016: 2.70 per cent; 2015: 2.76 per cent).

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.

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CHANGES IN NET INTEREST INCOME – VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between volume and rate for 2017 compared with 2016 and for 2016 compared with 2015. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2017 compared with 2016 Increase/(decrease)			2016 compared with 2015 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	(110)	(61)	(49)	(16)	(56)	40
Loans and advances to customers	(478)	231	(709)	(1,066)	(212)	(854)
Debt securities	(13)	(6)	(7)	16	24	(8)
Available-for-sale financial assets	218	185	33	37	(7)	44
Held-to-maturity investments	(231)	(231)	–	34	40	(6)
Total banking book interest receivable and similar income	(614)	118	(732)	(995)	(211)	(784)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	178	(49)	227	(361)	(109)	(252)
Total interest receivable and similar income	(436)	69	(505)	(1,356)	(320)	(1,036)
Interest payable						
Deposits by banks	12	(45)	57	25	1	24
Customer deposits	(798)	(86)	(712)	(779)	(96)	(683)
Liabilities to banks and customers under sale and repurchase agreements	72	60	12	4	10	(6)
Debt securities in issue	(533)	(45)	(488)	213	(4)	217
Amounts payable to unitholders in consolidated open-ended investment vehicles	(622)	(301)	(321)	1,813	(228)	2,041
Subordinated liabilities	(383)	(290)	(93)	(227)	(221)	(6)
Total banking book interest payable	(2,252)	(707)	(1,545)	1,049	(538)	1,587
Total interest payable on trading and other liabilities at fair value through profit or loss	(56)	39	(95)	(216)	(114)	(102)
Total interest payable	(2,308)	(668)	(1,640)	833	(652)	1,485

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RISK OVERVIEW

Effective risk management and control

As a Group, managing risk effectively is fundamental to the Group's strategy and to operating successfully. The Group is a simple, low risk, UK focused bank with a culture founded on a prudent through the cycle risk appetite.

A strong risk management culture is crucial for sustainable growth and within Lloyds it is at the heart of everything the Group does.

The Group's approach to risk is founded on an effective control framework, which guides how its colleagues work, behave and the decisions they make. Risk appetite – the amount and type of risk the Group is prepared to seek, accept or tolerate – is approved by the Board and embedded in policies, authorities and limits across the Group.

The Group's prudent risk culture and appetite, along with close collaboration between Risk division and the business, supports effective decision making and has enabled the Group to continue to deliver against its strategic priorities in 2017, simplifying and strengthening the business whilst growing in targeted areas. The Group has created a strong foundation to enable this progress, ensuring it reacts appropriately to the ever changing macroeconomic and regulatory environment.

RISK AS A STRATEGIC DIFFERENTIATOR

Group strategy and risk appetite are developed together to ensure one informs the other to deliver on the Group's purpose to help Britain prosper whilst becoming the best bank for customers, colleagues and shareholders.

Risks are identified, managed and mitigated using the Group's comprehensive Risk Management Framework (see overleaf), and the Group's well articulated risk appetite provides a clear framework for effective decision making. The principal risks the Group faces, which could significantly impact the delivery of its strategy, are discussed on pages 39–44.

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

Prudent approach to risk

Implementing a prudent approach to risk across the Group and embedding a strong risk culture ensures alignment to the Group's strategy.

Strong control framework

The Group's Risk Management Framework is the foundation for the delivery of effective risk control and ensures that the Group risk appetite is continually developed and adhered to.

Business focus and accountability

Effective risk management is a key focus and is included in key performance measures against which business units are assessed. Business units in the first line of defence are accountable for risk with oversight from a strong and independent, second line of defence Risk division.

Effective risk analysis, management and reporting

Continuing to deliver regular close monitoring and stringent reporting to all levels of management and the Board ensures appetite limits are maintained and subject to stressed analysis at a risk type and portfolio level.

Sustainable growth

Embedding a risk culture that ensures proactive support and constructive challenge takes place across the business is important for delivering sustainable growth.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE GROUP'S RISK MANAGEMENT FRAMEWORK

The diagram below outlines the framework in place for risk management across the Group.

RISK CONSIDERATIONS

The potential risks and impacts arising from the external environment are outlined below, with links to the Group's principal risks and strategic priorities. For information on how the Group manages its emerging risks, see page 47.

The links shown here between these five factors and the Group's principal risks and strategic priorities are not an exhaustive list.

ECONOMY

Risk and potential impact

Economic headwinds such as rising inflation could impact households' disposable income and businesses' profitability, impairing customers' ability to repay their borrowing, and potentially hindering sustainable growth.

The impact of EU exit on the Group's portfolios remains uncertain. Operational changes are likely to be limited given the Group's UK focus but the impact on the UK economy may affect business performance.

The Group considers an array of scenarios as part of its operating plan and stress testing exercises, to identify and implement appropriate mitigating actions.

Link to principal risks

Credit
Operational
Insurance underwriting
Capital
Funding and liquidity
Market

Link to strategic priorities

Maximising the Group’s capabilities
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REGULATION AND LEGAL

Risk and potential impact

The financial services industry continues to experience significant legislative and regulatory change and interpretation giving rise to uncertainty surrounding the nature, scale and complexity of implementation requirements.

This has the potential to impact, for example, the resource and investment available to allocate to the Group's strategic priorities.

The Group has a proven track record in implementing complex legal and regulatory programmes and will continue to manage any potential impact by remaining actively engaged with governmental bodies, regulatory authorities and industry associations.

Link to principal risks

Credit
Regulatory and legal
Capital
Funding and liquidity
Market

Link to strategic priorities

Delivering a leading customer experience

CUSTOMER

Risk and potential impact

The availability and delivery of services through digital channels is becoming increasingly important for customer satisfaction. Accelerated change in customer behaviour and expectations may require increased agility to accommodate the pace and scale of change and could lead to customer detriment if this change is poorly executed.

The Group will continue to focus on change execution whilst keeping pace with developments to meet new and evolving customer needs.

Link to principal risks

Regulatory and legal
Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience

TECHNOLOGY

Risk and potential impact

New technologies such as public cloud and artificial intelligence along with growing interconnectivity between the Group, customers, and third parties create new risks.

Increasing capabilities of cyber-attackers and higher volumes of connected devices increases the potential for cyber-enabled fraud and other crime, including attacks that could disrupt service for customers.

The Group continues to optimise its approach to operational resilience by enhancing systems that support the Group's critical business processes, evolving controls within new technologies and channels, and making significant investment to improve data privacy, including the security of data.

Link to principal risks

Conduct
Operational

Link to strategic priorities

Delivering a leading customer experience
Digitising the Group
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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMPETITION

Risk and potential impact

Technological change is driving an increase in the number, and changing the nature of competitors in the UK financial services industry, opening up opportunities for consumers even as levels of regulatory focus rise.

The Group must ensure that an unexpectedly fast pace of change, which may accelerate customer disintermediation, does not lead to its involvement in anti-competitive practices, or prevent certain customer groups from having equal access to its products and services.

The Group will continue to address this through innovation and developing new products that respond to market trends and meet customer changing needs.

Link to principal risks

Regulatory and legal
Conduct
Operational
People

Link to strategic priorities

Delivering a leading customer experience
Maximising the Group's capabilities

PRINCIPAL RISKS

The most significant risks which could impact the delivery of the Group's long-term strategic objectives and the Group's approach to each risk, are detailed below.

As part of the Group's ongoing assessment of the potential implications of the UK leaving the European Union, the Group continues to consider the impact to its customers, colleagues and products – as well as legal, regulatory, tax, financial and capital implications.

There remains continued uncertainty around both the UK and global political and macroeconomic environment. The potential impacts of external factors have been considered in all principal risks to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

Principal risks and uncertainties are reviewed and reported regularly. This year the Group has added a new principal risk, model risk, to reflect the Group's increasing use of analytics and models to make decisions.

Credit

The risk that parties with whom the Group has contracted, fail to meet their financial obligations (both on and off balance sheet).

Example

Adverse impact on profitability due to an increase in impairment losses, write downs and/or decrease in asset valuations which can occur for a number of reasons, including adverse changes in the economic, geopolitical and market environment. For example, low interest rates have helped customer affordability, but there is a risk of increased defaults as interest rates rise.

Key mitigating actions

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

Robust risk assessment and credit sanctioning to ensure the Group lends appropriately and responsibly.

Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight.

Effective, well-established governance process supported by independent credit risk assurance.

Early identification of signs of stress leading to prompt action in engaging the customer.

Key risk indicators

Impairment charge	Impaired assets
£795m	**£7,841m**
2016: £645m	2016: £8,495m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group seeks to support sustainable growth in its targeted segments. The Group has a conservative and well balanced credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.

The Group is committed to better addressing its customers' banking needs through consistent, fair and responsible credit risk decisions, aligned to customers' circumstances, whilst staying within prudent risk appetite.

Impairments remain below long-term levels and are expected to increase as the level of write-backs and releases reduces and impairments normalise.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Regulatory and legal

The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which the Group operates may have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

Examples

Increased regulatory oversight and prudential regulatory requirements.

Increased legislative requirements, such as ring-fencing legislation, Payment Services Directive 2 (PSD2), Open Banking and General Data Protection Regulation (GDPR).

Key mitigating actions

Ensure the Group develops comprehensive plans for delivery of all legal and regulatory changes and track their progress. Group-wide projects implemented to address significant impacts.

Continued investment in people, processes, training and IT to assess impact and help meet the Group's legal and regulatory commitments.

Engage with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations.

Key risk indicators

Mandatory, legal and regulatory investment spend

£886m

2016: £555m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group is committed to operating sustainably and responsibly, and commits significant resource and expense to ensure it meet its legal and regulatory obligations.

The Group responds as appropriate to impending legislation, regulation and associated consultations and participates in industry bodies. The Group continues to be subject to significant ongoing and new legislation, regulation and court proceedings.

Conduct

Conduct risk can arise from a number of areas including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; failing to promote effective competition in the interest of customers; and exhibiting behaviours which could impact on the integrity of the market or undermine wider regulatory standards.

Example

The most significant conduct cost in recent years has been PPI mis-selling.

Key mitigating actions

Conduct risk appetite metrics provide a granular view of how the Group's products and services are performing for customers.

Product approval, continuous product review processes and customer outcome testing (across products and services) supported by conduct management information.

Learning from past mistakes through root cause analysis and clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.

Further enhancements and embedding of the Group's framework to support customers in vulnerable circumstances.

Key risk indicators

Conduct risk
appetite metric
performance-Group
92.3%
2016: 92.1%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

As the Group transforms its business, minimising conduct risk is critical to achieving the Group's strategic goals and meeting regulatory standards.

The Group's focus on embedding a customer-centric culture and delivering good outcomes through good conduct is subject to robust review by the Group Customer First Committee. This supports the Group's vision of being the best bank for customers, enabling the delivery of a leading customer experience through effective root cause analysis and learning from customer feedback.

Operational

The Group faces significant operational risks which may disrupt services to customers, cause reputational damage, and result in financial loss. These include the availability, resilience and security of the Group's core IT systems, unlawful or inappropriate use of customer data, theft of sensitive data, fraud and financial crime threats, and the potential for failings in the Group's customer processes.

Example

The dynamic threat posed by cyber risk to the confidentiality and integrity of electronic data or the availability of systems.

Key mitigating actions

- Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems, and to ensure effective third party assurance.
- Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis.
- Significant investment in compliance with GDPR and Basel Committee on Banking Supervision standards.
- Working with industry bodies and law enforcement agencies to identify and combat fraud and money laundering.

Key risk indicators

Availability of core systems

99.98%

2016: 99.97%

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group recognises that resilient and secure technology, and appropriate use of data, is critical to delivering a leading customer experience and maintaining trust across the wider industry.

The availability and resilience of IT systems remains a key strategic priority and the Cyber Programme continues to focus on enhancing cyber security controls. Internal programmes ensure that data is used correctly, and the control environment is regularly assessed through both internal and third party testing.

People

Key people risks include the risk that the Group fails to maintain organisational skills, capability, resilience and capacity levels in response to organisational, political and external market change and evolving business needs.

Example

Inability to attract or retain colleagues with key skills could impact the achievement of business objectives.

Key mitigating actions

Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues.

Managing organisational capability and capacity to ensure there are the right skills and resources to meet the Group's customers' needs.

Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations.

Key risk indicators
Best bank for customers index
80%
2016: 77%

Alignment to strategic priorities and future focus

Transforming ways of working

Continued regulatory change relating to personal accountability and remuneration rules could affect the Group's ability to attract and retain the calibre of colleagues required to meet the Group's changing customer needs. The Group will continue to invest in the development of colleague capabilities and agile working practices in order to deliver a leading customer experience, and to respond quickly to the rapidly evolving change in customers' decision making in an increasingly digital marketplace.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance underwriting

Key insurance underwriting risks within the Insurance business are longevity, persistency and property insurance. Longevity risk is expected to increase as the Group's presence in the bulk annuity market increases.

Example

Uncertain property insurance claims impact Insurance earnings and capital, e.g. extreme weather conditions, such as flooding, can result in high property damage claims.

Key mitigating actions

Processes for underwriting, claims management, pricing and product design seek to control exposure. Longevity and bulk pricing experts support the bulk annuity proposition.

The merits of longevity risk transfer and hedging solutions are regularly reviewed for the Insurance business.

Property insurance exposures are mitigated by a broad reinsurance programme.

Key risk indicators

Insurance (Life and Pensions) present value of new business premiums	General Insurance underwritten total gross written premiums
£9,951m	**£733m**
2016: £8,919m	2016: £831m

Alignment to strategic priorities and future focus

Delivering a leading customer experience

The Group is committed to meeting the changing needs of customers by working to provide a range of insurance products via multiple channels. The focus is on delivering a leading customer experience by helping customers protect themselves today whilst preparing for a secure financial future.

Strategic growth initiatives within Insurance are developed and managed in line with a defined risk appetite, aligned to the Group risk appetite and strategy.

Capital

The risk that the Group has a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group.

Example

A worsening macroeconomic environment could lead to adverse financial performance, which could deplete capital resources and/or increase capital requirements due to a deterioration in customers' creditworthiness.

Key mitigating actions

A comprehensive capital management framework that includes setting of capital risk appetite and dividend policy.

Close monitoring of capital and leverage ratios to ensure the Group meets regulatory requirements and risk appetite.

Comprehensive stress testing analyses to evidence capital adequacy under various adverse scenarios.

Key risk indicators

Common equity tier 1 ratio[1,2]	UK leverage ratio[1,3]
13.9%	**5.4%**
2016: 12.9%	2016: 5.2%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

Ensuring the Group holds an appropriate level of capital to maintain financial resilience and market confidence, underpins the Group's strategic objectives of supporting the UK economy and growth in targeted segments.

1 Adjusted basis.

2 CET1 ratio after ordinary dividends and share buyback. 2016 adjusted for MBNA.

3 Calculated in accordance with the UK Leverage Ratio Framework which requires qualifying central bank claims to be excluded from the leverage exposure measure.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Funding and liquidity

The risk that the Group has insufficient financial resources to meet its commitments as they fall due.

Example

A deterioration in either the Group's or the UK's credit rating, or a sudden and significant withdrawal of customer deposits, would adversely impact the Group's funding and liquidity position.

Key mitigating actions

Holding liquid assets to cover potential cash and collateral outflows and to meet regulatory requirements. In addition, maintaining a further pool of assets that can be used to access central bank liquidity facilities.

Undertaking daily monitoring against a number of market and Group-specific early warning indicators.

Maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.

Key risk indicators

LCR eligible assets	Loan to deposit ratio
£121bn	**110%**
2016: £121bn	2016: 109%

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group maintains a strong funding position in line with its low risk strategy and the loan to deposit ratio remains within the Group's target range. The Group's funding position allows the Group to grow targeted business segments and better address its customers' needs.

Governance

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from meeting the requirements to ring-fence core UK financial services and activities from January 2019 and further requirements under the Senior Manager & Certification Regime (SM&CR).

Examples

Inadequate or complex governance arrangements to address ring-fencing requirements could result in a weaker control environment, delays in decision making and lack of clear accountability.

Non-compliance with or breaches of SM&CR requirements could result in lack of clear accountability and legal and regulatory consequences.

Key mitigating actions

Leveraging the Group's considerable change experience to meet ring-fencing requirements before the regulatory deadlines, and the continuing evolution of SM&CR.

Programme in place to address ring-fencing. In close and regular contact with regulators to develop and deploy the Group's planned operating and legal structure.

Evolving risk and governance arrangements to continue to be appropriate to comply with regulatory objectives.

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Delivering a leading customer experience

Ring-fencing will ensure the Group becomes safer and continues to deliver a leading customer experience by providing further protection to core retail and SME deposits, increasing transparency of the Group's operations and facilitating the options available in resolution.

The Group's governance framework and strong culture of ownership and accountability enabled effective, on time, compliance with the SM&CR requirements and enable the Group to demonstrate clear accountability for decisions.

Market

The risk that the Group's capital or earnings profile is affected by adverse market rates, in particular interest rates and credit spreads in the banking business, equity and credit spreads in the Insurance business, and credit spreads in the Group's defined benefit (DB) pension schemes.

Examples

Earnings are impacted by the Group's ability to forecast and model customer behaviour accurately and establish appropriate hedging strategies.

The Insurance business is exposed indirectly to equity risk through the value of future management charges on policyholder funds. Credit spread risk within the Insurance business primarily arises from bonds and loans used to back annuities.

Narrowing credit spreads will increase the cost of pension scheme benefits.

Key mitigating actions

Structural hedge programmes implemented to manage liability margins and margin compression.

Equity and credit spread risks are closely monitored and, where appropriate, asset and liability matching is undertaken.

The Group's DB pension schemes have increased their credit allocation and hedged against nominal rate and inflation movements.

Key risk indicators
IAS19 Pension surplus
£509m
2016: £(244)m

Alignment to strategic priorities and future focus

Maximising the Group's capabilities

The Group actively manages its exposure to movements in market rates, to drive lower volatility earnings and offer a comprehensive customer proposition with hedging strategies to support strategic aims. Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. Effective interest rate and inflation hedging has kept volatility in the Group's DB pension schemes low and helped to return the schemes to IAS19 surplus in 2017. This allows the Group to more efficiently utilise available capital resources to better enable the Group to maximise its capabilities.

Model (NEW)

The risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application and ongoing operation of financial models and rating systems.

Examples

Examples of the consequences of inadequate models include:

- Inappropriate levels of capital or impairments.
- Inappropriate credit or pricing decisions.
- Adverse impacts on funding or liquidity, or the Group's earnings and profits.

Key mitigating actions

A comprehensive model risk management framework including:

- Defined roles and responsibilities, with clear ownership and accountability.
- Principles regarding the requirements of data integrity, development, validation, implementation and ongoing maintenance.
- Regular model monitoring.

Independent review of models.

Periodic validation and re-approval of models.

Key risk indicators

N/A

Alignment to strategic priorities and future focus

Digitising the Group

The Group's models play a vital role in supporting Group strategy to ensure profitable growth in targeted segments and the Group's drive toward automation and digital solutions to enhance customer outcomes. Model risk management helps ensure these models are implemented in a controlled and safe manner for both the Group and customers.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT

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

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

The risk overview (pages 36–44) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, along with a brief overview of the Group's Risk Management Framework, the potential risks and impacts arising from the external environment, and the principal risks faced by the Group and key mitigating actions.

This full risk management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's emerging risks, approach to stress testing, risk governance, committee structure, appetite for risk (pages 45–54) and a full analysis of the primary risk categories (pages 54–108) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk category is described and managed using the following standard headings: definition, exposures, measurement, mitigation and monitoring.

The Group's approach to risk

The Group operates a prudent approach to risk with rigorous management controls to support sustainable business growth and minimise losses. Through a strong and independent risk function (Risk division) a robust control framework is maintained to identify and escalate current and emerging risks to support sustainable business growth within Group risk appetite and through good risk reward decision making.

RISK CULTURE

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

As part of a conservative business model that embodies a risk culture founded on a prudent approach to managing risk, the Group reviewed its code of responsibility in 2017, reinforcing its approach under which colleagues are accountable for the risks they take and for prioritising their customers' needs.

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

RISK APPETITE

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

Risk appetite is documented in a Group risk appetite statement which is reviewed by the Board Risk Committee and approved annually by the Board. The Group level metrics are supported by more detailed sub Board functional and divisional risk appetite metrics.

As a key component of the Risk Management Framework, Group risk appetite is embedded within principles, policies, authorities and limits across the Group and continues to evolve to reflect external market developments and composition of the Group.

The Group's strategy operates in tandem with the Group risk appetite and business planning is undertaken with a view to meeting the requirements of the Group risk appetite. Performance is optimised by allowing business units to operate within approved risk appetite and limits.

The Board Risk Committee is responsible for overseeing the development, implementation and maintenance of the Group's overall Risk Management Framework including its risk appetite, to ensure these are in line with emerging regulatory, corporate governance and industry best practice.

Group risk appetite includes the following areas:

Credit – the Group has a conservative and well balanced credit portfolio through the economic cycle, generating an appropriate return on equity, in line with the Group's target return on equity in aggregate.

Conduct – the Group's product design and sales practices ensure that products are transparent and meet customer needs.

Market – the Group has robust controls in place to manage the Group's inherent market risk and does not engage in any proprietary trading, reflecting the customer focused nature of the Group's activities.

Operational – the Group has robust controls in place to manage operational losses, reputational events and regulatory breaches.

Funding and liquidity – the Group maintains a prudent liquidity profile and a balance sheet structure that limits its reliance on potentially volatile sources of funding.

Capital – the Group maintains capital levels commensurate with a prudent level of solvency, and aims to deliver consistent and high quality earnings.

Regulatory and legal – the Group complies with all relevant regulation and all applicable laws (including codes of practice which have legal implications) and/or legal obligations.

People – the Group leads responsibly and proficiently, manages its people resource effectively, supports and develops colleague talent, and meets legal and regulatory obligations related to its people.

Governance – the Group has governance arrangements that support the effective long-term operation of the business, maximise shareholder value and meet regulatory and societal expectations.

Model – the Group has embedded a framework for the management of model risk to ensure effective control and oversight, compliance with all regulatory rules and standards, and to facilitate appropriate customer outcomes.

Financial reporting – the Group meets regulatory reporting and tax requirements in jurisdictions where it operates.

As separate regulated entities with their own Boards, the Insurance business and Lloyds Bank Corporate Markets each maintain their own risk appetite and framework, which are aligned to the Group risk appetite framework.

GOVERNANCE AND CONTROL

The Group's approach to risk is founded on a robust control framework and a strong risk management culture which are the foundation for the delivery of effective risk management and guide the way all employees approach their work, behave and make decisions.

Governance is maintained through delegation of authority from the Board down to individuals through the management hierarchy. Senior executives are supported by a committee based structure which is designed to ensure open challenge and support effective decision making.

The Group's risk appetite, principles, policies, procedures, controls and reporting are regularly reviewed and updated where needed to ensure they remain fully in line with regulations, law, corporate governance and industry good-practice.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

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

Line managers are directly accountable for identifying and managing risks in their individual businesses, ensuring that business decisions strike an appropriate balance between risk and reward and are consistent with the Group's risk appetite.

Clear responsibilities and accountabilities for risk are defined across the Group through a three lines of defence model which ensures effective independent oversight and assurance in respect of key decisions.

FINANCIAL REPORTING RISK MANAGEMENT SYSTEMS AND INTERNAL CONTROLS

The Group maintains risk management systems and internal controls relating to the financial reporting process, which are 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 UK Finance Code for Financial Reporting Disclosure.

The financial reporting process is actively monitored at business unit and Group levels. There are specific programmes of work undertaken across the Group to support:

- annual assessments of (i) the effectiveness of internal controls over financial reporting; and (ii) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act; and

- 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 Chief Financial Officer in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 156–159.

RISK DECISION MAKING AND REPORTING

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

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

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

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

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

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

The table below provides a high level guide to how the Group's business activities are reflected through its risk-weighted assets. Details of the business activities for each division are provided in the Divisional results on pages 27–32.

	Retail	Commercial Banking	Insurance & Wealth[1]	Run-off	Central items[2]	Group
	£bn	£bn	£bn	£bn	£bn	£bn
Risk-weighted assets (RWAs)						
– Credit risk	71.1	71.2	0.6	7.1	14.5	164.5
– Counterparty credit risk[3]	–	7.1	–	–	0.8	7.9
– Market risk	–	3.0	–	–	0.1	3.1
– Operational risk	19.7	4.3	0.7	0.2	0.4	25.3
Total (excluding threshold)	90.8	85.6	1.3	7.3	15.8	200.8
–Threshold[4]					10.1	10.1
Total	90.8	85.6	1.3	7.3	25.9	210.9

1 As a separate regulated business, Insurance (excluding Wealth) maintains its own regulatory solvency requirements, including appropriate management buffers, and reports directly to the Insurance Board. Insurance does not hold any RWAs, as its assets are removed from the Banking Group's regulatory capital calculations. However, in accordance with Capital Requirements Directive and Regulation (CRD IV) rules, part of the Group's investment in Insurance is included in the calculation of threshold RWAs, while the remainder is taken as a capital deduction.

2 Central items include assets held outside the main operating divisions, including assets relating to Group Corporate Treasury which holds the Group's liquidity portfolio, and Group Operations.

3 Exposures relating to the default fund of a central counterparty and credit valuation adjustment risk are included in counterparty credit risk.

4 Threshold is presented on a fully loaded CRD IV basis. Threshold risk-weighted assets reflect the proportion of significant investments and deferred tax assets that are permitted to be risk-weighted instead of deducted from common equity tier 1 (CET1) capital. Significant investments primarily arise from the investment in the Group's Insurance business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PRINCIPAL RISKS

The Group's principal risks are shown in the risk overview (pages 39–44). The Group's emerging risks are shown below. Full analysis of the Group's risk categories is on pages 54–108.

EMERGING RISKS

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group. These risks are considered alongside the Group's operating plan.

Risk	Key mitigating actions
Regulatory and legal: The industry continues to witness increased government and regulatory intervention in the financial sector with increasing regulatory rules and laws from both the UK and overseas affecting the Group's operation. There remains uncertainty as to the impact of EU exit on the regulatory and legal landscape; for example, the ability that the UK can continue to share data under the new data protection regime (both with other European countries and internationally) after EU exit.	– The Group continues to embed the regulatory and legal agenda across all areas of the Group ensuring that the customer is at the heart of the Group's business planning. – The Group works closely with regulatory authorities and industry bodies to ensure that the Group can identify and respond to the evolving regulatory and legal landscape. – The Group actively implements programmes to deliver regulatory and legal change requirements.
Macroeconomic headwinds and political uncertainties: Uncertainty over the UK's eventual relationship with the EU, and the implications of a minority UK government, create a more uncertain outlook for the UK economy. A rise in global protectionism led by the US, fuelled by growing income inequality and an accompanying rise in political populism, and the recent indecisive German election, generate heightened risks to the global political and macroeconomic environment.	– Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts, with a plan specifically for working through the potential impacts of the EU exit on the Group.

Further, high levels of credit market liquidity have reduced spreads and weakened terms in some sectors, creating a potential under-pricing of risk.	– Engagement with politicians, officials, media, trade and other bodies to reassure the Group's commitment to helping Britain prosper. – Wide array of risks considered in setting strategic plans. – Capital and liquidity is reviewed regularly through committees, ensuring compliance with risk appetite and regulatory requirements. – Continued investment in IT and to improve the effectiveness of the Group's IT resilience.
IT resilience and cyber: Increasing digitisation places greater reliance on the provision of resilient and secure services to customers. Continued increase in the volume and sophistication of cyber-attacks could disrupt service for customers, causing financial loss/reputational damage.	– Continued investment in the Group's Cyber Programme to ensure confidentiality and integrity of data and availability of key systems. – Collaboration with regulators and law enforcement agencies. – The Group is transforming the business to improve customer experience by digitising customer journeys and leveraging branches for complex needs, in response to customers' evolving needs and expectations.
Response to market changes (agility): As technology and customer needs change, the typical banking model is evolving and as such, operational complexity has the potential to restrict the Group's speed of response.	– The Group will deepen insight into customer segments, their perception of brands and what they value. – Agility will be increased by consolidating platforms and building new architecture aligned with customer journeys.
Strategic use of customer data: The implementation of open banking introduces data sharing with third parties, potentially increasing the risks	– The Group has implemented open banking and is actively monitoring the

of fraud and data loss. There is a continued need to defend against dynamic external challengers and meet consumer expectations. Failure to address growth in data movement or understand the supply chain/third party controls may increase exposure to cyber and fraud leading to conduct and reputational issues.

implications for its customers, including protecting them from fraud.

– The Group is making a significant investment to improve data privacy, including the security of data and oversight of third parties.

– The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.

– Risk appetite criteria limits single counterparty bank and non-bank exposures complemented by a UK-focused strategy.

Geopolitical shocks: Current uncertainties could further impede the global economic recovery. Events in North Korea, Russia, the Middle-East, as well as terrorist activity, have the potential to trigger changes in the economic outlook, market risk pricing and funding conditions.

– The Chief Security Office develops and maintains the Stability Response Plan with the Financial Stability Response Team acting as a rapid reaction group, should an external crisis occur.

– The Chief Security Office also maintains the operational resilience framework to embed resilience activities across the Group and limit the impact of internal or external events.

Capital stress testing

OVERVIEW

Stress testing is recognised as a key risk management tool within the Group by the Board, senior management, the businesses and the Risk and Finance functions. It is fully embedded in the planning process of the Group as a key activity in medium term planning, and senior management is actively involved in stress testing activities via a strict governance process.

The Group uses scenario stress testing for:

Risk identification:

– To understand key vulnerabilities of the Group under adverse economic conditions.

Risk appetite:

– Assess the results of the stress test against the Group's risk appetite to ensure the Group is managed within its risk parameters.

– Inform the setting of risk appetite by assessing the underlying risks under stress conditions.

Strategic and capital planning:

– Allow senior management and the Board to adjust strategies if the plan does not meet risk appetite in a stressed scenario.

– Support the Internal Capital Adequacy Assessment Process (ICAAP) by demonstrating capital adequacy, and meet the requirements of regulatory stress tests that are used to inform the setting of the Group's Prudential Regulation Authority (PRA) and management buffers (see capital risk on pages 87–94).

Risk mitigation:

– Drive the development of potential actions and contingency plans to mitigate the impact of adverse scenarios. Stress testing also links directly to the Group's recovery planning process.

REGULATORY STRESS TESTS

The concurrent UK stress test run by the Bank of England was also undertaken in 2017. As announced in November, despite the severity of the stress scenario, the Group exceeded the capital and leverage thresholds set out for the purpose of the stress test and was not required to take any capital action as a result.

INTERNAL STRESS TESTS

On at least an annual basis, the Group conducts macroeconomic stress tests of the operating plan, which are supplemented with higher-level refreshes if necessary. The exercise aims to highlight the key vulnerabilities of the Group's business plan to adverse changes in the economic environment, and to ensure that there are adequate financial resources in the event of a downturn.

REVERSE STRESS TESTING

Reverse stress testing is used to explore the vulnerabilities of the Group's strategies and plans to extreme adverse events that would cause the business to fail, in order to facilitate contingency planning. The scenarios used are those that would cause the Group to be unable to carry on its business activities. Where reverse stress testing reveals plausible scenarios with an unacceptably high risk when considered against the Group's risk appetite, the Group will adopt measures to prevent or mitigate that risk, which are then reflected in strategic plans.

OTHER STRESS TESTING ACTIVITY

The Group's stress testing programme also involves undertaking assessment of liquidity scenarios, market risk sensitivities and scenarios, and business specific scenarios (see the primary risk categories on pages 54–108 for further information on risk specific stress testing). If required, ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requests. This wide ranging programme provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

METHODOLOGY

The stress tests at all levels must comply with all regulatory requirements, achieved through comprehensive construction of macroeconomic scenarios and a rigorous divisional, functional, risk and executive review and challenge process, supported by analysis and insight into impacts on customers and business drivers.

The engagement of all required business, Risk and Finance areas is built into the preparation process, so that the appropriate analysis of each risk category's impact upon the business plans is understood and documented. The methodologies and modelling approach used for stress testing ensure that a clear link is shown between the macroeconomic scenarios, the business drivers for each area and the resultant stress testing outputs. All material assumptions used in modelling are documented and justified, with a clearly communicated review and sign-off process. Modelling is supported by expert judgement and is subject to the Group Model Governance Policy.

GOVERNANCE

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

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

The review and challenge of the detailed stress forecasts, the key assumptions behind these, and the methodology used to translate the economic assumptions into stressed outputs conclude with the divisional Finance Directors', appropriate Risk Directors' and Managing Directors' sign-off. The outputs are then presented to GFRC, Group Asset and Liability Committee/Group Risk Committee/Group Executive Committee and Board Risk Committee for Group level executive and non-executive review and challenge, before being approved by the Board.

How risk is managed in Lloyds Banking Group

The Group's Risk Management Framework (RMF) (see risk overview, page 37), is structured around the following components which meet and align with the industry-accepted internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The RMF applies to every area of the business and covers all types of risk. It is reviewed, updated and approved by the Board at least annually to reflect any changes in the nature of the Group's business and external regulations, law, corporate governance and industry best practice. In 2017 the annual update was also informed by the findings of an independent external review. The RMF 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.

ROLE OF THE BOARD AND SENIOR MANAGEMENT

Key responsibilities of the Board and senior management include:

– setting risk appetite and approval of the RMF;

– approval of Group-wide risk principles and policies;

– the cascade of delegated authority (for example to Board sub-committees and the Group Chief Executive); and

– effective oversight of risk management consistent with risk appetite.

RISK APPETITE

Risk appetite is defined within the Group as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate' (see the Group's approach to risk', pages 45–46).

GOVERNANCE FRAMEWORKS

The policy framework is founded on Board-approved key principles for the overall management of risk in the organisation, which are aligned with Group strategy and risk appetite and based on a current and comprehensive risk profile that identifies all material risks to the organisation. The principles are underpinned by a hierarchy of policies which define mandatory requirements for risk management and control which are consistently implemented across the Group.

Regular policy framework assessments are undertaken in all business areas, driving Board-level risk appetite metrics which monitor the operating effectiveness of policy controls and overall policy implementation. Robust processes and controls to identify and report policy breaches include clear materiality criteria and escalation procedures which ensure an appropriate level of visibility and prioritisation of remedial actions.

The risk committee governance framework is outlined on page 51.

THREE LINES OF DEFENCE MODEL

The RMF is implemented through a ‘three lines of defence’ model which defines clear responsibilities and accountabilities and ensures effective independent oversight and assurance activities take place covering key decisions.

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

Risk division (second line) is a centralised function headed by the Chief Risk Officer and consisting of eight Risk Directors and their specialist teams. The role of Chief Risk Officer was held by Juan Colombás until 4 September 2017 when he was succeeded by Stephen Shelley, previously Commercial Banking Risk Director. Within Risk division the Compliance function has been headed throughout 2017 by Letitia Smith, Group Director, Conduct, Compliance and Operational Risk.

Risk division provides oversight and independent constructive challenge to the effectiveness of risk decisions taken by business management, providing proactive advice and guidance, reviewing, challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.

It also has a key role in promoting the implementation of a strategic approach to risk management reflecting the risk appetite and RMF agreed by the Board that encompasses:

- embedded effective risk management processes;
- transparent, focused risk monitoring and reporting;
- provision of expert and high quality advice and guidance to the Board, executives and management on strategic issues and horizon scanning, including pending regulatory changes; and
- a constructive dialogue with the first line through provision of advice, development of common methodologies, understanding, education, training, and development of new tools.

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

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

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Risk Directors:

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

Group Internal Audit (third line) provides independent and objective assurance designed to add value and improve the organisation's operations. Group Internal Audit has been headed throughout 2017 by Paul Day, Chief Internal Auditor, on an interim secondment basis from 1 January to 31 May, and on a permanent basis thereafter. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. Group Internal 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 Internal Audit is fully independent of the business and the Risk division, and seeks to ensure objective challenge to the effectiveness of the risk governance framework.

RISK AND CONTROL CYCLE FROM IDENTIFICATION TO REPORTING

To allow senior management to make informed risk decisions, the business follows a continuous risk management approach which includes producing appropriate, accurate and focused risk reporting and risk management. The risk and control cycle sets out how this should be approached and produced with the appropriate controls and processes in place. This cycle, from identification to reporting, ensures consistency and is intended to manage and mitigate the risks impacting the Group.

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

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

All business areas complete a Control Effectiveness Review (CER) annually, reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. The CER reports are approved at divisional risk committees or directly by the relevant member of the Group Executive Committee to confirm the accuracy of the assessment. This key process is overseen and independently challenged by Risk division, reviewed by Group Internal Audit against the findings of its assurance activities, and reported to the Board.

RISK CULTURE

Supporting the formal frameworks of the RMF is the underlying culture, or shared behaviours and values, which sets out in clear terms what constitutes good behaviour and good practice. In order to effectively manage risk across the organisation, the functions encompassed within the three lines of defence have a clear understanding of risk appetite, business strategy and an understanding of (and commitment to) the role they play in delivering it. A number of levers are used to reinforce the risk culture, including tone from the top, clear accountabilities, effective communication and challenge and an appropriately aligned performance incentive and structure.

RISK RESOURCES AND CAPABILITIES

Appropriate mechanisms are in place to avoid over-reliance on key personnel or system/technical expertise within the Group. Adequate resources are in place to serve customers both under normal working conditions and in times of stress, and monitoring procedures are in place to ensure that the level of available resource can be increased if required. Colleagues undertake appropriate training to ensure they have the skills and knowledge necessary to enable them to deliver fair outcomes for customers, being mindful of the Group’s strategic conduct agenda, customer treatment policy/standards and Financial Conduct Authority requirements.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk governance

The risk governance structure below is integral to effective risk management across the Group. Risk division is appropriately represented on key committees to ensure that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and Risk division to Group Executive Committee and Board. Conversely, strategic direction and guidance is cascaded down from the Board and Group Executive Committee.

Company Secretariat support senior and Board level committees, and support the Chairs in agenda planning. This gives a further line of escalation outside the three lines of defence.

Table 1.2: Risk governance structure

Group Chief Executive Committees	**Business area principal Enterprise Risk Committees**	**Risk Division Committees and Governance**
Group Executive Committee (GEC)	Commercial Banking Risk Committee	**Credit risk**
Group Risk Committee (GRC)	Retail Risk Committee	– Executive Credit Approval Committee
Group Asset and Liability Committee (GALCO)	Insurance and Wealth Risk Committee	– Commercial Banking Credit Risk Committees
Group Customer First Committee	Community Banking Risk Committee	– Retail Credit Risk Committees
Group Cost Management Committee	Group Services Risk Committee	**Market risk**
Conduct Review Committee	Transformation Risk Committee	– Group Market Risk Committee
	Finance Risk Committee	**Conduct, compliance and operational risk**
		– Group Conduct, Compliance and Operational Risk Committee
		Fraud and financial crime risk
		– Group Fraud and Financial Crime Prevention Committee
		Financial risk

Group People Committee	People and Productivity Risk Committee	– Group Financial Risk Committee
Responsible Business Management Committee	Group Corporate Affairs Risk Committee	**Capital risk**
		– Group Capital Risk Committee
Senior Independent Performance Adjustment and Conduct Committee		**Model risk**
		– Group Model Governance Committee
		Insurance underwriting risk through the governance arrangements for Insurance Group (Insurance Group is a separate regulated entity with its own Board, governance structure and Chief Risk Officer)

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Board, Executive and Risk Committees

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

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 138–164, for further information on Board committees.

The divisional and functional risk committees review and recommend divisional and functional risk appetite and monitor local risk profile and adherence to appetite.

Insurance, which is subject to separate regulation, has its own Board and governance structure. The Insurance Board, assisted by a Risk Oversight Committee and Audit Committee, approves the governance, risk and control frameworks for the Insurance business and the Insurance business risk appetite, ensuring it aligns with the Group's framework and risk appetite.

Table 1.3: Executive and Risk Committees

The Group Chief Executive is supported by the following:

Committees	**Risk focus**
Group Executive Committee (GEC)	Supports the Group Chief Executive in exercising his authority in relation to material matters having strategic, cross-business area or Group-wide implications.
Group Risk Committee (GRC)	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, and material Group policies. The committee also regularly reviews risk exposures and risk/reward returns and approves models that are material at Group level.
Group Asset and Liability Committee (GALCO)	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.
Group Customer First Committee	Provides a Group-wide perspective on the progress of Group's, divisions' and functions' implementation of initiatives which enhance the delivery of customer outcomes and customer trust, and sets and promotes the appropriate tone from the top to fulfil the Group's vision to become the best bank for customers and help Britain prosper.

Group Cost Management Committee	Leads and shapes the Group's approach to cost management, ensuring appropriate governance and process over Group-wide cost management activities and effective control of the Group's cost base.
Conduct Review Committee	Provides oversight and challenge in connection with the Group's engagement with conduct review matters as agreed with the Group Chief Executive.
Group People Committee	Oversees the Group's colleague policy, remuneration policy and Group-wide remuneration matters, oversees compliance with Senior Manager and Certification Regime (SM&CR) and other regulatory requirements, monitors colleague engagement surveys and ensures that colleague-related issues are managed fairly, effectively and compliantly.
Responsible Business Management Committee	Recommends and implements the strategy and plans to deliver the Group's aspiration to be a leader in responsible business as part of the objective of helping Britain prosper.
Senior Independent Performance Adjustment and Conduct Committee	Responsible for providing recommendations regarding performance adjustment, including the individual risk adjustment process and risk adjusted performance assessment, and making final decisions on behalf of the Group on the appropriate course of action relating to conduct breaches, under the formal scope of the SM&CR.

The Group Risk Committee is supported through escalation and ongoing reporting by business area risk committees, cross-divisional committees addressing specific matters of Group-wide significance and the following second line of defence Risk committees which ensure effective oversight of risk management:

Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Group Conduct, Compliance and Operational Risk Committee	Responsible for monitoring breaches, material events and risk issues, and conducting deep dive assessments on specific conduct, compliance or operational risk subjects to inform corrective action along with the sharing of information and best practice.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Committees	Risk focus
Group Fraud and Financial Crime Prevention Committee	Reviews and challenges the management of fraud and financial crime risk including overall strategy and performance, Group-level risk appetite and broader corporate responsibilities, and engagement with relevant authorities and other external parties. The committee is accountable for ensuring that, at Group level, current and emerging fraud and financial crime risks are effectively identified and managed within appetite, and that strategies and investments to improve fraud and financial crime prevention are co-ordinated and implemented in relevant business areas.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC, GRC and GALCO, the Group Individual Liquidity Adequacy Assessment (ILAAP) and Internal Capital Adequacy Assessment Process (ICAAP) submissions, Pillar 3 Disclosures, the Group recovery and resolution plans, and the annual stress testing of the Group's operating plan, Prudential Regulation Authority (PRA) and European Banking Authority (EBA) stress tests, and any other analysis as required.
Group Capital Risk Committee	Responsible for providing oversight of all relevant capital matters within the Group including the Group's capital position, Pillar 2 requirements, regulatory reform and accounting developments specific to capital, as well as other areas such as stress testing and modelling activity. It also reviews regulatory submissions including the ICAAP and recovery plan prior to submission to Group Financial Risk Committee.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's modelling framework, specifically regarding consistency of approach across business units and risk types. It approves banking models other than those material at Group level, which are approved by GRC, and meets the PRA requirements regarding the governance and approval for Internal Ratings Based (IRB) methodologies. An equivalent committee exists in the Insurance division for approval of insurance models.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Full analysis of risk categories

The Group's risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. A detailed description of each category is provided on pages 54–108.

Following a review of the Group's risk categories in 2017, model risk is now a primary risk category, and is described in detail on page 108. Financial reporting risk, previously a primary risk category, is now considered as a secondary risk category of operational risk (see pages 84–85; additionally the main features of the Group's internal control system in relation to the financial reporting process are described on page 46).

Primary risk categories	**Secondary risk categories**		
Credit risk Page 54	– Retail credit	– Commercial credit	
Regulatory and legal risk Page 82	– Regulatory compliance	– Legal	
Conduct risk Page 83	– Conduct		
Operational risk	– Business process	– External service provision	– Internal service provision
Page 84	– Change	– Financial crime	– IT systems
	– Cyber and information security	– Financial reporting	– Operational resilience
	– Data management	– Fraud	– Physical security/health and safety
	– Sourcing		
People risk Page 85	– People		
Insurance underwriting risk Page 86	– Insurance underwriting		
Capital risk Page 87	– Capital		
Funding and liquidity risk	– Funding and liquidity		

The Group considers both reputational and financial impact in the course of managing all its risks and therefore does not classify reputational impact as a separate risk category.

CREDIT RISK

DEFINITION

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

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 51 on page F-78. Credit risk exposures are categorised as ‘retail’, arising primarily in the Retail and Run-off divisions, and some small and medium sized enterprises (SMEs) and ‘corporate’ (including larger SMEs, corporates, banks, financial institutions and sovereigns) arising primarily in the Commercial Banking, Run-off and Insurance and Wealth divisions and Group Corporate Treasury (GCT).

In terms of loans and advances, (for example loans and overdrafts) and contingent liabilities (for example credit instruments such as guarantees and standby, documentary and commercial letters of credit), credit risk arises both from amounts advanced and commitments to extend credit to a customer or bank. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit may be cancelled and the creditworthiness of customers is monitored regularly. Most commercial term commitments to extend credit are contingent upon customers maintaining specific credit standards, which together with the creditworthiness of customers are monitored regularly.

Credit risk also arises from debt securities and derivatives. The total notional principal amount of interest rate, exchange rate, credit derivative and other contracts outstanding at 31 December 2017 is shown on page 62. 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 51 on page F-78.

Additionally, credit risk arises from leasing arrangements where the Group is the lessor. Note 2(J) on page F-14 provides details on the Group's approach to the treatment of leases.

Credit risk exposures in the Insurance and Wealth division largely result from holding bond and loan assets, together with some related swaps, in the shareholder funds (including the annuity portfolio) and from exposure to reinsurers.

The investments held in the Group's defined benefit pension schemes also expose the Group to credit risk. Note 35 on page F-44 provides further information on the defined benefit pension schemes' assets and liabilities.

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

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' (PD) 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').

Assessment of obligor quality for both retail and commercial counterparties is largely based on the outcomes of credit risk PD rating models. The Group operates a number of different regulatory rating models, typically developed internally using statistical analysis and management judgement – retail models rely more on the former, commercial models include more of the latter, especially in the larger corporate and more specialised lending portfolios. Internal data is supplemented with external data, 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 and governance including, where appropriate, benchmarking to external information.

In the principal retail portfolios, exposure at default and loss given default models are in use. For regulatory reporting purposes, counterparties are 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 PD changes. The retail master scale comprises 13 non-default ratings and one default rating.

In commercial portfolios the PD models also segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities. Counterparties migrate between rating grades if the assessment of the PD changes. The corporate (non-retail) master scale comprises of 19 non-default ratings and 4 default rating grades, and forms the basis on which internal reporting is completed.

Use of internally modelled outputs in the regulatory capital process is specific to the calculation approach being used. Under the Retail Internal Ratings Based (IRB) approach the rating system PD assessment is used alongside calculated exposure at default and loss given default values in order to derive risk-weighted assets (RWAs) and regulatory Expected Loss (EL). The Foundation IRB approach requires the use of the rating system PD alongside regulatory prescribed exposure at default and loss given default values. Slotting portfolios do not use loss given default whilst Standardised requires the use of regulatory refined exposure at default in a defined RWA calculation.

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 regulatory EL models. Note 2(H) on page F-13 provides details of the Group's approach to the impairment of financial assets.

MITIGATION

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

Prudent, through the cycle credit principles, risk policies and appetite statements: The independent Risk division sets out the credit principles, credit risk policies and credit risk appetite statements. Principles and policies are reviewed regularly, and any changes are subject to an approval process. Policies and risk appetite statements, where appropriate, are supported by procedures, which provide a disciplined and focused benchmark for credit decisions. 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, which includes tracking portfolio performance against an agreed set of credit risk appetite tolerances. Oversight and reviews are also undertaken by independent credit risk oversight functions and Group Internal Audit.

Strong models and controls: The independent Risk division has established a set of model risk management principles, designed to ensure models and associated rating systems are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements. Internal rating models are developed and owned by the Risk division. The designated model owner takes responsibility for ensuring the fitness for purpose of the rating systems, supported and challenged by the independent specialist Group function.

Limitations on concentration risk: There are portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual, customer and bank limit guidelines. Credit policies and appetite statements are aligned to the Group's risk appetite and restrict exposure to higher risk countries and potentially vulnerable sectors and asset classes. Note 17 on page F-31 provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent both an excessive concentration of risk and single name concentrations. These concentration risk controls are not necessarily in the form of a maximum limit on exposure, but may instead require new business in concentrated sectors to fulfil additional minimum policy and/or guideline requirements. The Group's largest exposures are regularly reported to the Board Risk Committee and reported in accordance with regulatory reporting requirements.

Robust country risk management: The Board sets a broad maximum country risk appetite. Within this, the Executive Credit Approval Committee approves the Group country risk framework and sovereign limits on an annual basis. Risk based country appetite for all countries is set within the independent Risk division, taking into account economic, financial, political and social factors as well as the approved business and strategic plans of the Group.

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

Stress testing and scenario analysis: The Group's credit portfolios are also subjected to regular stress testing, with stress scenario assessments run at various levels of the organisation. Exercises focused on individual divisions and portfolios are performed in addition to the Group led and regulatory stress tests. For further information on stress testing process, methodology and governance, see page 48.

Frequent and robust credit risk oversight and assurance: Undertaken by independent credit risk oversight functions operating within Retail Credit Risk and Commercial Banking Risk which are part of the Group's second line of defence. Their primary objective is to provide reasonable and independent oversight that credit risk is being managed with appropriate and effective controls.

Group Internal Audit provides assurance to the Board Audit Committee on the effectiveness of credit risk management controls across the Group's activities. The team carries out independent risk based control audits across the full credit lifecycle.

Additional mitigation for Retail customers

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant's previous credit history using internal data and information held by Credit Reference Agencies (CRA).

The Group also assesses the affordability and sustainability of lending for each borrower; for secured lending this includes use of an appropriate stressed interest rate scenario. Affordability assessments are compliant with relevant regulatory conduct guidelines. The Group takes reasonable steps to validate information used in the assessment of a customer's income and expenditure.

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 policy limits above which the Group will reject borrowing applications. The Group also applies 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.

For UK Secured, the Group's policy permits owner occupier applications with a loan to value (LTV) maximum of 95 per cent. Applications with an LTV above 90 per cent are subject to enhanced underwriting criteria, including higher scorecard cut-offs.

Buy-to-let mortgages are limited to a maximum loan size of £1,000,000 and 75 per cent LTV. Buy-to-let applications must pass a minimum rental cover ratio of 125 per cent under stressed interest rates, after applicable tax liabilities. Since September 2017, Portfolio Landlords (customers with four or more mortgaged buy-to-let properties) have been subject to additional controls including evaluation of overall portfolio resilience.

The Group's policy is to reject any application for a lending product where a customer is registered as bankrupt or insolvent, or has a recent County Court Judgment or financial default registered at a CRA used by the Group above de minimis thresholds. In addition, the Group rejects applicants where total unsecured debt, debt-to-income ratios, or other indicators of financial difficulty exceed policy limits.

Where credit acceptance scorecards are used, new models, model changes and monitoring of model effectiveness are independently reviewed and approved in accordance with the governance framework set by the Group Model Governance Committee.

Additional mitigation for Commercial customers

Individual credit assessment and independent sanction of customer and bank limits: With the exception of small exposures to SME customers where relationship managers have limited delegated sanctioning authority, credit risk in commercial customer portfolios is subject to sanction by the independent Risk division, which considers the strengths and weaknesses of individual transactions, the balance of risk and reward, and how credit risk aligns to the Group's risk appetite. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities and limit guidelines. Approval requirements for each decision are based on a number of factors including, but not limited to, the transaction amount, the customer's aggregate facilities, credit policy, risk appetite, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty and customer underwriting is generally the same as that for assets intended to be held to maturity. All hard underwriting must be sanctioned via credit limits and a pre-approved credit matrix may be used for ‘best efforts’ underwriting.

Counterparty credit 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 derivatives and securities financing transactions, which incorporates potential future exposures from market movements against agreed confidence intervals. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

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

Collateral

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

– residential and commercial properties;

– charges over business assets such as premises, inventory and accounts receivable;

– financial instruments such as debt securities;

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– vehicles;

– cash; and

– guarantees received from third parties.

The Group maintains appetite guidelines on the acceptability of specific classes of collateral.

Collateral held as security for financial assets other than loans and advances is determined by the nature of the underlying exposure. Debt securities, including treasury and other bills, are generally unsecured, with the exception of asset-backed securities and similar instruments such as covered bonds, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, however 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 financial counterparties are typically collateralised under a Credit Support Annex (CSA) in conjunction with the International Swaps and Derivatives Association (ISDA) Master Agreement. Derivative transactions with non-financial customers are not usually supported by a CSA.

No collateral is held in respect of retail credit card or unsecured personal lending. For non-mortgage retail lending to small businesses, collateral may include second charges over residential property and the assignment of life cover.

Commercial lending decisions must be based on an obligor’s ability to repay from normal business operations rather than reliance on the disposal of any security provided. The requirement for collateral and the type to be taken at origination will be based upon the nature of the transaction and the credit quality, size and structure of the borrower. For non-retail exposures, the Group will often require the collateral to include a first charge over land and buildings owned and occupied by the business, a debenture over one or more of the assets of a company or limited liability partnership, personal guarantees, limited in amount, from the directors of a company or limited liability partnership and key man insurance. The Group maintains policies setting out acceptable collateral bases for valuation, maximum LTV ratios and other criteria to be considered when reviewing an application. Other than for project finance, object finance and income producing real estate where charges over the subject assets are required, the provision of collateral will not determine the outcome of an application. Notwithstanding this, the fundamental business proposition must evidence the ability of the business to generate funds from normal business sources to repay a customer or counterparty’s financial commitment.

The extent to which collateral values are actively managed will depend on the credit quality and other circumstances of the obligor and type of underlying transaction. Although lending decisions are based on expected cash flows, any collateral provided may impact the pricing and other terms of a loan or facility granted. This will have a financial impact on the amount of net interest income recognised and on internal loss given default estimates that contribute to the determination of asset quality and returns.

Collateral values are assessed at the time of loan origination. The Group requires collateral to be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. In certain circumstances, for Retail residential mortgages this may include the use of automated valuation models based on market data, subject to accuracy criteria and LTV limits. Collateral values are reviewed on a regular basis which will vary according to the type of lending, collateral involved and account performance. Such reviews are undertaken to confirm that the value recorded in the Bank's systems remains appropriate and whether revaluation is required, considering for example, account performance, market conditions and any information available that may indicate that the value of the collateral has materially declined. In such instances, the Group may seek additional collateral. For Retail, the Group adjusts open market values to take account of the costs of realisation and any discount associated with the realisation of the collateral when estimating credit losses.

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.

The Group seeks to avoid correlation or wrong way risk where possible. Under repurchase (repo) policy, the issuer of the collateral and the repo counterparty should be neither the same nor connected. The same rule applies for derivatives. The Risk division has the necessary discretion to extend this rule to other cases where there is significant correlation. Countries with a rating equivalent to AA- and above may be considered to have no adverse correlation between the counterparty domiciled in the country and that country of risk (issuer of securities).

Refer to note 51 on page F-78 for further information on collateral.

Master netting agreements

It is credit policy that a Group approved master netting agreement must be used for all derivative and traded property transactions and must be in place prior to trading. Any exceptions must be approved by the credit sanctioner. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis, within relevant jurisdictions and for appropriate counterparty types they do reduce the credit risk to the extent that, if an event of default occurs, all trades with the counterparty may be terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since this is the net position of all trades under the master netting agreement.

Other credit risk transfers

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

MONITORING

In conjunction with Risk division, businesses identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed and monitored 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 divisional risk committees, Group Risk Committee and the Board Risk Committee.

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

Intensive care of customers in financial difficulty

The Group operates a number of solutions to assist borrowers who are experiencing financial stress. The material elements of these solutions through which the Group has granted a concession, whether temporarily or permanently, are set out below.

Retail customers

The Group's aim in offering forbearance and other assistance to customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and by bringing customer facilities back into a sustainable position which, for owner occupier mortgages, also means keeping customers in their homes. The Group offers a range of tools and assistance to support 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.

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

- Reduced payment arrangements: a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay.
- Term extensions: a permanent account change for customers in financial distress where the overall term of the mortgage is extended, resulting in a lower contractual monthly payment.

- Repair: a permanent account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

Forbearance identification, classification and measurement

The Group classifies Retail accounts as forborne at the time a customer in financial difficulty is granted a concession. Accounts are classified as forborne only for the period of time which the exposure is known to be, or may still be, in financial difficulty. Where temporary forbearance is granted, exit criteria are applied to include accounts until they are known to no longer be in financial difficulty. Where the treatment involves a permanent change to the contractual basis of the customer's account such as a capitalisation of arrears or term extension, the Group may classify the balance as forborne for a period of 24 months, after which no distinction is made between these accounts and others where no change has been made.

Those forborne loans which fall below individual assessment limits for impairment are grouped with other assets of similar characteristics and assessed collectively in accordance with the Group impairment policy detailed in note 2(H) on page F-13. The Group's approach is to ensure that provisioning models, supported by management judgement, appropriately reflect the underlying loss risk of exposures. The performance and output of models are monitored and challenged on an ongoing basis, in line with the Group's model governance policies.

The Group measures the success of a forbearance scheme for secured customers based upon the proportion of customers performing (less than or equal to three months in arrears) over the 24 months following the exit from a forbearance treatment. For temporary treatments, 80.7 per cent of customers accepting reduced payment arrangements are performing. For permanent treatments, 83.4 per cent of customers who have accepted capitalisations of arrears and 84.3 per cent of customers who have accepted term extensions are performing.

Customers receiving support from UK government sponsored programmes

To assist customers in financial distress, the Group also participates in UK government sponsored programmes for households the most significant of which is the Income Support for Mortgage Interest (SMI) which provides certain defined categories of customers access to a benefit scheme, paid for by the government, which covers all or part of the interest on the mortgage. There are two primary categories:

- Customers claiming Jobseeker's Allowance, Income Support, Universal Credit or Employment and Support Allowance benefits: Qualifying customers are able to claim for mortgage interest at 2.61 per cent on up to £200,000 of the mortgage. There is a two year time limit on Jobseeker's Allowance claims that started getting SMI benefit after 5 January 2009. There is no time limit for Income Support, Universal Credit or Employment and Support Allowance customer claims.

– Pension Credit customers: Qualifying customers are able to claim for mortgage interest at 2.61 per cent on up to £100,000 of the mortgage and there is no time limit as to how long they can claim.

For both categories, 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 Department of Work and Pensions. The Group estimates that customers representing approximately £1.6 billion of its mortgage exposures are receiving this benefit, including those who are also receiving other treatments for financial difficulty.

Commercial customers

Early identification, control and monitoring are key to supporting the customer and protecting the Group. With the exception of small exposures in SME all non-retail exposures in the Commercial Banking and Run-off divisions are reviewed at least annually (and more frequently where required) by the independent Risk division. As part of the Group's established credit risk classification system, every exposure in the good book is categorised as either 'good' or 'watchlist'. The term 'watchlist' refers to cases which require closer monitoring on the good book and are split between 'special mention' and 'special review' (the latter being the more serious of the two). This complements the Group's risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. All watchlist names are reviewed by the business and Risk division regularly, and the classification is updated if required. This process seeks to ensure that relationship managers act promptly to identify, and highlight to senior management, those customers who have greater potential to become higher risk in the future.

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Those customers deemed higher risk where there is cause for concern over future repayment capability or where there is a risk of the asset becoming impaired will be transferred to the BSU at an early stage. The decision to transfer rests with the Credit teams and not the relationship team. On transfer, the BSU will take over the 'credit' responsibility for the customer relationship whilst the 'servicing' responsibility remains with the original relationship manager. The over-arching aim of the BSU is to provide support and work consensually with each customer to try and resolve the issues, restore the business to a financially viable position and thereby bring about a business turnaround. This may involve a combination of restructuring, work out strategies and other types of forbearance.

With the exception of small exposures (<£50,000) in SME, BSU case officers manage stressed and doubtful assets in Commercial Banking and are part of the independent Risk division. They are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and close scrutiny by senior management. Distressed run-off assets are managed to the same standards by Client Asset Management (CAM).

A detailed assessment is undertaken for cases in BSU to assist in reducing and minimising risk exposure and to also highlight potential strategic options. A range of information is required to fully appraise and understand the customer's business and cashflow (and therefore debt serviceability).

This may involve the Group, in addition to using its own internal sector experts, engaging professional advisers to perform asset valuations, strategic reviews and where applicable, independent business reviews. The assessment may also involve:

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

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

The level of Commercial Banking BSU gross loans and advances to customers reduced from £3.4 billion to £2.6 billion between 31 December 2016 and 31 December 2017. The net reduction of £0.8 billion in BSU managed lending in Commercial Banking was driven by returns to mainstream, disposals, write-offs and repayments.

The Group's treatment of loan renegotiations is included in the impairment policy in note 2(H) on page F-13 Income statement information set out in the credit risk tables is on an underlying basis (see note 4 on page F-18).

Forbearance

A key factor in determining whether the Group treats a commercial customer as forborne is the granting of a concession which is outside the Group's current risk appetite to a borrower who experiences, or is believed to be about to experience, financial difficulty. Where a concession is granted to a customer that is not in financial difficulty or the risk profile is considered within the Group's current risk appetite, the concession would not be considered to be an act of forbearance. The Group does not believe forbearance reporting is appropriate for derivatives, available for sale assets and the trading book where assets are marked to market daily.

The Group recognises that forbearance alone is not necessarily an indicator of impaired status, but it is a trigger for the review of the customer's credit profile. If there is any concern over the future cash flows and/or the Group incurring a loss, then forborne loans will be classified as impaired in accordance with the Group's impairment policy. All impaired loans, including recoveries portfolios, are currently reported as forborne.

Recovery can sometimes be through improvement in market or economic conditions, or the customer may benefit from access to alternative sources of liquidity, such as an equity injection. These can be especially relevant in real estate or other asset backed transactions where a fire sale of assets in a weak market may be unattractive.

Depending on circumstances and when operated within robust parameters and controls, the Group believes forbearance can help support the customer in the short to medium-term. The Group expects to have unimpaired forborne assets within its portfolios, where default has been avoided, or when no longer considered impaired, although the majority of these cases will be managed in the BSU, where more intensive management and monitoring is available.

Unimpaired forborne assets are included in calculating the overall collective unidentified impairment provision, which uses the historical observed default rate and loss emergence period of the relevant portfolio as a whole as part of its calculation.

Whilst the material portfolios have been reviewed for forbearance, some non-retail loans and advances in the Commercial Banking and Run-off divisions have not been reviewed on the basis that the level of unimpaired forbearance is relatively immaterial, or because the concept of forbearance is not relevant. These include, but are not limited to, Lloyds Bank Commercial Finance Ltd and The Agricultural Mortgage Corporation Plc.

Types of forbearance

The Group's strategy and offer of forbearance is largely dependent on each customer's individual situation. Early identification, control and monitoring are key to supporting the customer and protecting the Group. Concessions are often provided to help the customer with their day-to-day liquidity and working capital. A number of options are available to the Group where a customer is facing financial difficulty and each case is treated depending on its own specific circumstances.

For commercial customers, the Group currently looks at forbearance concessions including changes to:

- Contractual payment terms (for example loan maturity extensions, or changes to capital and/or interest servicing arrangements, including capital repayment holidays or conversion to interest only terms); and
- Non-payment contractual terms (for example covenant amendments or waivers) where the concession enables default to be avoided.

The main types of forbearance concessions to commercial customers in or facing financial difficulty are set out below:

- Covenants: This includes temporary and permanent waivers, amendment or resetting of non-payment contractual covenants (including LTV and interest cover). The granting of this type of concession in itself would not result in the loan being classified as impaired and the customer is kept under review in the event that further forbearance is necessary;

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– Extensions and alterations: This includes extension and/or alteration of repayment terms to a level outside of market or the Group's risk appetite due to the customer's inability to make existing contractual repayment terms; amendments to an interest rate to a level considered outside of market or the Group's risk appetite, or other amendments such as changes to capital and/or interest servicing arrangements including capital repayment holidays or conversion to interest only terms; and

– Multiple type of forbearance (a combination of the above two).

Forbearance identification, classification and measurement

All non-retail loans and advances on the watchlist are further categorised depending on the current and expected credit risk attaching to the customer and the transaction. All watchlist names are reviewed by the business and independent Risk function regularly and the classification is updated if required.

Any event that causes concern over future payments is likely to result in the customer being assessed for impairment and, if required, an impairment allowance recognised. If impairment is identified, the customer is immediately transferred to BSU (if not already managed there) and the lending will be treated as impaired.

All of a customer's impaired loans are treated as forborne as they are considered to have been (or will be) granted some form of forbearance. Most impaired loans and advances exist only in the BSU within Commercial Banking and Run-off divisions.

A portfolio approach is taken for SME customers with exposures below £1 million managed in BSU. All customers with exposures below £1 million are reported as forborne whilst they are managed by SME BSU (whether impaired or unimpaired).

All reviews performed in the good book, BSU within Commercial Banking or in the Run-off division include analysis of latest financial information, a consideration of the market and sector the customer operates in, performance against plan and revised terms and conditions granted as part of any forbearance concession that may have been provided.

Exit from forbearance

Where forbearance has been granted a customer will remain treated and recorded as forborne until the customer evidences acceptable performance over a period of time. This period will depend on a number of factors such as whether the customer is trading in line with its revised plan, it is operating within the new terms and conditions (including observation to revised covenants and contractual payments), its financial performance is stable or improving and there are no undue concerns over its future performance. As a minimum, this cure period is currently expected to be at least 12 months following a forbearance event. Customers curing are managed according to their overriding credit risk classification categorisation; this could be in BSU, Run-off or in the mainstream good book.

The exception to this 12 month minimum period is where a permanent structural cure is made (for example, an injection of new collateral security or a partial repayment of debt to restore an LTV to within a covenant). In this case, the customer may exit forbearance once the permanent cure has been made.

Notwithstanding this, the overriding requirement for exit from forbearance in all cases is that the customer is not impaired and the reason for the forbearance event is no longer present.

Upon exit from forbearance the customer may be returned to the mainstream good classification. It is important to note that such a decision can be made only by the independent Risk division.

THE GROUP CREDIT RISK PORTFOLIO IN 2017

Overview

- Asset quality remains strong with portfolios continuing to benefit from the Group's proactive approach to risk management, continued low interest rates and a resilient UK economic environment.

- Gross impairment charges remain broadly flat, including the acquisition of MBNA.

- Gross asset quality ratio (excluding releases and write-backs) was stable at 28 basis points.

- The net impairment charge increased to £795 million in 2017 compared to £645 million in 2016, reflecting expected lower provision releases and write-backs and the acquisition of MBNA (£118 million). The net asset quality ratio for 2017 was 18 basis points (2016: 15 basis points).

- The Group expects an asset quality ratio of around 35 basis points through the cycle and less than 30 basis points through the plan period and in 2018.

- Impaired loans as a percentage of closing loans and advances reduced to 1.6 per cent (31 December 2016: 1.8 per cent) with impaired loans down £0.7 billion to £7.8 billion (31 December 2016: £8.5 billion), with reductions across Retail, Commercial Banking and Run-off divisions. As at 31 December Retail impaired loans were £104 million lower at £4,951 million, despite including £151 million relating to the acquisition of MBNA. Commercial Banking impaired loans reduced by £270 million to £1,927 million, driven by impaired loan repayments and reductions, partly offset by a large newly impaired loan.

Low risk culture and prudent risk appetite

– The Group continues to take a prudent approach to credit risk, with robust credit quality and affordability controls at origination and a prudent through the cycle credit risk appetite. The Group's portfolios are well positioned against an uncertain economic outlook and potential market volatility.

– The Group continues to grow lending to key segments while maintaining prudent credit criteria.

– The Group's effective risk management ensures early identification and management of customers and counterparties who may be showing signs of distress.

– Sector concentrations within the lending portfolios are closely monitored and controlled, with mitigating actions taken where appropriate. Sector and product caps limit exposure to certain higher risk and vulnerable sectors and asset classes. In particular:

  – The average indexed LTV of the UK Retail mortgage portfolio improved to 43.6 per cent (31 December 2016: 44.0 per cent) and the percentage of Secured loans and advances with an indexed LTV greater than 100 per cent was 0.6 per cent (31 December 2016: 0.7 per cent). The average LTV for new UK Retail mortgages written in 2017 was 63.0 per cent (31 December 2016: 64.4 per cent).

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– The value of UK Retail mortgage lending with an indexed LTV of greater than 80 per cent fell to £30,680 million (31 December 2016: £32,395 million).

– Total UK Direct Real Estate gross lending across the Group was £17.9 billion at 31 December 2017 (31 December 2016: £19.9 billion) and includes Commercial Banking lending of £17.3 billion, and £0.2 billion within Retail Business Banking (within Retail). The Group's legacy run-off direct real estate portfolio has continued to fall and was £0.4 billion at 31 December 2017.

– Run-off net external assets stood at £9.1 billion at 31 December 2017, down from £11.3 billion at 31 December 2016. The portfolio represents only 1.8 per cent of the overall Group's loans and advances (31 December 2016: 2.1 per cent).

Table 1.4: Group impairment charge

2017	**Loans and advances to customers £m**	**Debt securities classified as loans and receivables £m**	**Available -for-sale financial assets £m**	**Other credit risk provisions £m**	**Total £m**	2016[1] £m
Retail	717	–	–	–	717	654
Commercial Banking	117	–	3	(5)	115	17
Insurance and Wealth	–	–	–	–	–	–
Run-off	(31)	(6)	–	(4)	(41)	(26)
Central items	1	–	3	–	4	–
Total impairment charge	804	(6)	6	(9)	795	645
Asset quality ratio					0.18%	0.15%
Gross asset quality ratio					0.28%	0.28%

1 Restated. See page F-18.

Table 1.5: Movement in gross impaired loans

	2017					
	Retail £m	**Commercial Banking £m**	**Insurance and Wealth £m**	**Run-off £m**	**Total £m**	2016 Total £m
At 1 January[1]	5,055	2,197	26	1,217	8,495	9,590
Classified as impaired during the year	2,342	637	9	101	3,089	3,154
Transferred to not impaired during the year	(783)	(132)	(8)	(67)	(990)	(1,047)

Repayments	(711)	(601)	(2)	(163)	(1,477)	(1,327)
Amounts written off	(1,073)	(136)	2	(133)	(1,340)	(1,472)
Impact of disposal of business and asset sales	(8)	–	–	(20)	(28)	(492)
Impact of acquisition of businesses	138	–	–	–	138	–
Exchange and other movements	(9)	(38)	1	–	(46)	89
At 31 December	4,951	1,927	28	935	7,841	8,495

1 Restated. See page F-18.

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Table 1.6: Group impaired loans and provisions

	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[2] %
At 31 December 2017					
Retail	341,705	4,951	1.4	2,147	46.1
Commercial Banking	100,812	1,927	1.9	830	43.1
Insurance and Wealth	818	28	3.4	9	32.1
Run-off	8,533	935	11.0	456	48.8
Reverse repos and other items[3]	23,886				
Total gross lending	475,754	7,841	1.6	3,442	45.6
Impairment provisions	(3,442)				
Fair value adjustments[4]	186				
Total Group	472,498				
At 31 December 2016[5]					
Retail	332,953	5,055	1.5	2,011	42.9
Commercial Banking	102,398	2,197	2.1	828	37.7
Insurance and Wealth	812	26	3.2	11	42.3
Run-off	10,259	1,217	11.9	682	56.0
Reverse repos and other items[3]	15,249				
Total gross lending	461,671	8,495	1.8	3,532	43.4
Impairment provisions	(3,532)				
Fair value adjustments[4]	(181)				
Total Group	457,958				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries in Retail (31 December 2017: £291 million; 31 December 2016: £365 million).

3 Includes £6.9 billion (December 2016: £6.7 billion) of lower risk loans sold by Commercial Banking and Retail to Insurance and Wealth to back annuitant liabilities.

4 The Group made adjustments to reflect the HBOS and MBNA loans and advances at fair value on acquisition. At 31 December 2017, the remaining fair value adjustment was £186 million comprising a positive adjustment of £270 million in respect of the MBNA assets and a negative adjustment of £84 million in respect of the HBOS assets. The fair value unwind in respect of impairment losses incurred was £85 million for the year ended 31 December 2017 (31 December 2016: £70 million). The fair value adjustment in respect of loans and advances is expected to

continue to decrease in future years and will reduce to zero over time.

5 Restated. See page F-18.

Table 1.7: Derivative credit risk exposures

	2017				2016			
		Traded over the counter				Traded over the counter		
	Traded on recognised exchanges £m	**Settled by central counterparties £m**	**Not settled by central counterparties £m**	**Total £m**	Traded on recognised exchanges £m	Settled by central counterparties £m	Not settled by central counterparties £m	Total £m
Notional balances								
Foreign exchange	–	19	278,833	278,852	–	254	369,368	369,622
Interest rate	109,492	2,903,481	324,834	3,337,807	167,399	3,023,742	423,709	3,614,850
Equity and other	15,455	–	9,695	25,150	32,172	–	11,046	43,218
Credit	–	–	4,568	4,568	–	–	8,098	8,098
Total	124,947	2,903,500	617,930	3,646,377	199,571	3,023,996	812,221	4,035,788
Fair values								
Assets		280	25,155			262	35,563	
Liabilities		(592)	(25,454)			(1)	(34,506)	
Net asset		(312)	(299)			261	1,057	

The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2017 and 31 December 2016 is shown in the table above. 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 51 on page F-78.

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Retail

– Asset quality remains strong across all portfolios, with stable new business quality and flow of loans entering arrears.

– The impairment charge increased by £63 million to £717 million. Excluding MBNA, impairments were £55 million lower driven by a net release on the Secured portfolio, due to reduced impaired loans and rising house prices, which was offset by higher impairment charges on the Loans and UK Motor Finance portfolios.

– Impairment provisions as a percentage of impaired loans increased to 46.1 per cent from 42.9 per cent at the end of 2016.

Table 1.8: Retail impairment charge

	2017 £m	2016[1] £m	Change %
Secured	(15)	104	
Credit cards	254	136	(87)
Loans	111	70	(59)
Overdrafts	227	241	6
UK Motor Finance	111	75	(48)
Retail Business Banking	27	27	–
Europe	2	1	
Total impairment charge	717	654	(10)
Asset quality ratio	0.21 %	0.20 %	1bp

1 Restated. See page F-18.

Table 1.9: Retail impaired loans and provisions

	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[2] %**
At 31 December 2017					

Secured	292,187	3,886	1.3	1,443	37.1
Credit cards	18,134	413	2.3	267	82.9
Loans	8,010	254	3.2	107	79.9
Overdrafts	1,595	197	12.4	113	86.3
UK Motor Finance	13,738	134	1.0	171	127.6
Retail Business Banking	928	24	2.6	23	230.0
Europe	7,113	43	0.6	23	53.5
Total gross lending	341,705	4,951	1.4	2,147	46.1
Impairment provisions	(2,147)				
Fair value adjustments	186				
Total	339,744				
At 31 December 2016[3]					
Secured	294,503	4,104	1.4	1,503	36.6
Credit cards	9,843	307	3.1	157	81.8
Loans	7,767	277	3.6	92	81.4
Overdrafts	1,952	179	9.2	90	82.6
UK Motor Finance	11,555	120	1.0	127	105.8
Retail Business Banking	1,004	27	2.7	22	200.0
Europe	6,329	41	0.6	20	48.8
Total gross lending	332,953	5,055	1.5	2,011	42.9
Impairment provisions	(2,011)				
Fair value adjustments	(181)				
Total	330,761				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Credit cards (31 December 2017: £91 million; 31 December 2016: £115 million), Loans (31 December 2017: £120 million; 31 December 2016: £164 million), Overdrafts (31 December 2017: £66 million; 31 December 2016: £70 million) and Retail Business Banking (31 December 2017: £14 million; 31 December 2016: £16 million).

3 Restated. See page F-18.

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Secured

– Total loans and advances reduced by 0.8 per cent to £292,187 million (31 December 2016: £294,503 million). The closed Specialist portfolio has continued to run-off, reducing by 10.9 per cent to £15,668 million.

– New business quality remained stable and early arrears have continued to reduce.

– The value of mortgages greater than three months in arrears (excluding repossessions) reduced to £5,437 million at 31 December 2017 (31 December 2016: £6,033 million).

– Impaired loans decreased by £218 million to £3,886 million (31 December 2016: £4,104 million), and impaired loans as a percentage of closing advances reduced to 1.3 per cent (31 December 2016: 1.4 per cent).

– UK house prices increased by 2.7 per cent over 2017 (on a quarterly non-seasonally adjusted basis).

– The average indexed LTV of the portfolio improved to 43.6 per cent (31 December 2016: 44.0 per cent).

– The value of lending with an indexed LTV of greater than 80 per cent fell to £30,680 million (31 December 2016: £32,395 million).

– The percentage of loans and advances with an indexed LTV in excess of 100 per cent fell to 0.6 per cent (31 December 2016: 0.7 per cent).

– The average LTV for new mortgages written in 2017 was 63.0 per cent (31 December 2016: 64.4 per cent).

– Net impairment release of £15 million in 2017 (2016: £104 million charge) reflects an improvement in the level of impaired loans in the portfolio.

– Impairment provisions as a percentage of impaired loans increased to 37.1 per cent (31 December 2016: 36.6 per cent), reflecting the continued prudent approach to provisioning.

Table 1.10: Retail secured loans and advances to customers

	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Mainstream	223,322	222,450
Buy-to-let	53,197	54,460
Specialist	15,668	17,593

Total secured 292,187 294,503

Table 1.11: Mortgages greater than three months in arrears (excluding repossessions)

	Number of cases		**Total mortgage accounts %**		**Value of loans[1]**		**Total mortgage balances %**	
	2017	2016	**2017**	2016	**2017**	2016	**2017**	2016
at 31 Dec	**Cases**	Cases	**%**	%	**£m**	£m	**%**	%
Mainstream	32,383	35,254	1.6	1.7	3,502	3,865	1.6	1.7
Buy-to-let	4,710	5,324	1.0	1.1	581	660	1.1	1.2
Specialist	8,313	9,078	7.3	7.2	1,354	1,508	8.7	8.6
Total	45,406	49,656	1.7	1.8	5,437	6,033	1.9	2.0

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

The stock of repossessions increased to 777 cases at 31 December 2017 compared to 678 cases at 31 December 2016.

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Table 1.12: Period end and average LTVs across the Retail mortgage portfolios

	Mainstream %	**Buy-to-let** %	**Specialist** %	**Total** %	**Unimpaired** %	**Impaired** %
At 31 December 2017						
Less than 60%	57.1	53.9	57.6	56.4	56.7	41.7
60% to 70%	16.9	25.0	18.4	18.5	18.5	18.6
70% to 80%	14.5	15.7	12.8	14.6	14.6	14.6
80% to 90%	9.0	4.1	6.4	8.0	7.9	10.5
90% to 100%	2.1	0.7	1.6	1.9	1.8	5.3
Greater than 100%	0.4	0.6	3.2	0.6	0.5	9.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	223,322	53,197	15,668	292,187	288,301	3,886
Average loan to value[1]:						
Stock of residential mortgages	41.7	53.0	47.4	43.6		
New residential lending	63.7	59.1	**n/a**	63.0		
Impaired mortgages	50.0	68.3	60.4	54.1		
At 31 December 2016						
Less than 60%	56.8	52.0	53.8	55.8	56.0	38.3
60% to 70%	17.8	25.4	17.8	19.2	19.3	18.4
70% to 80%	14.0	14.4	13.6	14.0	14.0	15.3
80% to 90%	8.4	6.1	8.6	8.0	7.9	11.9
90% to 100%	2.4	1.5	3.1	2.3	2.2	6.8
Greater than 100%	0.6	0.6	3.1	0.7	0.6	9.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	222,450	54,460	17,593	294,503	290,399	4,104
Average loan to value[1]:						
Stock of residential mortgages	41.8	53.7	49.2	44.0		
New residential lending	65.0	61.9	n/a	64.4		
Impaired mortgages	51.8	69.0	61.9	55.8		

1 Average loan to value is calculated as total loans and advances as a percentage of the total indexed collateral of these loans and advances.

Interest only mortgages

The Group provides interest only mortgages to owner occupier mortgage customers whereby only payments of interest are made for the term of the mortgage with the customer responsible for repaying the principal outstanding at the end of the loan term. At 31 December 2017, owner occupier interest only balances as a proportion of total owner occupier balances had reduced to 29.2 per cent (31 December 2016: 31.8 per cent). The average indexed loan to value improved to 41.7 per cent (31 December 2016: 42.6 per cent).

For existing interest only mortgages, a contact strategy is in place throughout the term of the mortgage to ensure that customers are aware of their obligations to repay the principal upon maturity of the loan.

Treatment strategies are in place to help customers anticipate and plan for repayment of capital at maturity and support those who may have difficulty in repaying the principal amount. A dedicated specialist team supports customers who have passed their contractual maturity date and are unable to fully repay the principal. A range of treatments are offered such as full (or part) conversion to capital repayment, and extension of term to match the maturity dates of any associated repayment vehicles.

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Table 1.13: Analysis of owner occupier interest only mortgages

	2017	2016[1]
Interest only balances (£m)	69,703	76,229
Of which, impaired (%)	3.0	3.0
Average loan to value (%)	41.7	42.6
Maturity profile (£m):		
Due	1,093	1,028
1 year	2,672	2,499
2-5 years	10,227	10,287
6-10 years	18,026	17,368
>11 years	37,685	45,047
Past term interest only balances (£m)[2]	1,553	1,365
Of which, impaired (%)	13.1	11.7
Average loan to value (%)	33.4	31.5
Negative equity (%)	2.1	1.6

1 2016 values have been restated to include Scottish Widows Bank Mortgages and certain other interest only balances of £3,578 million.

2 Balances where all interest only elements have moved past term. Some may subsequently have had a term extension, so are no longer classed as due.

Credit cards

- Loans and advances increased by 84.2 per cent to £18,134 million (31 December 2016: £9,843 million), of which £8,003 million relates to MBNA. The MBNA portfolio is performing broadly in line with both the Group's expectations and the existing credit card portfolio.

- Impaired loans increased by £106 million to £413 million (31 December 2016: £307 million), of which £151 million related to MBNA. Impaired loans as a percentage of closing loans and advances improved to 2.3 per cent (31 December 2016: 3.1 per cent), reflecting good credit performance and the continued sale of debt in recoveries.

- The impairment charge increased to £254 million (2016: £136 million), driven by the acquisition of MBNA (£118 million).

Loans

- Loans and advances increased by 3.1 per cent to £8,010 million (31 December 2016: £7,767 million).

- Impaired loans decreased by £23 million to £254 million (31 December 2016: £277 million), largely due to the sale of debt in recoveries. Impaired loans as a percentage of closing loans and advances improved to 3.2 per cent (31 December 2016: 3.6 per cent).

- The impairment charge increased to £111 million (2016: £70 million), reflecting a one-off change relating to policy alignment across brands for franchised customers, and reducing cash flows due to previous sales of debt in recoveries.

Overdrafts

- Loans and advances decreased to £1,595 million (31 December 2016: £1,952 million).

- Impaired loans increased by £18 million to £197 million (31 December 2016: £179 million), and impaired loans as a percentage of closing advances increased to 12.4 per cent (31 December 2016: 9.2 per cent), reflecting a one-off impact relating to changes in overdraft fees and charges.

- The impairment charge decreased by 5.8 per cent to £227 million (2016: £241 million), largely due to increased sale of debt in recoveries and improved underlying performance.

UK Motor Finance

- Loans and advances increased by £2,183 million to £13,738 million (31 December 2016: £11,555 million), with 49.7 per cent of growth from Jaguar Land Rover business. The book continues to benefit from conservative residual values and prudent provisioning with stable credit quality and flows into arrears.

- Impaired loans increased by £14 million to £134 million (31 December 2016: £120 million), reflecting growth in the portfolio. Impaired loans as a percentage of closing loans and advances were stable at 1.0 per cent.

- The impairment charge increased by £36 million to £111 million (2016: £75 million), driven by portfolio growth and increased provisions for residual value risks reflecting a more conservative outlook on used car prices.

Forborne loans

Forborne loans and advances on the principal Retail portfolios reduced by £601 million in 2017 to £1,951 million, driven by improvements on the Secured portfolio. As a percentage of loans and advances, forborne loans and advances on these portfolios improved to 0.6 per cent (31 December 2016: 0.8 per cent).

Impairment provisions as a percentage of loans and advances that are forborne increased to 13.0 per cent (31 December 2016: 9.6 per cent).

Secured forborne loans and advances reduced by £668 million in 2017 to £1,428 million, primarily due to a reduction in recapitalisations (with historically higher levels of cases exiting the two year probation period) and a reduction in the level of reduced payment arrangements.

Within the other portfolios, movements were seen in the level of forborne loans and advances in relation to one off changes for 2017. This included the acquisition of MBNA in the Credit cards portfolio (with forborne loans and advances of £112 million and impaired forborne loans and advances of £90 million), and improved customer views and the reclassification of some treatments across the Loans and UK Motor Finance portfolios.

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Table 1.14: UK Retail forborne loans and advances (audited)[1]

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as a % of loans and advances which are forborne	
	At Dec 2017 £m	At Dec 2016 £m	**At Dec 2017 £m**	At Dec 2016 £m	**At Dec 2017 %**	At Dec 2016 %
Temporary reduced payment arrangements	249	428	76	101	5.7	4.9
Permanent term extensions and repair	1,179	1,668	61	116	4.0	4.7
Secured	1,428	2,096	137	217	4.3	4.7
Credit cards	295	212	190	119	36.0	29.0
Loans[2]	86	49	45	46	27.9	44.4
Overdrafts	108	78	94	61	47.0	38.0
UK Motor Finance[2]	34	117	19	62	36.6	27.0
Total	1,951	2,552	485	505	13.0	9.6

1 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last three months for Secured, and six months for other portfolios. Permanent changes, such as refinancing or recapitalisation which commenced during the last 24 months, are also included.

2 Figures for 2017 include improved customer views and the reclassification of some treatments.

The movements in Retail forborne loans and advances during the year are as follows:

Table 1.15: Movement in UK Retail forborne loans and advances (audited)

	2017					
	Secured £m	**Credit cards £m**	**Loans £m**	**Overdrafts £m**	**UK Motor Finance £m**	**Total £m**
At 1 January	2,096	212	49	78	117	2,552

Classified as forborne during the year	744	159	44	85	24	1,056
Written-off/sold	(13)	(100)	(18)	(32)	(20)	(183)
Exit from forbearance	(1,217)	(41)	(3)	(19)	(15)	(1,295)
Redeemed or repaid	(162)	(15)	(6)	–	(8)	(191)
Exchange and other movements[1]	(20)	80	20	(4)	(64)	12
At 31 December	1,428	295	86	108	34	1,951

	2016					
	Secured £m	Credit cards £m	Loans £m	Overdrafts £m	UK Motor Finance £m	Total £m
At 1 January	3,102	225	60	87	100	3,574
Classified as forborne during the year	975	110	34	50	82	1,251
Written-off/sold	(12)	(46)	(24)	(31)	(16)	(129)
Exit from forbearance	(1,741)	(43)	(4)	(24)	(22)	(1,834)
Redeemed or repaid	(200)	(9)	(6)	–	(16)	(231)
Exchange and other movements	(28)	(25)	(11)	(4)	(11)	(79)
At 31 December	2,096	212	49	78	117	2,552

1 Exchange and other movements for 2017 reflects the acquisition of MBNA within Credit cards, and improved customer views and the reclassification of some treatments across the Loans and UK Motor Finance portfolios.

Commercial Banking

– Net impairment charge was £115 million in 2017 (2016: £17 million) with the increase due to a lower level of write-backs and provision releases rather than a deterioration in the underlying portfolio.

– Both 2016 and 2017 included material charges against a single customer (2016: oil & gas sector, 2017: construction sector), but otherwise gross charges have remained relatively low.

– The portfolio continues to benefit from effective risk management, a resilient economic environment and continued low interest rates.

– Credit quality of the portfolio and new business remains generally good and the Group is not relaxing risk appetite despite a more competitive market.

– Impaired loans reduced by 12 per cent to £1,927 million at 31 December 2017 compared with £2,197 million at 31 December 2016, driven by impaired loan repayments and reductions, partly offset by a large newly impaired loan. Impaired loans as a percentage of closing loans and advances reduced to 1.9 per cent from 2.1 per cent at 31 December 2016.

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- Impairment provisions were broadly flat at £830 million at 31 December 2017 (31 December 2016: £828 million) and includes collective unidentified impairment provisions of £183 million (31 December 2016: £183 million). Provisions as a percentage of impaired loans increased from 37.7 per cent to 43.1 per cent during 2017, driven by a number of isolated cases.

- An uncertain UK and global economic outlook and uncertainty relating to EU exit negotiations have the ability to impact the Commercial Banking portfolios.

- Internal and external key performance indicators continue to be monitored closely to help identify early signs of any deterioration and portfolios remain subject to ongoing risk mitigation actions as appropriate.

- Despite the uncertain economic outlook, the portfolios are well positioned and the Group's through the cycle risk appetite approach is unchanged. Monitoring indicates no material deterioration in the credit quality of the Group's portfolios. Notwithstanding this, impairments are likely to increase from their historic low levels, driven mainly by lower levels of releases and write-backs and an element of credit normalisation.

Table 1.16: Commercial Banking impairment charge

	2017 **£m**	2016[1] £m	Change %
SME	7	(7)	
Other	108	24	
Total impairment charge	115	17	
Asset quality ratio[2]	0.12%	0.02%	10bp

1 Restated. See page F-18.

2 In respect of loans and advances to customers.

Table 1.17: Commercial Banking impaired loans and provisions

	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 2017					

SME	30,480	821	2.7	151	18.4
Other	70,332	1,106	1.6	679	61.4
Total gross lending	100,812	1,927	1.9	830	43.1
Impairment provisions	(830)				
Total	99,982				
At 31 December 2016[2]					
SME	29,959	923	3.1	173	18.7
Other	72,439	1,274	1.8	655	51.4
Total gross lending	102,398	2,197	2.1	828	37.7
Impairment provisions	(828)				
Total	101,570				

1 Impairment provisions include collective unidentified impairment provisions.

2 Restated. See page F-18.

Portfolios

– The SME Banking portfolio continues to grow within prudent credit risk appetite parameters. As a result of the Group's customer driven relationship management, net lending has increased 2 per cent in 2017. Portfolio credit quality has remained stable or improved across the majority of key risk metrics.

– The Mid Markets portfolio is domestically focused and reflects the underlying performance of the UK economy and the Group's prudent credit risk appetite. Credit quality has been stable with levels of financial stress and impairment remaining low.

– The Global Corporates business continues to have a predominance of investment grade clients, primarily UK based. The portfolio remains of good quality despite the current global economic uncertainty particularly relating to the EU Exit and a softer outlook in a number of sectors, including construction and retail.

– The commercial real estate business within the Group's Mid Markets and Global Corporate portfolio is focused on clients operating in the UK commercial property market ranging in size from medium-sized private real estate entities up to publicly listed property companies. The market for UK real estate has continued to be resilient, with appetite from a range of investors. UK real estate continues to offer attractive yields compared to other asset classes and the fall in Sterling has boosted the attractiveness to foreign investors. Credit quality remains good with minimal impairments/stressed loans. Recognising this is a cyclical sector, appropriate caps are in place to control exposure and business propositions continue to be written in line with a prudent, through the cycle risk appetite with conservative LTVs, strong quality of income and proven management teams.

– Through clearly defined sector strategies Financial Institutions serves predominantly investment grade counterparties with whom relationships are either client focused or held to support the Group's funding, liquidity or general hedging requirements. The portfolio continues to be prudently managed within the Group's conservative risk appetite and clearly defined sector strategies.

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– The Group continues to adopt a conservative stance across the Eurozone maintaining close portfolio scrutiny and oversight particularly given the current macro environment and horizon risks.

Commercial Banking UK Direct Real Estate LTV analysis

– The Group classifies Direct Real Estate as exposure which is directly supported by cash flows from property activities (as opposed to trading activities, such as hotels, care homes and housebuilders).

– Focus remains on the UK market, on good quality customers, with a proven track record in Real Estate and where cash flows are robust.

– Commercial Banking UK Direct Real Estate gross lending stood at £17.3 billion at 31 December 2017.

– Approximately 70 per cent of loans and advances to UK Direct Real Estate relate to commercial real estate with the remainder relating to residential real estate. The portfolio continues to be heavily weighted towards investment real estate (c.90 per cent) over development.

– The LTV profile of the UK Direct Real Estate portfolio in Commercial Banking continues to improve.

Table 1.18: LTV – UK Direct Real Estate

	At 31 December 2017[1]				At 31 December 2016[1]			
	Unimpaired	**Impaired**	**Total**		Unimpaired	Impaired	Total	
	£m	**£m**	**£m**	**%**	£m	£m	£m	%
UK Exposures > £5m								
Less than 60%	5,567	–	5,567	77.8	5,721	14	5,735	67.2
60% to 70%	855	–	855	12.0	1,470	–	1,470	17.2
70% to 80%	183	25	208	2.9	506	9	515	6.1
80% to 100%	14	54	68	1.0	20	6	26	0.3
100% to 120%	–	–	–	–	–	–	–	–
120% to 140%	–	–	–	–	–	–	–	–
Greater than 140%	–	49	49	0.7	–	68	68	0.8
Unsecured[2]	404	–	404	5.6	689	26	715	8.4
	7,023	128	7,151	100.0	8,406	123	8,529	100.0
UK Exposures <£5m[3]	9,443	305	9,748		9,563	429	9,992	
Total	16,466	433	16,899		17,969	552	18,521	

1 Excludes Islands Commercial UK Direct Real Estate of £0.4 billion (31 December 2016: £0.5 billion).

2 Predominantly investment grade corporate CRE lending where the Group is relying on the corporate covenant.

3 December 2017 <£5m exposures include £9.2 billion within SME which has an LTV profile broadly similar to the >£5m exposures.

Forborne loans

Commercial Banking forbearance

At 31 December 2017, £2,374 million (31 December 2016: £2,663 million) of total loans and advances were forborne of which £1,927 million (31 December 2016: £2,197 million) were impaired. Impairment provisions as a percentage of forborne loans and advances increased from 31.1 per cent at 31 December 2016 to 35.0 per cent at 31 December 2017.

Table 1.19: Commercial Banking forborne loans and advances (audited)

	Total loans and advances which are forborne		**Impairment provisions as a % of loans and advances which are forborne**	
	2017	2016[1]	**2017**	2016[1]
	£m	£m	**%**	%
Impaired	1,927	2,197	43.1	37.7
Unimpaired	447	466	–	–
Total	2,374	2,663	35.0	31.1

1 Restated. See page F-18.

All Commercial Banking impaired assets are considered forborne.

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Impaired loans and advances

The movements in Commercial Banking impaired forborne loans and advances were as follows:

Table 1.20: Movement in Commercial Banking impaired forborne loans and advances (audited)

	2017	2016[1]
	£m	£m
At 1 January	2,197	2,543
Classified as impaired during the year		
Exposures >£5m	518	547
Exposures <£5m	119	124
	637	671
Transferred to unimpaired		
Exposures >£5m but still reported as forborne	–	–
Exposures >£5m no longer reported as forborne	(51)	(31)
Exposures <£5m	(81)	(81)
	(132)	(112)
Written-off	(136)	(311)
Asset disposals/sales of impaired assets	–	(33)
Drawdowns/repayments	(601)	(595)
Exchange and other movements	(38)	34
At 31 December	1,927	2,197

1 Restated. See page F-18.

Unimpaired loans and advances

Unimpaired forborne loans and advances were £447 million at 31 December 2017 (31 December 2016: £466 million).

The table below sets out the largest unimpaired forborne loans and advances to Commercial Banking customers (exposures over £5 million) as at 31 December 2017 by type of forbearance:

Table 1.21: Commercial Banking unimpaired forborne loans and advances[1] (audited)

	31 Dec 2017 £m	31 Dec 2016 £m
Type of unimpaired forbearance		
Exposures >£5m		
Covenants	157	153
Extensions/alterations	–	7
Multiple	–	21
	157	181
Exposures <£5m	290	285
Total	447	466

1 Material portfolios only.

Table 1.22: Movement in Commercial Banking unimpaired forborne loans and advances >£5m[1] (audited)

	2017 £m	2016 £m
At 1 January	181	669
Classified as impaired during the year	(34)	(63)
Cured no longer forborne	(50)	(413)
Classified as forborne during the tear	90	88
Transferred from impaired but still reported as forborne	–	–
Asset disposal/sales	–	–
Net drawdowns/repayments	(25)	(100)
Exchange and other movements	(5)	–
At 31 December	157	181

1 Balances exclude intra-year movements.

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Run-off

Table 1.23: Run-off impairment charge

	2017 £m	2016 £m	Change %
Ireland	(9)	(14)	36
Corporate real estate and other corporate	(13)	1	
Specialist finance	(15)	(2)	
Other	(4)	(11)	64
Total	(41)	(26)	(58)
Asset quality ratio[1]	(0.32%)	(0.15%)	(17)bp

1 In respect of loans and advances to customers.

Table 1.24: Run-off impaired loans and provisions

	Loans and advances to customers £m	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions £m**	**Impairment provisions as a % of impaired loans %**
At 31 December 2017					
Ireland	4,391	136	3.1	115	84.6
Corporate real estate and other corporate	815	692	84.9	287	41.5
Specialist finance	2,327	23	1.0	29	126.1
Other	1,000	84	8.4	25	29.8
Total gross lending	8,533	935	11.0	456	48.8
Impairment provisions	(456)				
Total	8,077				
At 31 December 2016					
Ireland	4,498	139	3.1	133	95.7
Corporate real estate and other corporate	1,190	896	75.3	399	44.5
Specialist finance	3,374	99	2.9	111	112.1
Other	1,197	83	6.9	39	47.0
Total gross lending	10,259	1,217	11.9	682	56.0

Impairment provisions	(682)
Total	9,577

EUROZONE EXPOSURES

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2017. The exposures comprise on balance sheet exposures based on their balance sheet carrying values net of provisions and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

The Group manages its exposures to individual countries through authorised country limits which take into account economic, financial, political and social factors. In addition, the Group manages its direct risks to the selected countries by establishing and monitoring risk limits for individual banks, financial institutions, corporates and individuals.

Identified indirect exposure information, where available, is also taken into account when setting limits and determining credit risk appetite for individual counterparties. This forms part of the Group's credit analysis undertaken at least annually for counterparty and sector reviews, with interim updates performed as necessary. Interim updates would usually be triggered by specific credit events such as rating downgrades, sovereign events or other developments such as spread widening. Examples of indirect risk which have been identified, where information is available, are: European banking groups with lending and other exposures to certain Eurozone countries; corporate customers with operations or significant trade in certain European jurisdictions; major travel operators known to operate in certain Eurozone countries; and international banks with custodian operations based in certain European locations.

The Chief Security Office (formerly the Group Financial Stability Forum) monitors developments within the Eurozone, carries out stress testing through detailed scenario analysis and completes appropriate due diligence on the Group's exposures. The Group has pre-determined action plans that would be executed in certain scenarios which set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross International Financial Reporting Standards (IFRS) basis and are disclosed based on the counterparty rather than the collateral (repos and stock lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Exposures to central clearing counterparties are shown net.

For multi-country asset backed securities exposures, the Group has reported exposures based on the largest country exposure. The country of exposure for asset backed securities is based on the location of the underlying assets which are predominantly residential mortgages not on the domicile of the issuer.

For Insurance, the Group has reported shareholder exposures i.e. where the Group is directly exposed to risk of loss. These shareholder exposures relate to direct investments where the issuer is resident in the named Eurozone country and the credit rating is consistent with the tight credit criteria defined under the appropriate investment mandate. Insurance also has interests in funds domiciled in Ireland and Luxembourg where, in line with the investment mandates, cash is invested in short term financial instruments. The exposure is analysed on a look through basis to the country of risk of the obligors of the underlying assets rather than treating as exposure to country of domicile of the fund.

Exposures to selected Eurozone countries

The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.25: Selected Eurozone exposures

	Sovereign debt		**Financial Institutions**						
	Direct Sovereign Exposures £m	**Cash at Central Banks £m**	**Banks £m**	**Other[1] £m**	**Asset backed securities £m**	**Corporate £m**	**Personal £m**	**Insurance Assets[1] £m**	**Total £m**
At 31 December 2017									
Ireland	–	–	177	300	100	749	4,276	–	5,602
Spain	–	–	103	4	–	591	51	68	817
Portugal	–	–	5	–	–	9	7	–	21
Italy	–	–	33	–	–	78	–	99	210
Greece	–	–	–	–	–	–	–	–	–
	–	–	318	304	100	1,427	4,334	167	6,650

At 31 December 2016									
Ireland	–	–	215	512	91	929	4,363	–	6,110
Spain	23	–	76	126	–	630	41	19	915
Portugal	–	–	7	–	–	22	7	–	36
Italy	–	–	38	–	–	59	–	67	164
Greece	–	–	–	–	–	–	–	–	–
	23	–	336	638	91	1,640	4,411	86	7,225

1 Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £16,323 million (2016: £14,506 million) on a gross basis.

In addition to the exposures detailed above, the Group has exposures in the following Eurozone countries:

Table 1.26: Other Eurozone exposures

	Sovereign debt		Financial Institutions						
	Direct Sovereign Expenses £m	Cash at Central Banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance Assets £m	Total £m
At 31 December 2017									
Netherlands	38	12,182	269	303	29	1,678	6,673	433	21,605
France	205	–	1,059	128	–	2,040	91	1,142	4,665
Germany	2,008	68	325	–	261	1,581	575	473	5,291
Luxembourg	22	–	306	702	629	1,130	–	4	2,793
Belgium	22	–	142	7	–	110	–	113	394
All other Eurozone countries	80	–	22	–	–	423	–	58	583
	2,375	12,250	2,123	1,140	919	6,962	7,339	2,223	35,331
At 31 December 2016									
Netherlands	–	8,795	343	324	50	1,610	6,315	423	17,860
France	–	–	1,907	620	41	2,648	96	851	6,163
Germany	1,543	93	538	31	224	1,598	443	477	4,947
Luxembourg	7	–	306	1,484	619	923	–	–	3,339
Belgium	35	–	1,009	300	–	114	–	49	1,507
All other Eurozone countries	38	–	95	–	–	354	–	62	549
	1,623	8,888	4,198	2,759	934	7,247	6,854	1,862	34,365

1 Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £2,644 million (2016: £2,679 million) on a gross basis.

Environmental risk management

The Group ensures appropriate management of the environmental impact, including climate change, of its lending activities. The Group-wide credit risk principles require all credit risk to be incurred with due regard to environmental legislation and the Group's code of responsibility.

The Group's divisions are each exposed to different types and levels of climate-related risk in their operations. For example, the general insurance division regularly uses weather, climate and environmental models and data to assess its insurance risk from covered perils such as windstorm and flood. A team of specialist scientists are employed within underwriting to do this work and they also regularly monitor the state of climate science to assess the need to include its potential impacts within pricing and solvency. In response to the Task Force on Climate-related Financial Disclosure recommendations, in 2018 the Group will commence a systematic review of climate-related risks and opportunities across the Group's core divisions.

The Group has been a signatory to the Equator Principles since 2008 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance, Project-Related Corporate loans and Bridge loans. The Group has also been a signatory to the UN Principles for Responsible Investment (UNPRI) since 2012, which incorporate ESG (environmental, social and governance risk) considerations in asset management. Scottish Widows is responsible for the annual UNPRI reporting process.

Within Commercial Banking, an electronic Environmental Risk Screening Tool is the primary mechanism for assessing environmental risk for lending transactions. This system provides 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. Where required, the Group's panel of environmental consultants provide additional expert support.

The Group provides colleague training on environmental risk management as part of the standard suite of Commercial Banking credit risk courses. To support this training, a range of online resource is available to colleagues and includes environmental risk theory, procedural guidance, and information on environmental legislation and sector-specific environmental impacts.

Table 1.27: Environmental risk management approach

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LOAN PORTFOLIO

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.

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Loans and advances to banks	6,611	26,902	25,117	26,155	25,365
Loans and advances to customers:					
Mortgages	304,665	306,682	312,877	333,318	335,611
Other personal lending	28,757	20,761	20,579	23,123	23,230
Agriculture, forestry and fishing	7,461	7,269	6,924	6,586	6,051
Energy and water supply	1,609	2,320	3,247	3,853	4,414
Manufacturing	7,886	7,285	5,953	6,000	7,650
Construction	4,428	4,535	4,952	6,425	7,024
Transport, distribution and hotels	14,074	13,320	13,526	15,112	22,294
Postal and telecommunications	2,148	2,564	2,563	2,624	2,364
Financial, business and other services	57,006	49,197	43,072	44,979	42,478
Property companies	30,980	32,192	32,228	36,682	44,277
Lease financing	2,094	2,628	2,751	3,013	4,435
Hire purchase	13,591	11,617	9,536	7,403	5,090
Total loans	481,310	487,272	483,325	515,273	530,283
Allowance for impairment losses	(2,201)	(2,412)	(3,033)	(6,414)	(11,966)
Total loans and advances net of allowance for impairment losses	479,109	484,860	480,292	508,859	518,317

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

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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.

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Balance at beginning of year	2,412	3,033	6,414	11,966	15,253
Exchange and other adjustments	132	69	(246)	(410)	291
Disposal of businesses	–	–	(82)	–	(176)
Advances written off:					
Loans and advances to customers:					
Mortgages	(42)	(42)	(71)	(87)	(601)
Other personal lending	(925)	(728)	(853)	(1,329)	(1,437)
Agriculture, forestry and fishing	(1)	(1)	(1)	(8)	(11)
Energy and water supply	–	(9)	(73)	–	(102)
Manufacturing	(40)	(19)	(126)	(59)	(130)
Construction	(65)	(96)	(21)	(157)	(84)
Transport, distribution and hotels	(65)	(64)	(728)	(1,119)	(798)
Postal and telecommunications	–	(189)	(11)	–	(14)
Financial, business and other services	(158)	(712)	(604)	(946)	(1,030)
Property companies	(136)	(215)	(1,648)	(2,669)	(1,891)
Lease financing	(2)	–	(31)	(4)	(10)
Hire purchase	(65)	(36)	(37)	(54)	(121)
Loans and advances to banks	–	–	–	–	(3)
Total advances written off	(1,499)	(2,111)	(4,204)	(6,432)	(6,232)
Recoveries of advances written off:					
Loans and advances to customers:					
Mortgages	17	44	35	18	28
Other personal lending	419	329	366	600	408
Energy and water supply	–	3	5	–	–
Manufacturing	–	80	–	–	–
Construction	4	78	–	–	–
Transport, distribution and hotels	15	50	63	–	–
Financial, business and other services	6	241	193	–	–
Property companies	–	34	101	–	–
Lease financing	19	–	–	–	–
Hire purchase	2	2	1	63	20
Total recoveries of advances written off	482	861	764	681	456
Total net advances written off	(1,017)	(1,250)	(3,440)	(5,751)	(5,776)

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	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m
Effect of unwinding of discount recognised through interest income	(23)	(32)	(56)	(126)	(351)
Allowances for impairment losses charged against income for the year:					
Loans and advances to customers:					
Mortgages	(119)	(23)	33	(138)	224
Other personal lending	596	438	437	536	920
Agriculture, forestry and fishing	2	3	1	2	–
Energy and water supply	–	(4)	35	28	95
Manufacturing	5	(48)	23	(4)	31
Construction	85	143	13	(81)	66
Transport, distribution and hotels	(19)	(35)	(88)	198	421
Postal and telecommunications	1	191	(2)	6	(3)
Financial, business and other services	42	6	77	179	552
Property companies	(7)	(166)	(140)	40	457
Lease financing	–	15	31	(1)	(26)
Hire purchase	111	72	23	(30)	(12)
Loans and advances to banks	–	–	–	–	–
Total allowances for impairment losses charged against income for the year	697	592	443	735	2,725
Total balance at end of year	2,201	2,412	3,033	6,414	11,966
Ratio of net write-offs during the year to average loans outstanding during the year	0.2%	0.3%	0.8%	1.1%	1.1%

Following the reduction in the Group’s non-UK activities, an analysis between domestic and foreign operations is not provided.

The Group’s impairment allowances in respect of loans and advances to banks and customers decreased by £211 million, or 9 per cent, from £2,412 million at 31 December 2016 to £2,201 million at 31 December 2017. This decrease resulted from a charge to the income statement of £697 million being more than offset by net advances written off of £1,017 million (advances written off of £1,499 million less recoveries £482 million). The increase in the charge to the income statement of £105 million, or 18 per cent, from £592 million in 2016 to £697 million in 2017 reflects lower levels of releases and write-backs and the acquisition of MBNA. By category of lending, the most significant elements of the charge to the income statement were charges of £596 million in respect of other personal lending and £85 million in respect of construction together with a credit of £119 million in respect of mortgages. Of the net advances written off of £1,017 million, £506 million related to other personal lending, £152 million related to financial, business and other services and £136 million to property companies.

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The following table analyses the coverage of the allowance for loan losses by category of loans.

	2017 Allowance £m	**2017 Percentage of loans in each category to total loans %**	2016 Allowance £m	2016 Percentage of loans in each category to total loans %	2015 Allowance £m	2015 Percentage of loans in each category to total loans %	2014 Allowance £m	2014 Percentage of loans in each category to total loans %	2013 Allowance £m	2013 Percentage of loans in each category to total loans %
Balance at year end applicable to:										
Loans and advances to banks	–	1.4	–	5.5	–	5.2	–	5.1	–	4.8
Loans and advances to customers:										
Mortgages	485	63.4	576	63.0	479	64.7	460	64.7	657	63.5
Other personal lending	381	6.0	356	4.3	388	4.3	607	4.5	919	4.4
Agriculture, forestry and fishing	8	1.6	13	1.5	15	1.4	18	1.3	38	1.1
Energy and water supply	5	0.3	6	0.5	20	0.7	61	0.7	149	0.8
Manufacturing	35	1.6	84	1.5	70	1.2	179	1.2	296	1.4
Construction	410	0.9	319	0.9	165	1.0	158	1.3	395	1.3
Transport, distribution and hotels	57	2.9	161	2.7	219	2.8	1,051	2.9	1,954	4.2
Postal and telecommunications	5	0.4	5	0.5	4	0.5	17	0.5	11	0.4
Financial, business and other services	312	11.9	312	10.1	811	8.9	1,225	8.7	2,293	8.0
Property companies	343	6.4	470	6.6	790	6.7	2,553	7.1	5,145	8.3
Lease financing	–	0.4	–	0.5	–	0.6	1	0.6	6	0.8
Hire purchase	160	2.8	110	2.4	72	2.0	84	1.4	103	1.0
Total balance at year end	2,201	100.0	2,412	100.0	3,033	100.0	6,414	100.0	11,966	100.0

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

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RISK ELEMENTS IN THE LOAN PORTFOLIO

The Group's credit risk elements analysed by categories reflecting US lending and accounting practices, which differ from those employed in the UK, are detailed below:

NON-PERFORMING LENDING

In the US, it is the normal practice to stop accruing interest when payments are 90 days or more past due or when recovery of both principal and interest is doubtful. When the loans are transferred to non-accrual status, accrued interest is reversed from income and no further interest is recognised until it becomes probable that the principal will be repaid in full. Loans on which interest has been accrued but suspended would be included in risk elements as loans accounted for on a non-accrual basis.

In the US non-performing loans and advances are typically written off more quickly than in the UK. Consequently a UK bank may appear to have a higher level of non-performing loans and advances than a comparable US bank although the reported net income may be similar in both the US and the UK.

The Group complies with IFRS 7, which requires detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, the table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, not requiring a provision and (iv) impaired with a provision.

	Loans and	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
	advances to banks	**Retail – mortgages**	**Retail – other**	**Commercial**	**Total**	
(audited)	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
31 December 2017						
Neither past due nor impaired	6,577	295,765	48,897	116,396	461,058	31,590
Past due but not impaired	6	5,934	585	336	6,855	–
Impaired – no provision required	28	640	306	700	1,646	–
– provision held	–	3,529	1,053	1,613	6,195	–

Gross	6,611	305,868	50,841	119,045	475,754	31,590
31 December 2016						
Neither past due nor impaired	26,888	296,303	39,478	109,364	445,145	33,079
Past due but not impaired	14	7,340	386	305	8,031	–
Impaired – no provision required	–	784	392	689	1,865	–
– provision held	–	3,536	1,038	2,056	6,630	–
Gross	26,902	307,963	41,294	112,414	461,671	33,079
31 December 2015						
Neither past due nor impaired	25,006	302,063	38,886	100,001	440,950	33,174
Past due but not impaired	111	8,233	393	463	9,089	–
Impaired – no provision required	–	732	690	1,092	2,514	–
– provision held	–	3,269	911	2,896	7,076	–
Gross	25,117	314,297	40,880	104,452	459,629	33,174
31 December 2014						
Neither past due nor impaired	26,003	320,324	37,886	106,768	464,978	36,725
Past due but not impaired	152	10,311	674	488	11,473	–
Impaired – no provision required	–	578	938	847	2,363	–
– provision held	–	3,766	1,109	7,070	11,945	–
Gross	26,155	334,979	40,607	115,173	490,759	36,725
31 December 2013						
Neither past due nor impaired	25,219	318,668	36,789	107,764	463,221	29,443
Past due but not impaired	146	12,329	580	786	13,695	–
Impaired – no provision required	–	637	1,284	1,824	3,745	–
– provision held	–	6,229	1,456	20,829	28,514	–
Gross	25,365	337,863	40,109	131,203	509,175	29,443

The analysis of lending between retail and commercial 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 commercial are exposures to corporate customers and other large institutions.

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The loans that are past due but not impaired are further analysed in the table below according to the number of days that have elapsed since the last payment was due from the borrower.

	Loans and advances to banks	Loans and advances to customers				Loans and advances designated at fair value through profit or loss
		Retail – mortgages	Retail – other	Commercial	Total	
(audited)	£m	£m	£m	£m	£m	£m
31 December 2017						
0-30 days	6	3,057	458	246	3,761	–
30-60 days	–	1,115	111	10	1,236	–
60-90 days	–	785	3	13	801	–
90-180 days	–	977	3	8	988	–
Over 180 days	–	–	10	59	69	–
Total	6	5,934	585	336	6,855	–
31 December 2016						
0-30 days	14	3,547	285	157	3,989	–
30-60 days	–	1,573	75	37	1,685	–
60-90 days	–	985	2	74	1,061	–
90-180 days	–	1,235	6	14	1,255	–
Over 180 days	–	–	18	23	41	–
Total	14	7,340	386	305	8,031	–
31 December 2015						
0-30 days	111	4,066	276	248	4,590	–
30-60 days	–	1,732	81	100	1,913	–
60-90 days	–	1,065	9	52	1,126	–
90-180 days	–	1,370	8	19	1,397	–
Over 180 days	–	–	19	44	63	–
Total	111	8,233	393	463	9,089	–
31 December 2014						
0-30 days	152	4,854	453	198	5,505	–
30-60 days	–	2,309	110	51	2,470	–
60-90 days	–	1,427	90	139	1,656	–
90-180 days	–	1,721	5	38	1,764	–
Over 180 days	–	–	16	62	78	–
Total	152	10,311	674	488	11,473	–
31 December 2013						
0-30 days	146	5,596	489	347	6,432	–
30-60 days	–	2,639	87	102	2,828	–
60-90 days	–	1,734	4	57	1,795	–

90-180 days	–	2,360	–	41	2,401	–
Over 180 days	–	–	–	239	239	–
Total	146	12,329	580	786	13,695	–

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

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POTENTIAL PROBLEM LOANS

Potential problem loans are loans where known information about possible credit problems causes management to have concern as to the borrower's ability to comply with the present loan repayment terms.

IFRS 7 requires the disclosure of information about the credit quality of loans and advances that are neither past due nor impaired. The Group's disclosures analyse these loans between those that the Group believes are of good quality, satisfactory quality, and lower quality and those that are below standard but not impaired. The below standard but not impaired balances represent potential problem loans.

	Loans and advances	**Loans and advances to customers**				**Loans and advances designated at fair value through profit or loss**
		Retail – mortgages	**Retail – other**	**Commercial**	**Total**	
	to banks					
(audited)	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
31 December 2017						
Good quality	6,351	294,748	43,145	81,121		31,548
Satisfactory quality	198	790	4,770	30,154		42
Lower quality	28	32	286	4,807		–
Below standard, but not impaired	–	195	696	314		–
Total	6,577	295,765	48,897	116,396	461,058	31,590
31 December 2016						
Good quality	26,745	295,286	34,195	72,083		33,049
Satisfactory quality	87	814	4,479	30,433		30
Lower quality	3	39	387	6,433		–
Below standard, but not impaired	53	164	417	415		–
Total	26,888	296,303	39,478	109,364	445,145	33,079
31 December 2015						
Good quality	24,670	301,403	33,589	63,453		33,156
Satisfactory quality	311	527	4,448	28,899		15
Lower quality	4	27	476	7,210		3
Below standard, but not impaired	21	106	373	439		–
Total	25,006	302,063	38,886	100,001	440,950	33,174
31 December 2014						
Good quality	25,654	318,967	30,993	65,106		36,482
Satisfactory quality	263	1,159	5,675	28,800		238
Lower quality	49	72	623	11,204		5

Below standard, but not impaired	37	126	595	1,658		–
Total	26,003	320,324	37,886	106,768	464,978	36,725
31 December 2013						
Good quality	25,044	314,749	29,129	66,345		29,432
Satisfactory quality	171	2,948	6,414	29,038		7
Lower quality	2	308	501	9,991		3
Below standard, but not impaired	2	663	745	2,390		1
Total	25,219	318,668	36,789	107,764	463,221	29,443

For further details see note 51 on page F-81.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

	2017 **£m**
Interest income that would have been recognised under original contract terms	265
Interest income included in profit	(179)
Interest foregone	86

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TROUBLED DEBT RESTRUCTURINGS

In the US, loans whose terms have been modified due to problems with the borrower are required to be separately disclosed. If the new terms were in line with market conditions at the time of the restructuring and the restructured loan remains current as to repayment of principal and interest then the disclosure is discontinued at the end of the first year. The Company's accounting policy for loans that are renegotiated is set out in note 2(H)(l) to the financial statements. The table below sets out loans that are forborne at 31 December 2017, 2016, 2015 and 2014, separately identifying those loans that are also impaired:

	Total forborne loans and advances which are not impaired £m	Total forborne loans and advances which are impaired £m	Total loans and advances which are forborne £m	Impairment allowance as a % of loans and advances which are forborne %
At 31 December 2017				
UK secured retail	1,291	137	1,428	4.3
UK unsecured retail	55	139	194	38.6
Consumer credit cards	105	190	295	36.0
Asset Finance UK Retail	15	19	34	36.6
Run off: Ireland secured retail	213	25	238	21.0
Commercial Banking	447	1,927	2,374	35.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	–	715	715	44.1
At 31 December 2016				
UK secured retail	1,879	217	2,096	4.7
UK unsecured retail	20	107	127	40.5
Consumer credit cards	93	119	212	29.0
Asset Finance UK Retail	55	62	117	27.0
Run off: Ireland secured retail	137	19	156	16.6
Commercial Banking[1]	466	2,197	2,663	31.1
Run off: Corporate Real Estate, other Corporate and Specialist Finance	3	995	998	51.1
At 31 December 2015				
UK secured retail	2,929	173	3,102	4.2
UK unsecured retail	28	119	147	40.0
Consumer credit cards	105	120	225	26.8
Asset Finance UK Retail	49	51	100	25.5

Run off: Ireland secured retail	143	26	169	13.3
Commercial Banking[1]	986	2,543	3,529	30.9
Run off: Corporate Real Estate, other Corporate and Specialist Finance	9	1,771	1,780	52.5
Run-off Ireland: Commercial real estate and corporate	32	5	37	0.0
At 31 December 2014				
UK secured retail	4,128	266	4,394	3.5
UK unsecured retail	23	139	162	39.4
Consumer credit cards	94	140	234	29.1
Asset Finance UK Retail	56	53	109	20.5
Run off: Ireland secured retail	239	41	280	12.7
Commercial Banking	1,896	3,241	5,137	31.0
Run off: Corporate Real Estate, other Corporate and Specialist Finance	86	1,912	1,998	58.3
Run-off Ireland: Commercial real estate and corporate	384	3,052	3,436	72.2

1 Restated.

The Group assesses whether a loan benefiting 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 benefiting from such a programme.

Further information on the schemes operated by the Group to assist borrowers who are experiencing financial stress and on the Group's forborne loans is set out on pages 57 to 61 and pages 66 to 71.

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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. The Group's gains or losses on sale of the acquired property are recorded within the provision for loan losses during the reporting period.

The difference in practices has no effect on net income reported in the UK compared to that reported in the US but it does result in a difference in classification of losses and recoveries in the income statement. It also has the effect of causing UK banks to report an increased level of non-performing loans compared with US banks.

In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

CROSS BORDER OUTSTANDINGS

The business of Lloyds Banking Group involves 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.

	Total	Governments and official institutions	Banks and other financial institutions	Commercial, industrial and other

	% of assets	£m	£m	£m	£m
At 31 December 2017:					
United States of America	1.6	12,963	6,760	3,205	2,998
At 31 December 2016:					
United States of America	1.6	13,224	7,564	1,718	3,942
At 31 December 2015:					
United States of America	1.5	11,748	6,349	952	4,447

At 31 December 2017, United States of America had commitments of £941 million.

At 31 December 2017, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2016, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2015, no countries had cross border outstandings of between 0.75 per cent and 1 per cent of assets.

REGULATORY AND LEGAL RISK

DEFINITION

Regulatory and legal risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including codes of practice which could have legal implications), regulations, codes of conduct or legal obligations.

EXPOSURES

Whilst the Group has a zero risk appetite for material regulatory breaches or material legal incidents, the Group remains exposed to material regulatory breaches and material legal incidents outside of its risk appetite. Exposure is driven by significant ongoing and new legislation, regulation and court proceedings in the UK and overseas which in each case needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group.

MEASUREMENT

Regulatory and legal risks are measured against a set of risk appetite metrics, with appropriate thresholds, which are approved annually by the Board and which are regularly reviewed and monitored. Metrics include assessments of control and material regulatory rule breaches.

MITIGATION

The Group has have taken a number of steps and has outlined below the following key components:

– The Board establishes a Group-wide risk appetite and metrics for regulatory and legal risk;

– Group policies and procedures set out the principles and key controls that should apply across the business which are aligned to the Group risk appetite. Mandated policies and processes require appropriate control frameworks, management information, standards and colleague training to be implemented to identify and manage regulatory and legal risk;

– Business units assess and implement policy and regulatory requirements and establish local control, processes and procedures to ensure governance and compliance;

– Material risks and issues are escalated to divisional and then Group-level bodies which challenge and support the business on its management of them;

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- Business units regularly produce management information to assist in the identification of issues and test management controls are working effectively;
- Risk division and Legal provide oversight and proactive support and constructive challenge to the business in identifying and managing regulatory and legal issues;
- Risk division will conduct thematic reviews of regulatory compliance across businesses and divisions where appropriate; and
- Business units with the support of divisional and Group-level bodies conduct ongoing horizon scanning to identify and address changes in regulatory and legal requirements.

MONITORING

Business unit risk exposure is reported to Risk division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Conduct, Compliance and Operational Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory and legal sections in the Group's consolidated risk reporting.

CONDUCT RISK

DEFINITION

The risk of customer detriment due to poor design, distribution and execution of products and services or other activities which could undermine the integrity of the market or distort competition, leading to unfair customer outcomes, regulatory censure and financial and reputational loss.

EXPOSURES

The Group faces significant conduct risks, which affect all aspects of the Group's operations and all types of customers.

Conduct risks can impact directly or indirectly on the Group's customers and can materialise from a number of areas across the Group, including: sales processes resulting in poor customer outcomes; products and services not meeting the customers' needs; failing to deal with customers' complaints effectively; failing to promote effective competition in the interest of customers and failing to identify and report behaviour which could undermine the integrity of the market.

There is an ongoing high level of scrutiny regarding financial institutions' treatment of customers, including those in vulnerable circumstances, from regulatory bodies, the media, politicians and consumer groups. There is also a significant regulatory focus on market misconduct, resulting from previous issues which include London Interbank Offered Rate (LIBOR) and Foreign Exchange (FX).

As a result, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or in a manner that fails to deliver fair and reasonable customer treatment.

The Group may also be liable for damages to third parties harmed by the conduct of its business.

MEASUREMENT

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite.

Conduct risk appetite metrics (CRAMs) have been designed for all product families offered by the Group; a set of common metrics supports a consistent approach across products and services. These contain a range of product design, sales and service metrics (such as sales volume, usage and customer outcome testing) to provide a more holistic view of conduct risks; each product also has additional bespoke metrics.

Each of the tolerances for the metrics are agreed for the individual product or service and are tracked monthly. At a consolidated level these metrics are part of the Board approved risk appetite. The Group is also evolving its approach to measurements supporting customer vulnerability and customer journeys.

Measurements in relation to market integrity continued to evolve in 2017, including additional business unit level risk control metrics to enhance the established suite of metrics (which already cover key topics such as the management of conflicts of interest and the handling of market sensitive information).

MITIGATION

The Group takes a range of mitigating actions with respect to conduct risk. The Group's ongoing commitment to good customer outcomes sets the tone from the top and supports the development of the right customer centric culture – strengthening links between actions to support conduct, culture and customer and enabling more effective control management. Actions to enable good conduct include:

– Conduct risk appetite established at Group and business area level, with metrics included in the Group risk appetite to ensure ongoing focus;

– Customer needs explicitly considered within business and product level planning and strategy, through divisional customer and culture plans, with integral conduct lens, reviewed and challenged by Group Customer First Committee (GCFC);

– Cultural transformation, supported by strong direction and tone from senior executives and the Board. This is underpinned by the Group's values and codes of responsibility, to deliver the best bank for customers;

– Further embedding of the customer vulnerability framework. The Customer Vulnerability Cross Divisional Committee operates at a senior level to prioritise change, drive implementation and ensure consistency across the Group. Significant partnership established with Macmillan to support customers with cancer;

– Embedding and evolving the Group's customer journey strategy and framework to support the Group's focus on conduct from an end-to-end customer perspective;

– Enhanced product governance framework to ensure products continue to offer customers fair value, and consistently meet their needs throughout their product life cycle;

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- Enhanced complaints management through effectively responding to, and learning from, root causes to reduce complaint volumes and the Financial Ombudsman Service change rate;

- Enhanced recruitment and training, with a focus on how the Group manages colleagues' performance with clearer customer accountabilities; and

- Ongoing focus on the strategic conduct agenda in the Group's interactions with third parties involved in serving the Group's customers to ensure consistent delivery.

The Group continues to prioritise activity designed to reinforce good conduct in its engagement with the markets in which it operates, with the Market Conduct Steering Committee leading read-across activity of industry issues for LBG consideration. Further training has been delivered for colleagues, and the focus on enhanced procedures, and the enhancement of preventative and detective controls continues – including the Group's trade surveillance and continuous surveillance capability.

The Group's leadership team, through GCFC, support the development of the conduct agenda and priorities. The Board and Group Risk Committee receive regular qualitative and quantitative reports to track progress on how the Group is meeting customer needs and minimising conduct risk across all areas of the business.

The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of concerns related to customer treatment, effective competition and market integrity, to ensure that the Group's strategic conduct focus continues to meet evolving stakeholder expectations.

MONITORING

Monitoring and reporting is undertaken at Board, Group and business area committees. As part of the reporting of CRAMs, a robust outcomes testing regime for both sales and complaints processes is in place to test performance of customer critical activities.

GCFC has responsibility for monitoring and reviewing integrated measurement of enhanced outcomes and customer views, including challenging divisions to make changes based on key learnings to support the delivery of the Group's vision and foster a customer centric culture.

OPERATIONAL RISK

DEFINITION

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, which can lead to adverse customer impact, reputational damage or financial loss.

EXPOSURES

The principal operational risks to the Group are:

– A cyber-attack could result in customer detriment, financial loss, disruption and/or reputational damage;

– Failure in IT systems, due to volume of change, and/or aged infrastructure, could result in unfair customer outcomes, financial loss and/or reputational damage;

– Failure to protect and manage customers’ data could result in customer detriment, financial loss, disruption and/or reputational damage;

– Internal and/or external fraud or financial crime could result in customer detriment, financial loss, disruption and/or reputational damage;

– Failure to ensure compliance with increasingly complex and detailed anti-money laundering, anti-terrorism, sanctions and prohibitions laws and regulations, as such a failure would adversely impact the Group’s reputation and potentially incur fines and other legal enforcements; and

– Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events.

A number of these risks could increase where there is a reliance on third party suppliers to provide services to the Group or its customers.

MEASUREMENT

Operational risk is managed across the Group through an operational risk framework and operational risk policies. The operational risk framework includes a risk control self-assessment process, risk impact likelihood matrix, key risk and control indicators, risk appetite, a robust operational event management and escalation process, scenario analysis and operational losses process.

Table 1.28 below shows high level loss and event trends for the Group using Basel II categories. Based on data captured on the Group's Operational Risk System, in 2017 the highest frequency of events occurred in external fraud (64.37 per cent) and execution, delivery and process management (22.69 per cent). Clients, products and business practices accounted for 72.74 per cent of losses by value, driven by legacy issues where impacts materialised in 2017 (excluding PPI).

Table 1.28: Operational risk events by risk category (losses greater than or equal to £10,000), excluding PPI

	% of total volume		**% of total losses**	
	2017	2016	**2017**	2016
Business disruption and system failures	**1.35**	1.01	**0.92**	0.55
Clients, products and business practices	**10.12**	11.31	**72.74**	77.62
Damage to physical assets	**1.10**	1.05	**0.07**	0.27
Employee practices and workplace safety	**–**	0.04	**–**	–
Execution, delivery and process management	**22.69**	24.80	**22.80**	19.23
External fraud	**64.37**	61.58	**3.50**	2.31
Internal fraud	**0.37**	0.21	**(0.03)**	0.02
Total	**100.00**	100.00	**100.00**	100.00

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Operational risk losses and scenario analysis is used to inform the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its minimum (Pillar I) operational risk capital requirements using The Standardised Approach (TSA). Pillar II is calculated using Internal and External loss data and extreme but plausible scenarios that may occur in the next 12 months.

MITIGATION

The Group's strategic review considers the changing risk management requirements, adapting the change delivery model to be more agile and develop the people skills and capabilities needed to be the 'Bank of the Future'. The Group continues to review and invest in its control environment to ensure it addresses the inherent risks faced. Risks are reported and discussed at local governance forums and escalated to executive management and Board as appropriate to ensure the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (including insurance) and acceptance. Where there is a reliance on third party suppliers to provide services, the Group's sourcing policy ensures that outsourcing initiatives follow a defined process including due diligence, risk evaluation and ongoing assurance.

Mitigating actions to the principal operational risks are:

- The threat landscape associated with cyber risk continues to evolve and there is significant regulatory attention on this subject. The Board has defined a cyber risk appetite and has completed a three year programme to deliver capability to meet that risk appetite. Given the nature of the threat, the Group continues to invest heavily in protecting against malicious cyber-attacks and is commencing further investment in enhancing the protection of its customers and their data, improving capability to detect and respond to attacks and protecting its most critical systems.

- The Group continues to optimise its approach to IT and operational resilience by investing in technology improvements and enhancing the resilience of systems that support the Group's critical business processes, primarily through the Technology Resilience Programme, with independent verification of progress on an annual basis. The Board recognises the role that resilient technology plays in achieving the Group's strategy of becoming the best bank for customers and in maintaining banking services across the wider industry. As such, the Board dedicates considerable time and focus to this subject at both the Board and the Board Risk Committee, and continues to sponsor key investment programmes that enhance resilience.

- The Group is making a significant investment to improve data privacy, including the security of data and oversight of third parties. The Group's strategy is to introduce advanced data management practices, based on Group-wide standards, data-first culture and modern enterprise data platforms, supported by a simplified modern IT architecture.

- The Group adopts a risk based approach to mitigate the internal and external fraud risks it faces, reflecting the current and emerging fraud risks within the market. Fraud risk appetite metrics have been defined, holistically covering the impacts of fraud in terms of losses to the Group, costs of fraud systems and operations, and customer experience of actual and attempted fraud. Oversight of the appropriateness and performance of these metrics is undertaken regularly through business area and Group-level committees. This approach drives a continual programme of prioritised enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Group-wide policies and operational control frameworks are maintained and designed to provide customer confidence, protect the Group's commercial interests and reputation, comply with legal requirements and meet regulatory expectations. The Group's fraud awareness programme remains a key component of its fraud control environment, and awareness of fraud risk is supported by mandatory training for all colleagues. The Group also plays an active role with other financial institutions, industry bodies, and enforcement agencies in identifying and combatting fraud.

The Group has adopted policies and procedures designed to detect and prevent the use of its banking network for money laundering, terrorist financing, bribery, tax evasion, human trafficking, and modern-day slavery, and activities prohibited by legal and regulatory sanctions. Against a background of increasingly complex and detailed laws and regulations, and of increased criminal and terrorist activity, the Group regularly reviews and assesses its policies, procedures and organisational arrangements to keep them current, effective and consistent across markets and jurisdictions. The Group requires mandatory training on these topics for all employees. Specifically, the anti-money laundering procedures include 'know-your-customer' requirements, transaction monitoring technologies, reporting of suspicions of money laundering or terrorist financing to the applicable regulatory authorities, and interaction between the Group's Financial Intelligence Unit and external agencies and other financial institutions. The Anti-Bribery Policy prohibits the payment, offer, acceptance or request of a bribe, including 'facilitation payments' by any employee or agent and provides a confidential reporting service for anonymous reporting for suspected or actual bribery activity. The Sanctions and Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.

Operational resilience measures and recovery planning defined in the Group's Resilience and Continuity (including Incident Management) Policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, cyber, economic instability, pandemic planning and operational incidents. The Group considers its operational resilience across five key pillars; cyber, third parties, IT, people and property.

MONITORING

Monitoring and reporting of operational risk is undertaken at Board, Group and divisional risk committees. Each committee monitors key risks, control effectiveness, key risk and control indicators, events, operational losses, risk appetite metrics and the results of independent testing conducted by Risk and/or Group Internal Audit.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined, where possible, and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

PEOPLE RISK

DEFINITION

The risk that the Group fails to provide an appropriate colleague and customer centric culture, supported by robust reward and wellbeing policies and processes; effective leadership to manage colleague resources; effective talent and succession management; and robust control to ensure all colleague-related requirements are met.

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EXPOSURES

The Group's management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. Over the coming year the Group anticipates the following key people risk exposures:

- Maintaining organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change;
- Senior Managers and Certification Regime (SM&CR) and additional regulatory constraints on remuneration structures may impact the Group's ability to attract and retain talent;
- The increasing digitisation of the business is changing the capability mix required and may impact the Group's ability to attract and retain talent; and
- Colleague engagement may continue to be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct.

MEASUREMENT

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group such as succession, retention, colleague engagement and performance management. In addition to risk appetite measures and limits, people risks and controls are monitored on a monthly basis via the Group's risk governance framework and reporting structures.

MITIGATION

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Continued focus on the Group's culture by developing and delivering initiatives that reinforce the appropriate behaviours which generate the best possible long-term outcomes for customers and colleagues;

- Managing organisational capability and capacity through divisional people strategies to ensure there are the right skills and resources to meet the Group's customers' needs and deliver the Group's strategic plan;

- Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;

- Ensuring compliance with legal and regulatory requirements related to SM&CR, embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities; and

- Ongoing consultation with the Group's recognised unions on changes which impact their members.

MONITORING

People risks from across the Group are monitored and reported through Board and Group Governance Committees in accordance with the Group's Risk Management Framework and people risk sub-framework. Risk exposures are discussed monthly via the Group People Risk Committee with upwards reporting to Group Risk and Executive Committees. In addition, oversight, challenge and reporting is completed at Risk division level and, combined with risk assurance, Risk division reviews and assesses the effectiveness of controls, recommending follow up remedial action if relevant. All material people risk events are escalated in accordance with the formal Group Operational Risk Policy and People Policies to the respective divisional Managing Directors and the Group Director, Conduct, Compliance and Operational Risk.

INSURANCE UNDERWRITING RISK

DEFINITION

Insurance underwriting risk is defined as the risk of adverse developments in longevity, mortality, persistency, General Insurance underwriting and policyholder behaviour, leading to reductions in earnings and/or value.

EXPOSURES

The major source of insurance underwriting risk within the Group is the Insurance business.

Longevity and persistency are key risks within the life and pensions business. Longevity risk arises from the annuity portfolios where policyholders' future cashflows are guaranteed at retirement and increases in life expectancy, beyond current assumptions, will increase the cost of annuities. Longevity risk exposures are expected to increase with the Insurance business growth in the bulk annuity market. Persistency assumptions are set to give a best estimate, however customer behaviour may result in increased cancellations or cessation of contributions.

Property insurance risk is a key risk within the General Insurance business, through Home Insurance. Exposures can arise, for example, in extreme weather conditions, such as flooding, when property damage claims are higher than expected.

The Group’s defined benefit pension schemes also expose the Group to longevity risk. For further information please refer to the defined benefit pension schemes component of the market risk section and note 35 to the financial statements.

MEASUREMENT

Insurance underwriting risks are measured using a variety of techniques including stress, reverse stress and scenario testing, as well as stochastic modelling. Current and potential future insurance underwriting risk exposures are assessed and aggregated on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance’s regulatory capital assessments and other supporting measures where appropriate, including those set out in note 32 to the financial statements.

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MITIGATION

Insurance underwriting risk in the Insurance business is mitigated in a number of ways:

- General Insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements;
- Insurance processes on underwriting, claims management, pricing and product design;
- Longevity risk transfer and hedging solutions are considered on a regular basis and in 2017 the Group reinsured £1.3 billion of annuitant longevity. A team of longevity and bulk pricing experts has been built to support the new bulk annuity proposition; and
- Exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

MONITORING

Insurance underwriting risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Significant risks from the Insurance business and the defined benefit pension schemes are reviewed by the Group Executive and Group Risk Committees and/or Board.

Insurance underwriting risk exposures within the Insurance business are monitored against risk appetite. The Insurance business monitors experiences against expectations, for example business volumes and mix, claims and persistency experience. The effectiveness of controls put in place to manage insurance underwriting risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

CAPITAL RISK

DEFINITION

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

EXPOSURES

A capital risk exposure arises when the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. This could arise due to a depletion of the Group's capital resources as a result of the crystallisation of any of the risks to which it is exposed. Alternatively a shortage of capital could arise from an increase in the amount of capital that needs to be held. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

MEASUREMENT

The Group measures the amount of capital it requires and holds through applying the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA) and supplemented through additional regulation under the PRA Rulebook. Full details of the Group's regulatory capital and leverage frameworks, including the means by which its capital and leverage requirements and capital resources are calculated, will be provided in the Group's Pillar 3 Report.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of aggregate risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 requirements are supplemented by additional minimum requirements under Pillar 2A of the regulatory framework, the aggregate of which is to be referred to as the Group's Total Capital Requirement (TCR) from 1 January 2018, and a number of regulatory capital buffers as described below.

Additional minimum requirements under Pillar 2A are currently set by the PRA through the issuance of bank specific Individual Capital Guidance (ICG). This reflects a point in time estimate by the PRA, which may change over time, of the minimum amount of capital that is needed by the bank to cover risks that are not fully covered by Pillar 1, such as credit concentration and operational risk, and those risks not covered at all by Pillar 1, such as pensions and interest rate risk in the banking book (IRRBB). From 1 January 2018, Pillar 2A will be set as a firm specific capital requirement (Pillar 2R) rather than as individual capital guidance.

The Group is also required to maintain a number of regulatory capital buffers, which are required to be met with CET1 capital.

Systemic buffers are designed to hold systemically important banks to higher capital standards, so that they can withstand a greater level of stress before requiring resolution.

– Although the Group is not currently classified as a global systemically important institution (G-SII) under the Capital Requirements Directive, it has been classified as an ‘other’ systemically important institution (O-SII) by the PRA. The O-SII buffer is set to zero in the UK.

– The Systemic Risk Buffer (SRB) will be applied to UK ring-fenced banks from early 2019. The size of buffer applied to the Group’s ring-fenced bank (RFB) sub-group in 2019 will be dependent upon the total assets of the sub-group. The FPC anticipates applying a buffer of 2.5 per cent to the largest ring-fenced institutions. Although the SRB will apply at a sub consolidated level within the Group’s structure, the PRA have indicated that they will include in the Group’s PRA Buffer an amount equivalent to the RFB’s Systemic Risk Buffer. The amount included in the PRA Buffer is expected to be lower as a percentage of Group risk-weighted assets reflecting the assets of the Group that will not be held in the RFB sub-group and for which the SRB will not apply to.

The capital conservation buffer (CCB) is a standard buffer of 2.5 per cent of risk-weighted assets designed to provide for losses in the event of stress and is being phased in over the period from 1 January 2016 to 1 January 2019. During 2017 it was 1.25 per cent and during 2018 it will increase to 1.875 per cent.

The countercyclical capital buffer (CCyB) is time-varying and is designed to require banks to hold additional capital to remove or reduce the build-up of systemic risk in times of credit boom, providing additional loss absorbing capacity and acting as an incentive for banks to constrain further credit growth.

The amount of the buffer is determined by reference to buffer rates set by the (FPC) for the individual countries where the Group has relevant credit risk exposures. The CCyB rate for the UK is currently set at zero but will increase to 0.5 per cent on 27 June 2018 and to 1.0 per cent on 28 November 2018. The FPC will reconsider the adequacy of a 1.0 per cent UK CCyB rate during the first half of 2018 in light of the evolution of the overall risk environment. Non-zero buffer rates currently apply for Norway, Sweden, Hong Kong, Iceland, Slovakia and the Czech Republic. Given that the Group has minimal exposures to these jurisdictions, the overall countercyclical capital buffer requirement at 31 December 2017 is considered to be negligible.

As part of the capital planning process, forecast capital positions are subjected to extensive stress analyses to determine the adequacy of the Group's capital resources against the minimum requirements, including the ICG. The PRA uses the outputs from some of these stress analyses as one of the inputs that inform the setting of a bank-specific capital buffer for the Group, known as the PRA Buffer. The PRA Buffer also takes into account the CCB and CCyB. The PRA requires the PRA Buffer to remain confidential between the Group and the PRA.

All buffers are required to be met with CET1 capital. A breach of the PRA buffer would trigger a dialogue between the Group and the PRA to agree what action is required whereas a breach of the CRD IV combined buffer (all regulatory buffers excluding the PRA buffer) would give rise to automatic constraints upon any discretionary capital distributions by the Group.

In addition to the risk-based capital framework outlined above, the Group is also subject to minimum capital requirements under the UK Leverage Ratio Framework. The leverage ratio is calculated by dividing fully loaded tier 1 capital resources by a defined measure of on-balance sheet assets and off-balance sheet items.

The minimum leverage ratio requirement under the UK Leverage Ratio Framework is 3.25 per cent. In addition the framework requires two buffers to be maintained: an Additional Leverage Ratio Buffer (ALRB), which is calculated as 35 per cent of the Systemic Risk Buffer (applicable from 2019) and a time-varying Countercyclical Leverage Buffer (CCLB) which is calculated as 35 per cent of the countercyclical capital buffer rate (currently set at 0 per cent). At least 75 per cent of the minimum 3.25 per cent requirement and the entirety of any buffers that may apply must be met by CET1 capital.

The leverage ratio framework does not currently give rise to higher capital requirements for the Group than the risk-based capital framework.

MITIGATION

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, uses its capital resources efficiently and continues to comply with regulatory requirements.

The Group is able to accumulate additional capital through the retention of profits over time, which can be enhanced through cutting costs and reducing or cancelling dividend payments, by raising new equity via, for example, a rights issue or debt exchange and by raising additional tier 1 or tier 2 capital through issuing tier 1 instruments or subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals.

Additional measures to manage the Group’s capital position include seeking to optimise the generation of capital demand within the Group’s businesses to strike an appropriate balance of capital held within the Group’s Insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

MONITORING

Capital is actively managed and monitoring capital ratios is a key factor in the Group’s planning processes and stress analyses. Multi-year forecasts of the Group’s capital position, based upon the Group’s operating plan, are produced at least annually to inform the Group’s capital plan whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group’s actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a recovery plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

Regular reporting of actual and projected ratios, including those in stressed scenarios, is undertaken, including submissions to the Group Capital Risk Committee (GCRC), Group Financial Risk Committee (GFRC), Group Asset and Liability Committee (GALCO), Group Risk Committee (GRC), Board Risk Committee (BRC) and the Board. Capital policies and procedures are subject to independent oversight.

The regulatory framework within which the Group operates continues to evolve and further detail on this will be provided in the Group’s Pillar 3 report. The Group continues to monitor these developments very closely, analysing the potential capital impacts to ensure that, through organic capital generation, the Group continues to maintain a strong capital position that exceeds both minimum regulatory requirements and the Group’s risk appetite and is consistent with market expectations.

Target capital ratios

The Board's view of the level of CET1 capital required is c.13 per cent plus a management buffer of around 1 per cent.

This takes into account, amongst other things:

- the Pillar 2A ICG set by the PRA, reflecting their point in time estimate, which may change over time, of the amount of capital that is needed in relation to risks not covered by Pillar 1. During the year the PRA updated the Group's ICG representing an increase from 4.5 per cent to 5.4 per cent of risk-weighted assets at 31 December 2017, of which 3.0 per cent has to be met by CET1 capital.
- the PRA Buffer, which they set taking into account the results of the PRA stress tests and other information, as well as outputs from the Group's internal stress tests. The PRA requires the PRA Buffer itself to remain confidential between the Group and the PRA.
- future regulatory developments, including the introduction of the Systemic Risk Buffer in early 2019 and the CCyB on UK exposures during the course of 2018.

Dividend policy

The Group intends to maintain an ordinary dividend policy that is both progressive and sustainable. The rate of growth of the ordinary dividend will be decided by the Board in light of the circumstances at the time.

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The Board also gives due consideration to the distribution of surplus capital through the use of special dividends or share buybacks. Surplus capital represents the return of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties. The amount of required capital may vary from time to time depending on circumstances and by its nature there can be no guarantee that any surplus capital distribution will be appropriate in future years.

The ability of the Group to pay a dividend is also subject to constraints including the availability of distributable reserves, legal and regulatory restrictions and the financial and operating performance of the entity.

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2017 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £8.5 billion. Substantially all of the Company's merger reserve is available for distribution under UK company law as a result of transactions undertaken to recapitalise the Company in 2009.

Lloyds Banking Group plc acts as a holding company which also issues capital and other securities to capitalise and fund the activities of the Group. The profitability of the holding company, and consequently its ability to sustain dividend payments, is therefore dependent upon the continued receipt of dividends from its subsidiaries (representing both banking and insurance). A number of Group subsidiaries, principally those with banking and insurance activities, are also subject to regulatory capital requirements. These require entities to maintain minimum amounts of capital related to their size and risk. The principal operating subsidiary is Lloyds Bank plc which, at 31 December 2017, had a consolidated CET1 capital ratio of 15.8 per cent (31 December 2016: 15.1 per cent). The Group actively manages the capital of its subsidiaries, which includes monitoring the regulatory capital ratios for its banking and insurance subsidiaries against approved risk appetite limits. It operates a formal capital management policy which requires all subsidiary entities to remit any surplus capital to their parent companies.

Analysis of capital position

Excluding the capital impact of the acquisition of MBNA on 1 June 2017, the Group generated 2.63 per cent of CET1 capital on an adjusted basis before ordinary dividends and allowing for the share buyback, primarily as a result of:

- Strong underlying capital generation of 2.5 per cent, largely driven by underlying profits (2.2 per cent) and the dividend paid by the Insurance business in February 2018 in relation to 2017 earnings (0.3 per cent);

- A reduction in risk-weighted assets (prior to the impact of the acquisition of MBNA) resulting in an increase of 0.8 per cent, primarily reflecting updates made to both mortgage and unsecured retail IRB models, continued active portfolio management, foreign exchange movements, disposals and capital efficient securitisation activity, partly offset through targeted growth in key customer segments;

- The impact of market and other movements, generating an increase of 0.4 per cent, partially reflecting positive movements in available-for-sale assets and the defined benefit pension schemes;
- Offset by a reduction of (1.1) per cent for conduct provisions.

In addition, the Group utilised the 0.8 per cent of CET1 capital retained at 31 December 2016 to cover the acquisition of MBNA.

Overall the Group's CET1 ratio has strengthened to 15.5 per cent on an adjusted basis before ordinary dividends and the share buyback. After ordinary dividends the Group's CET1 ratio was 14.4 per cent on an adjusted basis. In addition the Board intends to implement a share buyback programme of up to £1 billion, equivalent to up to 1.4 pence per share. The buyback will impact the Group's capital position in 2018 and is expected to reduce CET1 capital by c.50 basis points. Allowing for this at 31 December 2017 the adjusted CET1 ratio would be 13.9 per cent (31 December 2016: 12.9 per cent on an adjusted basis after dividends and adjusting for MBNA).

Prior year comparatives reflect the additional provision of £350 million recorded following the clarification provided by the FCA on 2 March 2017 in relation to the consultation paper dealing with PPI. This resulted in a reduction of the adjusted CET1 ratio at 31 December 2016 by 18 basis points.

The accrual for foreseeable dividends reflects the recommended final ordinary dividend of 2.05 pence per share.

The transitional total capital ratio, after ordinary dividends remained unchanged at 21.2 per cent, largely reflecting amortisation on dated tier 2 instruments and foreign exchange movements on tier 1 and tier 2 instruments, offset by the increase in CET1 capital and the reduction in risk-weighted assets.

Applying the Bank of England's Minimum Requirement for Own Funds and Eligible Liabilities (MREL) policy to current capital requirements, the Group's indicative MREL requirement, excluding regulatory capital buffers, is as follows:

- From 2020, 2 times Pillar 1 plus Pillar 2A, equivalent to 21.4 per cent of risk-weighted assets
- From 2022, 2 times Pillar 1 plus 2 times Pillar 2A, equivalent to 26.8 per cent of risk-weighted assets

The Bank of England will review the calibration of MREL in 2020 before setting final end-state requirements to be met from 2022. This review will take into consideration any changes to the capital framework, including the finalisation of Basel III.

During 2017, the Group issued £8.5 billion (sterling equivalent as at 31 December 2017) of senior unsecured securities from Lloyds Banking Group plc which, while not included in total capital, are eligible to meet MREL. Combined with previous issuances made during 2016 the Group remains comfortably positioned to meet MREL requirements from 2020 and, as at 31 December 2017, had a transitional MREL ratio of 25.7 per cent of risk-weighted assets.

The UK leverage ratio, after ordinary dividends, increased from 5.2 per cent on an adjusted basis to 5.4 per cent on an adjusted basis, largely reflecting the increase in fully loaded tier 1 capital and the underlying reduction in balance sheet assets, net of qualifying central bank claims and deconsolidation adjustments.

An analysis of the Group's capital position as at 31 December 2017 is presented in the following section on both a CRD IV transitional arrangements basis and a CRD IV fully loaded basis.

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The table below summarises the consolidated capital position of the Group. The Group's Pillar 3 Report will provide a comprehensive analysis of the own funds of the Group.

Table 1.29: Capital resources (audited)

	Transitional		Fully loaded	
	At 31 Dec 2017 £m	At 31 Dec 2016 £m	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Common equity tier 1				
Shareholders' equity per balance sheet	43,551	42,670	43,551	42,670
Adjustment to retained earnings for foreseeable dividends	(1,475)	(1,568)	(1,475)	(1,568)
Deconsolidation adjustments[1]	1,301	1,342	1,301	1,342
Adjustment for own credit	109	87	109	87
Cash flow hedging reserve	(1,405)	(2,136)	(1,405)	(2,136)
Other adjustments	(177)	(276)	(177)	(276)
	41,904	40,119	41,904	40,119
less: deductions from common equity tier 1				
Goodwill and other intangible assets	(2,966)	(1,623)	(2,966)	(1,623)
Prudent valuation adjustment	(556)	(630)	(556)	(630)
Excess of expected losses over impairment provisions and value adjustments	(498)	(602)	(498)	(602)
Removal of defined benefit pension surplus	(541)	(267)	(541)	(267)
Securitisation deductions	(191)	(217)	(191)	(217)
Significant investments[1]	(4,250)	(4,317)	(4,250)	(4,317)
Deferred tax assets	(3,255)	(3,564)	(3,255)	(3,564)
Common equity tier 1 capital	29,647	28,899	29,647	28,899
Additional tier 1				
Other equity instruments	5,330	5,320	5,330	5,320
Preference shares and preferred securities[2]	4,503	4,998	–	–
Transitional limit and other adjustments	(1,748)	(1,692)	–	–
	8,085	8,626	5,330	5,320
less: deductions from tier 1				
Significant investments[1]	(1,403)	(1,329)	–	–
Total tier 1 capital	36,329	36,196	34,977	34,219
Tier 2				
Other subordinated liabilities[2]	13,419	14,833	13,419	14,833
Deconsolidation of instruments issued by insurance entities[1]	(1,786)	(1,810)	(1,786)	(1,810)
Adjustments for transitional limit and non-eligible instruments	1,617	1,351	(1,252)	(1,694)
Amortisation and other adjustments	(3,524)	(3,447)	(3,565)	(3,597)
	9,726	10,927	6,816	7,732
Eligible provisions	120	186	120	186
less: deductions from tier 2				

Significant investments[1]	(1,516)	(1,571)	(2,919)	(2,900)
Total capital resources	44,659	45,738	38,994	39,237
Risk-weighted assets	210,919	215,446	210,919	215,446
Common equity tier 1 capital ratio[3]	14.1 %	13.4 %	14.1 %	13.4 %
Tier 1 capital ratio	17.2 %	16.8 %	16.6 %	15.9 %
Total capital ratio	21.2 %	21.2 %	18.5 %	18.2 %

1 For regulatory capital purposes, the Group's Insurance business is deconsolidated and replaced by the amount of the Group's investment in the business. A part of this amount is deducted from capital (shown as 'significant investments' in the table above) and the remaining amount is risk-weighted, forming part of threshold risk-weighted assets.

2 Preference shares, preferred securities and other subordinated liabilities are categorised as subordinated liabilities in the balance sheet.

3 The common equity tier 1 ratio is 14.4 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2018 in relation to its 2017 earnings (31 December 2016: 13.7 per cent on an adjusted basis).

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The key difference between the transitional capital calculation as at 31 December 2017 and the fully loaded equivalent is primarily related to capital securities that previously qualified as tier 1 or tier 2 capital, but that do not fully qualify under CRD IV, which can be included in additional tier 1 (AT1) or tier 2 capital (as applicable) up to specified limits which reduce by 10 per cent per annum until 2022.

The movements in the transitional CET1, AT1, tier 2 and total capital positions in the period are provided below.

Table 1.30: Movements in capital resources

	Common Equity tier 1 £m	Additional Tier 1 £m	Tier 2 £m	Total capital £m
At 31 December 2016	28,899	7,297	9,542	45,738
Profit attributable to ordinary shareholders[1]	2,864	–	–	2,864
Movement in foreseeable dividends[2]	93	–	–	93
Dividends paid out on ordinary shares during the year	(2,284)	–	–	(2,284)
Dividends in respect of 2016 earnings and 2017 interim earnings received from the Insurance business[1]	575	–	–	575
Movement in treasury shares and employee share schemes	3	–	–	3
Pension movements:				
Removal of defined benefit pension surplus	(274)	–	–	(274)
Movement through other comprehensive income	428	–	–	428
Available-for-sale reserve	(74)	–	–	(74)
Prudent valuation adjustment	74	–	–	74
Deferred tax asset	309	–	–	309
Goodwill and other intangible assets	(1,343)	–	–	(1,343)
Excess of expected losses over impairment provisions and value adjustments	104	–	–	104
Significant investments	67	(74)	55	48
Eligible provisions	–	–	(66)	(66)
Movements in subordinated debt:				
Repurchases, redemptions and other	–	(541)	(1,201)	(1,742)
Other movements	206	–	–	206
At 31 December 2017	29,647	6,682	8,330	44,659

1 Under the regulatory framework, profits made by Insurance are removed from CET1 capital. However, when dividends are paid to the Group by Insurance these are recognised through CET1 capital.

2 Includes the accrual for the 2017 full year ordinary dividend and the reversal of the accrual for the 2016 full year ordinary and special dividends which were paid during the year.

CET1 capital resources have increased by £748 million in the year, primarily reflecting a combination of profit generation, dividends received from the Insurance business during the year, movements in the defined benefit pension schemes and a reduction in the deferred tax asset deducted from capital, partially offset by the payment of the 2017 interim dividend, the accrual of the full year ordinary dividend and an increase in the deduction for goodwill and other intangible assets, largely in relation to the acquisition of MBNA.

AT1 capital resources have reduced by £615 million in the year, primarily reflecting the annual reduction in the transitional limit applied to grandfathered AT1 capital instruments and foreign exchange movements.

Tier 2 capital resources have reduced by £1,212 million in the year largely reflecting the amortisation of dated tier 2 instruments and foreign exchange movements on subordinated debt, partly offset by the transitioning of grandfathered AT1 instruments to tier 2.

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Table 1.31: Risk-weighted assets

	At 31 Dec 2017 £m	At 31 Dec 2016 £m
Foundation Internal Ratings Based (IRB) Approach	60,207	64,907
Retail IRB Approach	61,588	64,970
Other IRB Approach	17,191	17,788
IRB Approach	138,986	147,665
Standardised (STA) Approach	25,503	18,956
Credit risk	164,489	166,621
Counterparty credit risk	6,055	8,419
Contributions to the default fund of a central counterparty	428	340
Credit valuation adjustment risk	1,402	864
Operational risk	25,326	25,292
Market risk	3,051	3,147
Underlying risk-weighted assets	200,751	204,683
Threshold risk-weighted assets[1]	10,168	10,763
Total risk-weighted assets	210,919	215,446

1 Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital. Significant investments primarily arise from investment in the Group's Insurance business.

Table 1.32: Risk-weighted assets movement by key driver

	Credit risk IRB £m	**Credit risk STA £m**	**Credit risk[1] £m**	**Counterparty credit risk[2] £m**	**Market risk £m**	**Operational risk £m**	**Total £m**
Total risk-weighted assets as at 31 December 2016							215,446
Less total threshold risk-weighted assets[3]							(10,763)
Risk-weighted assets as at 31 December 2016	147,665	18,956	166,621	9,623	3,147	25,292	204,683
Asset size	(2,465)	100	(2,365)	(403)	–	–	(2,768)
Asset quality	322	(112)	210	(222)	–	–	(12)
Model updates	(4,399)	–	(4,399)	–	349	–	(4,050)
Methodology and policy	(789)	434	(355)	(431)	–	–	(786)

Acquisitions and disposals	(606)	6,237	5,631	(26)	–	930	6,535
Movements in risk levels (market risk only)	–	–	–	–	(445)	–	(445)
Foreign exchange	(742)	(112)	(854)	(656)	–	–	(1,510)
Other	–	–	–	–	–	(896)	(896)
Risk-weighted assets as at 31 December 2017	138,986	25,503	164,489	7,885	3,051	25,326	200,751
Threshold risk-weighted assets[3]							10,168
Total risk-weighted assets as at 31 December 2017							210,919

1 Credit risk includes securitisation risk-weighted assets.

2 Counterparty credit risk includes movements in contributions to the default fund of central counterparties and movements in credit valuation adjustment risk.

3 Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital. Significant investments primarily arise from investment in the Group's Insurance business.

The risk-weighted assets movement tables provide analyses of the movement in risk-weighted assets in the period by risk type and an insight into the key drivers of the movements. The key driver analysis is compiled on a monthly basis through the identification and categorisation of risk-weighted asset movements and is subject to management judgment.

Credit risk-weighted assets reductions of £2.1 billion were driven by the following key movements:

– Asset size saw a reduction of £2.4 billion due to continued active portfolio management, partly offset by targeted growth in key customer segments.

– Model update reductions of £4.4 billion were mainly due to PRA approved model changes within the mortgage and unsecured retail portfolios.

– Methodology and policy reductions of £0.4 billion were principally the result of further capital efficient securitisation activity.

– Acquisitions and disposals increased by £5.6 billion and were primarily driven by the acquisition of MBNA, partly offset by the disposal of the Group's interest in a strategic equity investment.

– Sterling foreign exchange movements, principally with the Euro and US Dollar, contributed to an overall reduction in credit risk-weighted assets of £0.9 billion.

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Counterparty credit risk and CVA risk-weighted assets reductions of £1.7 billion were mainly driven by foreign exchange movements, reductions in position levels, updates to the calculation methodology following clarification of the regulatory approach and other movements.

Market risk, risk-weighted assets reduced by £0.1 billion largely due to a decrease in interest rate risk exposure, offset by an increase in the VaR multiplier, an increase in exposure to corporate bonds and refinements to internal models.

Operational risk, risk-weighted assets are broadly in line with the prior year, with the increase following the acquisition of MBNA mostly offset by the annual update of the income based Standardised Approach operational risk calculation.

Stress testing

The Group undertakes a wide ranging programme of stress testing providing a comprehensive view of the potential impacts arising from the risks to which the Group is exposed. One of the most important uses of stress testing is to assess the resilience of the operational and strategic plans of the Group to adverse economic conditions and other key vulnerabilities. As part of this programme, and in line with previous years, the Group conducted macroeconomic stress tests of the operating plan.

The concurrent UK stress test run by the Bank of England was also undertaken in 2017. As announced in November, despite the severity of the stress scenario, the Group exceeded the capital and leverage thresholds set out for the purpose of the stress test and was not required to take any capital action as a result.

Leverage ratio

The table below summarises the component parts of the Group’s leverage ratio. Further analysis will be provided in the Group’s Pillar 3 Report.

Table 1.33: Leverage ratio

	Fully loaded	
	At 31 Dec 2017	At 31 Dec 2016

Leverage ratio	£m	£m
Total tier 1 capital for leverage ratio		
Common equity tier 1 capital	29,647	28,899
Additional tier 1 capital	5,330	5,320
Total tier 1 capital	34,977	34,219
Exposure measure		
Statutory balance sheet assets		
Derivative financial instruments	25,834	36,138
Securities financing transactions	49,193	42,285
Loans and advances and other assets	737,082	739,370
Total assets	812,109	817,793
Qualifying central bank claims	(53,842)	(41,510)
Deconsolidation adjustments[1]		
Derivative financial instruments	(2,043)	(2,403)
Securities financing transactions	(85)	112
Loans and advances and other assets	(140,387)	(142,990)
Total deconsolidation adjustments	(142,515)	(145,281)
Derivatives adjustments		
Adjustments for regulatory netting	(13,031)	(20,490)
Adjustments for cash collateral	(7,380)	(8,432)
Net written credit protection	881	699
Regulatory potential future exposure	12,335	13,188
Total derivatives adjustments	(7,195)	(15,035)
Securities financing transactions adjustments	(2,022)	39
Off-balance sheet items	58,357	58,685
Regulatory deductions and other adjustments	(7,658)	(9,128)
Total exposure measure[2]	657,234	665,563
Average exposure measure[4]	660,557	
UK Leverage ratio[2,3,6]	5.3%	5.1%
Average UK leverage ratio[4]	5.4%	
CRD IV exposure measure[5]	711,076	707,073
CRD IV leverage ratio[5]	4.9%	4.8%

1 Deconsolidation adjustments relate to the deconsolidation of certain Group entities that fall outside the scope of the Group's regulatory capital consolidation, being primarily the Group's Insurance business.

2 Calculated in accordance with the UK Leverage Ratio Framework which requires qualifying central bank claims to be excluded from the leverage exposure measure.

3 The countercyclical leverage ratio buffer is currently nil.

4 The average UK leverage ratio is based on the average of the month end tier 1 capital and exposure measures over the quarter (1 October 2017 to 31 December 2017). The average of 5.4 per cent compares to 5.4 per cent at the start and 5.3 per cent at the end of the quarter.

5 Calculated in accordance with CRD IV rules which include central bank claims within the leverage exposure measure.

6 The UK leverage ratio is 5.4 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2018 in relation to its 2017 earnings (31 December 2016: 5.2 per cent on an adjusted basis).

Key movements

The Group's fully loaded UK leverage ratio increased by 0.2 per cent to 5.3 per cent reflecting the impact of both the increase in tier 1 capital and the £8.3 billion reduction in the exposure measure, the latter largely reflecting the underlying reduction in balance sheet assets (net of qualifying central bank claims and deconsolidation adjustments) driven by the reductions in both available-for-sale financial assets and derivatives assets, partially offset by the increase in loans and advances following the acquisition of MBNA and an increase in securities financing transactions (SFT) activity.

The derivatives exposure measure, representing derivative financial instruments per the balance sheet net of deconsolidation and derivatives adjustments, reduced by £2.1 billion during the year, primarily driven by market movements and a reduction in position levels.

The £4.7 billion increase in the SFT exposure measure during the year, representing SFT assets per the balance sheet net of deconsolidation and other SFT adjustments, reflected an increase in customer volumes, partially offset by reduced trading volumes and an increase in eligible netting adjustments.

Off-balance sheet items reduced by £0.3 billion during the year, primarily reflecting a net reduction in securitisation financing facility commitments together with corporate facility drawdowns, reductions and exits, largely offset by an increase in unconditionally cancellable credit card commitments following the acquisition of MBNA and new residential mortgage offers placed.

The average UK leverage ratio of 5.4 per cent over the quarter reflected a strengthening tier 1 capital position prior to the accrual for the announced full year ordinary dividend and further conduct provisions, and the reduction in underlying balance sheet assets during the quarter, net of qualifying central bank claims.

G-SIB indicators

Although the Group is not currently classified as a Global Systemically Important Bank (G-SIB), by virtue of the Group's leverage exposure measure exceeding €200 billion the Group is required to report G-SIB indicator metrics to the PRA. The Group's indicator metrics used within the 2017 Basel G-SIBs annual exercise will be disclosed in April 2018 and the results are expected to be made available by the Basel Committee later this year.

Insurance businesses

The business transacted by the insurance companies within the Group comprises both life insurance business and General Insurance business. Life insurance business comprises unit-linked business, non-profit business and with-profits business.

Scottish Widows Limited (SW Ltd) holds the only with-profit funds managed by the Group. Each insurance company within the Group is regulated by the PRA.

The Solvency II regime for insurers and insurance groups came into force from 1 January 2016. The insurance businesses are required to calculate solvency capital requirements and available capital on a risk-based approach. The Insurance business of the Group calculates regulatory capital on the basis of an internal model, which was approved by the PRA on 5 December 2015.

The minimum required capital must be maintained at all times throughout the year. These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met.

All minimum regulatory requirements of the insurance companies have been met during the year.

FUNDING AND LIQUIDITY RISK

DEFINITION

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding. Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due.

EXPOSURE

Liquidity exposure represents the potential stressed outflows in any future period less expected inflows. The Group considers liquidity from both an internal and a regulatory perspective.

MEASUREMENT

Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturities with behavioural overlays as appropriate. Note 51 on page F-78 sets out an analysis of assets and liabilities by relevant maturity grouping. Additionally the Group undertakes quantitative and qualitative analysis of behavioural aspects of its assets and liabilities in order to reflect their expected behaviour.

MITIGATION

Group Corporate Treasury (GCT) is responsible for managing and monitoring liquidity risks on behalf of the Group and ensuring that liquidity risk management systems and arrangements are adequate with regard to the internal risk appetite and Group strategy. Liquidity policies and procedures are subject to independent internal oversight by Risk. Overseas branches and subsidiaries of the Group may also be required to meet the liquidity requirements of the entity's domestic country. Management of liquidity requirements is performed by the overseas branch or subsidiary and overseen by GCT. Liquidity risk of the Insurance business is actively managed and monitored within the Insurance business. The Group plans funding requirements over the life of the funding plan, combining business as usual and stressed conditions. The Group manages its risk appetite and liquidity position with regard to its internal risk appetite and the Liquidity Coverage Ratio (LCR) required by the PRA and Capital Requirements Directive and Regulation (CRD IV) liquidity requirements.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships across customer segments. The Group has consistently observed that in aggregate the retail deposit base provides a stable source of funding. Funding concentration by counterparty, currency and tenor is monitored on an ongoing basis and where concentrations do exist, these are managed as part of the planning process and limited by internal risk appetite, with analysis regularly provided to senior management.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

To assist in managing the balance sheet the Group operates a Liquidity Transfer Pricing (LTP) process which: allocates relevant interest expenses from the centre to the Group's banking businesses within the internal management accounts; helps drive the correct inputs to customer pricing; and is consistent with regulatory requirements. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits, modelled on historic data.

The Group can monetise liquid assets quickly, either through the repurchase agreements (repo) market or through outright sale. In addition, the Group has pre-positioned a substantial amount of assets at the Bank of England's Discount Window Facility which can be used to access additional liquidity in a time of stress. The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of liquid assets. The liquid asset buffer is managed under the control of Group Corporate Treasury and is available for deployment at immediate notice, subject to complying with regulatory requirements.

Liquidity risk within the Insurance business may result from: the inability to sell financial assets quickly at their fair values; an insurance liability falling due for payment earlier than expected; the inability to generate cash inflows as anticipated; an unexpected large operational event; or from a general insurance catastrophe e.g. a significant weather event. Following the implementation of Solvency II, the annuity portfolio is ring-fenced and assets held to match annuity liability cashflows are excluded from shareholder liquidity. In the event a liquidity shortfall arises on the annuity portfolio, shareholder liquidity will be required to support this. As a result, the shareholder's exposure to liquidity risk is through Insurance's non-annuity and surplus assets, any shortfall arising in the annuity portfolio and the investment portfolios within the general Insurance business. Liquidity risk is actively managed and monitored within the Insurance business to ensure that, even under stress conditions, there is sufficient liquidity to meet obligations and remain within approved risk appetite.

MONITORING

Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. This captures regulatory metrics as well as metrics the Group considers relevant for its liquidity profile. These are a mixture of quantitative and qualitative measures, including: daily variation of customer balances; changes in maturity profiles; cash outflows; funding concentration; changes in LCR eligible liquidity portfolio; credit default swap (CDS) spreads; and changing funding costs.

The Group carries out internal stress testing of its liquidity and potential cash flow mismatch position over both short (up to one month) and longer term horizons against a range of scenarios forming an important part of the internal risk appetite. The scenarios and assumptions are reviewed at least annually to ensure that they continue to be relevant to the nature of the business including reflecting emerging horizon risks to the Group, such as the UK exit from the EU.

For further information on the Group's 2017 liquidity stress testing results refer to page 98.

The Group maintains a Contingency Funding Plan which is designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency Funding Plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators; prudential and regulatory liquidity risk limits and triggers; stress testing results; event and systemic indicators; and market intelligence.

Funding and liquidity management in 2017

The Group has maintained its strong funding and liquidity position with a loan to deposit ratio of 110 per cent at 31 December 2017 (109 per cent as at 31 December 2016).

During 2017, the Group drew down a further £15.4 billion under the Bank of England's Term Funding Scheme (TFS), now fully utilised at £20 billion as at 31 December 2017. The amount outstanding under the Bank of England's Funding for Lending Scheme (FLS) is £25.1 billion as at 31 December 2017 (£30.1 billion as at 31 December 2016).

As a result, wholesale funding has decreased by £9.7 billion to £101.1 billion as at 31 December 2017, with the amount maturing in less than one year falling to £28.5 billion as at 31 December 2017 (£35.1 billion as at 31 December 2016). In 2017, the Group issued term funding of £10.2 billion and following the full utilisation of the TFS, would expect term issuance volumes in 2018 to return to a steady-state requirement of between £15 billion and £20 billion per annum.

The Group's strong balance sheet and funding and liquidity position has been reflected in positive movements in the Group's credit ratings in 2017. During the second half of the year, Moody's upgraded Lloyds Bank plc's long-term rating by one notch to 'Aa3'. In addition, S&P improved Lloyds Bank plc's outlook to 'positive' to reflect the Group's improved bail-in capital position following recent Lloyds Banking Group plc issuance.

The Group's liquidity surplus continues to exceed the regulatory minimum and internal risk appetite, with a Liquidity Coverage Ratio of 127 per cent as at 31 December 2017 based on the EU Delegated Act.

Table 1.34: Summary funding and liquidity metrics

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	Change (%)
LCR eligible assets	**120.9**	120.8	–
Loan to deposit ratio (%)	**109.7**	108.9	1
LCR eligible liquid assets/money market funding less than one year maturity (x)[1]	**8.3**	8.8	(6)

1 Excludes balances relating to margins of £2.1 billion (31 December 2016: £3.2 billion) and settlement accounts of £1.5 billion (31 December 2016: £1.8 billion).

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Table 1.35: Group funding position

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	*Change %*
Funding requirement			
Loans and advances to customers[1]	455.7	449.7	1
Loans and advances to banks[2]	4.1	5.1	(20)
Debt securities	3.6	3.4	6
Reverse repurchase agreements	0.7	0.5	40
Available-for-sale financial assets – non-LCR eligible[3]	0.9	1.9	(53)
Cash and balances at central bank – non-LCR eligible[4]	4.8	4.8	–
Funded assets	469.8	465.4	1
Other assets[5]	234.7	249.9	(6)
	704.5	715.3	(2)
On balance sheet LCR eligible liquid assets			
Reverse repurchase agreements	16.9	8.7	94
Cash and balances at central banks[4]	53.7	42.7	26
Available-for-sale financial assets	41.2	54.6	(25)
Trading and fair value through profit and loss	1.7	1.8	(6)
Repurchase agreements	(5.9)	(5.3)	11
	107.6	102.5	5
Total Group assets	812.1	817.8	(1)
Less: other liabilities[5]	(226.5)	(240.7)	(6)
Funding requirement	585.6	577.1	1
Funded by			
Customer deposits	415.5	413.0	1
Wholesale funding[6]	101.1	110.8	(9)
	516.6	523.8	(1)
Term funding scheme	19.9	4.5	
Total equity	49.1	48.8	1
Total funding	585.6	577.1	1

1 Excludes £16.8 billion (31 December 2016: £8.3 billion) of reverse repurchase agreements.

2 Excludes £1.7 billion (31 December 2016: £20.9 billion) of loans and advances to banks within the Insurance business and £0.8 billion (31 December 2016: £0.9 billion) of reverse repurchase agreements.

3 Non-LCR eligible liquid assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

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

5

Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

6 The Group's definition of wholesale funding aligns with that used by other international market participants, including interbank deposits, debt securities in issue and subordinated liabilities.

Table 1.36: Reconciliation of Group funding to the balance sheet (audited)

	At 31 December 2017				At 31 December 2016			
	Included in funding analysis £bn	**Repos and cash collateral received by Insurance £bn**	**Fair value and other accounting methods £bn**	**Balance sheet £bn**	Included in funding analysis £bn	Repos and cash collateral received by Insurance £bn	Fair value and other accounting methods £bn	Balance sheet £bn
Deposits from banks	**5.1**	**24.1**	**0.6**	**29.8**	8.1	8.0	0.3	16.4
Debt securities in issue	**78.1**	**–**	**(5.6)**	**72.5**	83.0	–	(6.7)	76.3
Subordinated liabilities	**17.9**	**–**	**–**	**17.9**	19.7	–	0.1	19.8
Total wholesale funding	**101.1**	**24.1**			110.8	8.0		
Customer deposits	**415.5**	**2.6**	**–**	**418.1**	413.0	2.5	–	415.5
Total	**516.6**	**26.7**			523.8	10.5		

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Table 1.37: Analysis of 2017 total wholesale funding by residual maturity

	Less than one month £bn	One to three months £bn	Three to six months £bn	Six to nine months £bn	Nine months to one year £bn	One to two years £bn	Two to five years £bn	More than five years £bn	Total at 31 Dec 2017 £bn	Total at 31 Dec 2016 £bn
Deposit from banks	3.7	1.0	0.3	0.1	–	–	–	–	5.1	8.1
Debt securities in issue:										
Certificates of deposit	1.3	2.1	3.2	2.5	0.9	–	–	–	10.0	7.5
Commercial paper	0.4	2.8	–	–	–	–	–	–	3.2	3.2
Medium-term notes[1]	0.7	0.6	0.5	0.9	2.3	3.0	12.1	17.3	37.4	36.9
Covered bonds	1.5	–	0.7	0.1	–	2.8	12.3	7.3	24.7	29.1
Securitisation	–	0.4	–	0.1	0.1	0.6	1.3	0.3	2.8	6.3
	3.9	5.9	4.4	3.6	3.3	6.4	25.7	24.9	78.1	83.0
Subordinated liabilities	–	0.2	1.5	–	0.6	0.5	3.2	11.9	17.9	19.7
Total wholesale funding[2]	7.6	7.1	6.2	3.7	3.9	6.9	28.9	36.8	101.1	110.8
Of which issued by Lloyds Banking Group plc[3]	–	–	–	–	–	–	4.4	11.0	15.4	7.4

1 Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2016: £1.4 billion), which matured during 2017.

2 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

3 Consists of medium-term notes only.

Table 1.38: Total wholesale funding by currency (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2017	25.8	32.1	37.0	6.2	101.1
At 31 December 2016	30.6	33.0	41.4	5.8	110.8

Table 1.39: Analysis of 2017 term issuance (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	–	–	–	–	–
Medium-term notes	1.0	5.2	1.6	1.0	8.8
Covered bonds	1.0	–	–	–	1.0
Private placements[1]	0.1	0.3	–	–	0.4
Subordinated liabilities	–	–	–	–	–
Total issuance	2.1	5.5	1.6	1.0	10.2
Of which issued by Lloyds Banking Group plc[2]	1.0	5.2	1.6	1.0	8.8

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

2 Consists of medium-term notes only.

The Group continues to maintain a diversified approach to funding markets with trades in public and private format, secured and unsecured products and a wide range of currencies and markets. For 2018, the Group will continue to maintain this diversified approach to funding, including capital and funding from the holding company, Lloyds Banking Group plc, as needed to transition towards final UK Minimum Requirements for Own Funds and Eligible Liabilities (MREL). The contractual maturities for the FLS and TFS are fully factored into the Group's funding plan.

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Liquidity portfolio

At 31 December 2017, the banking business had £120.9 billion of highly liquid unencumbered LCR eligible assets (31 December 2016: £120.8 billion), of which £120.2 billion is LCR level 1 eligible (31 December 2016: £120.3 billion) and £0.7 billion is LCR level 2 eligible (31 December 2016: £0.5 billion). These assets are available to meet cash and collateral outflows and PRA regulatory requirements. A separate liquidity portfolio to mitigate any insurance liquidity risk is managed within the Insurance business. LCR eligible liquid assets represent over eight times the Group's money market funding less than one year to maturity (excluding derivative collateral margins and settlement accounts) and exceed total wholesale funding, and thus provide a substantial buffer in the event of market dislocation. As previously communicated, given the economic climate, the Group does not expect to hold gilts to maturity. The Group has therefore continued to reduce the size of its gilts portfolio owned outright.

Table 1.40: LCR eligible assets

	At 31 Dec 2017 £bn	At 31 Dec 2016 £bn	*Change %*	**Unweighted average 2017 £bn**	Unweighted average 2016 £bn
Level 1					
Cash and central bank reserves	53.7	42.7	26	51.0	53.7
High quality government/MDB/agency bonds[1]	65.8	75.3	(13)	72.0	72.4
High quality covered bonds	0.7	2.3	(70)	1.1	2.4
Total	120.2	120.3	–	124.1	128.5
Level 2[2]	0.7	0.5	40	0.6	0.5
Total LCR eligible assets	120.9	120.8	–	124.7	129.0

1 Designated multilateral development bank (MDB).

2 Includes Level 2A and Level 2B.

Table 1.41: LCR eligible assets by currency

	Sterling £bn	**US Dollar £bn**	**Euro £bn**	**Other currencies £bn**	**Total £bn**
At 31 December 2017					
Level 1	90.8	16.3	13.1	–	120.2
Level 2	0.2	0.5	–	–	0.7
Total	91.0	16.8	13.1	–	120.9

At 31 December 2016					
Level 1	96.0	12.5	11.8	–	120.3
Level 2	0.2	0.3	–	–	0.5
Total	96.2	12.8	11.8	–	120.8

The banking business also has a significant amount of non-LCR eligible assets which are eligible for use in a range of central bank or similar facilities. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

Stress testing results

Internal stress testing results at 31 December 2017 showed that the banking business had liquidity resources representing 142 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intraday requirements and rating dependent contracts under the Group's most severe liquidity stress scenario.

A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade implemented instantaneously by all major rating agencies, could result in a contractual outflow of £1.1 billion of cash over a period of up to one year, £2.0 billion of collateral posting related to customer financial contracts and £5.9 billion of collateral posting associated with secured funding.

Encumbered assets

This disclosure provides further detail on the availability of assets that could be used to support potential future funding requirements of the Group. The disclosure is not designed to identify assets that would be available in the event of a resolution or bankruptcy.

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The Board and the Group Asset and Liability Committee (GALCO) monitor and manage total balance sheet encumbrance via a number of risk appetite metrics. At 31 December 2017, the Group had £64.6 billion (31 December 2016: £83.5 billion) of externally encumbered on balance sheet assets with counterparties other than central banks. The decrease in encumbered assets was primarily driven by maturities of covered bond and securitisation issuances. The Group also had £587.5 billion (31 December 2016: £580.9 billion) of unencumbered on balance sheet assets, and £160.1 billion (31 December 2016: £153.5 billion) of pre-positioned and encumbered assets held with central banks. Primarily the Group encumbers mortgages, unsecured lending and credit card receivables through the issuance programmes and tradable securities through securities financing activity. The Group mainly positions mortgage assets at central banks.

Table 1.42: On balance sheet encumbered and unencumbered assets

	Encumbered with counterparties other than central banks				Pre-positioned and encumbered assets held with central banks £m	**Unencumbered assets not pre-positioned with central banks**				
	Securitisations £m	Covered bond £m	Other £m	Total £m		Readily realisable[1] £m	**Other realisable assets[2] £m**	**Cannot be used[3] £m**	Total £m	Total £m
At 31 December 2017										
Cash and balances at central banks	–	–	–	–	–	53,887	–	4,634	58,521	58,521
Trading and other financial assets at fair value through profit or loss	–	–	4,642	4,642	–	7,378	–	150,858	158,236	162,878
Derivative financial instruments	–	–	–	–	–	–	–	25,834	25,834	25,834
Loans and receivables:										
Loans and advances to banks	–	–	–	–	–	213	1,417	4,981	6,611	6,611
Loans and advances to customers	5,023	26,414	6,610	38,047	160,060	13,927	170,771	89,693	274,391	472,498
Debt securities	–	–	2,374	2,374	–	919	4	346	1,269	3,643
	5,023	26,414	8,984	40,421	160,060	15,059	172,192	95,020	282,271	482,752
	–	–	19,526	19,526	–	21,514	–	1,058	22,572	42,098

Available-for-sale financial assets										
Other[4]	–	–	–	–	–	16	1,175	38,835	40,026	40,026
Total assets	5,023	26,414	33,152	64,589	160,060	97,854	173,367	316,239	587,460	812,109
At 31 December 2016										
Cash and balances at central banks	–	–	–	–	–	42,998	–	4,454	47,452	47,452
Trading and other financial assets at fair value through profit or loss	–	–	4,806	4,806	–	9,175	22	137,171	146,368	151,174
Derivative financial instruments	–	–	–	–	–	–	–	36,138	36,138	36,138
Loans and receivables:										
Loans and advances to banks	–	–	32	32	–	528	1,825	24,517	26,870	26,902
Loans and advances to customers	14,542	30,883	7,305	52,730	153,482	7,032	152,997	91,717	251,746	457,958
Debt securities	–	–	904	904	–	2,344	5	144	2,493	3,397
	14,542	30,883	8,241	53,666	153,482	9,904	154,827	116,378	281,109	488,257
Available-for-sale financial assets	154	–	24,824	24,978	–	31,017	31	498	31,546	56,524
Other[4]	–	–	–	–	–	34	1,737	36,477	38,248	38,248
Total assets	14,696	30,883	37,871	83,450	153,482	93,128	156,617	331,116	580,861	817,793

1 Assets regarded by the Group to be readily realisable in the normal course of business, to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, and are not subject to any restrictions on their use for these purposes.

2 Assets where there are no restrictions on their use to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, but are not readily realisable in the normal course of business in their current form.

3 The following assets are classified as unencumbered – cannot be used: assets held within the Group's Insurance businesses which are generally held to either back liabilities to policyholders or to support the solvency of the Insurance subsidiaries; assets held within consolidated limited liability partnerships which provide security for the Group's obligations to its pension schemes; assets pledged to facilitate the use of intra-day payment and settlement systems; and reverse repos and derivatives balance sheet ledger items.

4 Other comprises: items in the course of collection from banks; investment properties; goodwill; value in-force business; other intangible assets; tangible fixed assets; current tax recoverable; deferred tax assets; retirement benefit assets; and other assets.

The above table sets out the carrying value of the Group's encumbered and unencumbered assets, separately identifying those that are available to support the Group's funding needs. The table does not include collateral received by the Group (i.e. from reverse repos) that is not recognised on its balance sheet, the vast majority of which the Group is permitted to repledge.

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CONTRACTUAL CASH OBLIGATIONS

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2017.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Long-term debt – dated	1,647	2,993	792	7,422	12,854
Debt securities in issue	21,071	17,118	15,709	26,364	80,262
Finance leases	3	4	–	12	19
Operating leases	275	378	467	934	2,054
Capital commitments	444	–	–	–	444
Other purchase obligations	1,195	1,778	1,071	707	4,751
	24,635	22,271	18,039	35,439	100,384

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 £750 million to these schemes in 2018.

At 31 December 2017, Lloyds Banking Group also had £5,068 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2017, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds Bank to pay dividends going forward, or for Lloyds Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

OFF-BALANCE SHEET ARRANGEMENTS

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2017 is included in note 51 to the financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £5,820 million at 31 December 2017 (with £3,132 million expiring within one year; £627 million between one and three years; £1,471 million between three and five years; and £590 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 2017, 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 18 and 19 to the financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

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.

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GOVERNANCE RISK

DEFINITION

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

EXPOSURES

The internal and corporate governance arrangements of major financial institutions continue to be subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation, both within the UK and across the multiple jurisdictions within which it operates, with which it must comply. Risk governance and risk culture are mutually reinforcing.

MEASUREMENT

The Group's governance arrangements are assessed against new or proposed legislation and regulation and best practice among peer organisations in order to identify any areas of enhancement required.

MITIGATION

The Group's Risk Management Framework (RMF) establishes robust arrangements for risk governance, in particular by:

- Defining individual and collective accountabilities for risk management, risk oversight and risk assurance through a three lines of defence model which supports the discharge of responsibilities to customers, shareholders and regulators;

– Outlining governance arrangements which articulate the enterprise-wide approach to risk management; and

– Supporting a consistent approach to Group-wide behaviour and risk decision making through a Group policy framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, standards, boundaries and risk appetite measures which can be controlled, enforced and monitored.

Under the banner of the RMF, training modules are in place to support all colleagues in understanding and fulfilling their risk responsibilities.

The Ethics and Responsible Business Policy and supporting code of responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the code in all aspects of their roles.

Effective implementation of the RMF mutually reinforces and is reinforced by the Group's risk culture, which is embedded in its approach to recruitment, selection, training, performance management and reward.

MONITORING

A review of the Group's RMF, which includes the status of the Group's principles and policy framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings are reported to the Group Risk Committee, Board Risk Committee and the Board.

This includes a review of the Group's current approach to governance and ongoing initiatives in light of the latest regulatory guidance, including in 2017 the continued enhancement of frameworks to address Senior Managers and Certification Regime (SM&CR) requirements and prepare for the requirement to ring-fence retail banking activities with effect from January 2019.

For further information on Corporate Governance see pages 138–164.

MARKET RISK

DEFINITION

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

Balance sheet linkages

The information provided in table 1.43 aims to facilitate the understanding of linkages between banking, trading, and insurance balance sheet items and the positions disclosed in the Group's market risk disclosures.

Table 1.43: Market risk linkage to the balance sheet

	Total	**Banking Trading book only**	**Non-trading**	**Insurance**	
2017	**£m**	**£m**	**£m**	**£m**	**Primary market risk factor**
Assets					
Cash and balances at central banks	**58,521**	**–**	**58,521**	**–**	Interest rate
Trading and other financial assets at fair value through profit or loss	**162,878**	**42,230**	**3,325**	**117,323**	Interest rate, foreign exchange, credit spread
Derivative financial instruments	**25,834**	**21,605**	**1,881**	**2,348**	Interest rate, foreign exchange, credit spread
Loans and receivables					
Loans and advances to banks	**6,611**	**–**	**4,274**	**2,337**	Interest rate
Loans and advances to customers[1]	**472,498**	**–**	**472,498**	**–**	Interest rate
Debt securities	**3,643**	**–**	**3,643**	**–**	Interest rate, credit spread
	482,752	**–**	**480,415**	**2,337**	
Available-for-sale financial assets	**42,098**	**–**	**42,098**	**–**	Interest rate, foreign exchange, credit spread
Value of in-force business	**4,839**	**–**	**–**	**4,839**	Equity
Other assets	**35,187**	**–**	**18,303**	**16,884**	Interest rate
Total assets	**812,109**	**63,835**	**604,543**	**143,731**	
Liabilities					
Deposit from banks	**29,804**	**–**	**29,804**	**–**	Interest rate
Customer deposits	**418,124**	**–**	**418,124**	**–**	Interest rate

Trading and other financial liabilities at fair value through profit or loss	**50,877**	**43,062**	**7,815**	**–**	Interest rate, foreign exchange
Derivative financial instruments	**26,124**	**21,699**	**1,613**	**2,812**	Interest rate, foreign exchange, credit spread
Debt securities in issue	**72,450**	**–**	**72,450**	**–**	Interest rate, credit spread
Liabilities arising from insurance and investment contracts	**118,860**	**–**	**–**	**118,860**	Credit spread
Subordinated liabilities	**17,922**	**–**	**16,131**	**1,791**	Interest rate, foreign exchange
Other liabilities	**28,805**	**–**	**8,345**	**20,460**	Interest rate
Total liabilities	**762,966**	**64,761**	**554,282**	**143,923**	

1 Includes £6.9 billion of lower risk loans within the banking book sold by Commercial Banking and Retail to Insurance to manage market risk arising from annuitant liabilities within the Insurance business.

The defined benefit pension schemes' assets and liabilities are included under Other assets and Other liabilities in this table and note 35 on page F-44 provides further information.

The Group's trading book assets and liabilities are originated by Commercial Banking (CB) Markets within the Commercial Banking division. Within the Group's balance sheet these fall under the trading assets and liabilities and derivative financial instruments. The assets and liabilities are classified as trading books if they have been acquired or incurred for the purpose of selling or repurchasing in the near future. These consist of government, corporate and financial institution bonds and loans/deposits and repos. Further information on these activities can be found under the Trading portfolios section on page 107.

Derivative assets and liabilities are held by the Group for three main purposes; to provide risk management solutions for clients, to manage portfolio risks arising from client business and to manage and hedge the Group's own risks. The majority of derivatives exposure arises within CB Markets. Insurance business assets and liabilities relate to policyholder funds, as well as shareholder invested assets, including annuity funds. The Group recognises the value of in-force business in respect of Insurance's long-term life assurance contracts as an asset in the balance sheet (see note 24, page F-36).

The Group ensures that it has adequate cash and balances at central banks and stocks of high quality liquid assets (e.g. gilts or US Treasury securities) that can be converted easily into cash to meet liquidity requirements. The majority of these assets are held as available-for-sale with the remainder held as financial assets at fair value through profit and loss. Further information on these balances can be found under Funding and liquidity risk on page 94. Interest rate risk in the asset portfolios is swapped into a floating rate.

The majority of debt issuance originates from the issuance, capital vehicles and medium term notes desks and the interest rate risk of the debt issued is hedged by swapping them into a floating rate.

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The non-trading book primarily consists of customer on balance sheet activities and the Group's capital and funding activities, which expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices, as described in further detail within the Banking activities section below.

Table 1.44 below shows the key material market risks for the Group's banking, defined benefit pension schemes, insurance and trading activities.

Table 1.44: Key material market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)

	Risk Type					
2017	**Interest Rate**	**Basis Risk**	**FX**	**Credit Spread**	**Equity**	**Inflation**
Banking activities[1]		–	–			–
Defined benefit pension schemes[1]		–	–			–
Insurance portfolios[1]		–	–			–
Trading portfolios[2]	–	–	–	–	–	–

Profit before tax	**Loss**	**Gain**
> £500m		
£250m – £500m		
£50m – <£250m		
Immaterial/zero	–	–

1 Banking activities, Pensions and Insurance stresses; Interest rate -100 bps, Basis Risk 3 month London Interbank Offered Rate (LIBOR) +100bps/bank base rate -25bps, Foreign Exchange (FX) -15 per cent GBP, Credit Spread +100 per cent, Equity -30 per cent, Inflation +50 bps

2 Trading Portfolios; Interest rate +30bps, FX +5 per cent GBP, Credit Spread +20 per cent, Inflation +50bps.

MEASUREMENT

In addition to measuring single factors, Group risk appetite is calibrated primarily to five multi-risk Group economic scenarios, and is supplemented with sensitivity based measures. The scenarios assess the impact of unlikely, but plausible adverse stresses on income, with the worst case for banking activities, defined benefit pensions, insurance and trading portfolios reported against independently, and across the Group as a whole.

The Group risk appetite is cascaded first to the Group Asset and Liability Committee (GALCO), chaired by the Chief Financial Officer, where risk appetite is approved and monitored by risk type, and then to Group Market Risk Committee (GMRC) where risk appetite is sub allocated by division. These metrics are reviewed regularly by senior management to inform effective decision making.

MITIGATION

GALCO is responsible for approving and monitoring Group market risks, management techniques, market risk measures, behavioural assumptions, and the market risk policy. Various mitigation activities are assessed and undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits. The mitigation actions will vary dependent on exposure, but will, in general, look to reduce risk in a cost effective manner, by offsetting balance sheet exposures and externalising through to the financial markets dependent on market liquidity. The market risk policy is owned by Group Corporate Treasury (GCT) and refreshed annually. The policy is underpinned by supplementary market risk procedures, which define specific market risk management and oversight requirements.

MONITORING

GALCO and the GMRC regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and Group Market Risk Policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk and where appropriate, escalation procedures are in place.

How market risks arise and are managed across the Group’s activities is considered in more detail below.

Banking activities

Exposures

The Group’s banking activities expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset or liability.

INTEREST RATE RISK

Yield curve risk in the Group's divisional portfolios, and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets, liabilities (see loans and advances to customers and customer deposits in table 1.43) and off balance sheet positions.

Basis risk arises from the possible changes in spreads, for example where the bank lends with reference to a central bank rate but funds with reference to LIBOR, and the spread between these two rates widens or tightens.

Optionality risk arises predominantly from embedded optionality within assets, liabilities or off-balance sheet items where either the Group or the customer can affect the size or timing of cash flows. One example of this risk is pipeline mortgage risk where the customer owns an option on a mortgage rate and changes in market rates can impact the take up of the committed offer. Mortgage prepayment risk is another example where the customer owns an option allowing them to prepay when it is economical to do so. This can result in customer balances amortising more quickly or slowly than anticipated due to economic conditions or customers' response to changes in economic conditions.

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FOREIGN EXCHANGE RISK

Economic foreign exchange exposure arises from the Group's investment in its overseas operations (net investment exposures are disclosed in note 51 on page F-78). In addition, the Group incurs foreign exchange risk through non-functional currency flows from services provided by customer facing divisions and the Group's debt and capital management programmes.

EQUITY RISK

Equity risk arises primarily from three different sources: (i) the Group's strategic equity holdings in Banco Sabadell, Aberdeen Asset Management, and Visa Europe; (ii) exposure to Lloyds Banking Group share price through deferred shares and deferred options granted to employees as part of their benefits package; and (iii) the Group's private equity investments held by Lloyds Development Capital.

CREDIT SPREAD RISK

Credit spread risk arises largely from: (i) the liquid asset portfolio held in the management of Group liquidity, comprising of government, supranational, and other eligible assets; (ii) the Credit Valuation Adjustment (CVA) and Debit Valuation Adjustment (DVA) sensitivity to credit spreads; and (iii) a number of the Group's structured medium term notes where its has elected to fair value the notes through the profit and loss account.

Measurement

Interest rate risk exposure is monitored monthly using, primarily:

(i) Market value sensitivity: this methodology considers all repricing mismatches (behaviourally adjusted where appropriate) in the current balance sheet and calculates the change in market value that would result from an instantaneous 25, 100 and 200 basis points parallel rise or fall in the yield curve (subject to an appropriate floor). The market value sensitivities are calculated on a static balance sheet using principal cash flows excluding commercial margins and other spread components and are therefore discounted at the risk free zero-coupon rate.

(ii) Interest income sensitivity: this measures the 12 month impact on future net interest income arising from various economic scenarios. These include instantaneous 25, 100 and 200 basis point parallel shifts in all yield curves and the five Group economic scenarios (subject to an appropriate floor). These scenarios are reviewed every year and are designed to replicate severe but plausible economic events, capturing risks that would not be evident through the use of parallel shocks alone such as basis risk and steepening or flattening of the yield curve. An additional negative rates scenario is also used for information purposes where all floors are removed; however this is not measured against the limit framework.

Unlike the market value sensitivities, the interest income sensitivities incorporate additional behavioural assumptions as to how and when individual products would reprice in response to changing rates. In addition a dynamic balance sheet is used which includes the run-off of current assets and liabilities and the addition of planned new business.

Reported sensitivities are not necessarily predictive of future performance as they do not capture additional management actions that would likely be taken in response to an immediate, large, movement in interest rates. The actions could reduce the net interest income sensitivity and help mitigate any adverse impacts or they may result in changes to total income that are not captured in the net interest income.

(iii) Market value limit: this caps the amount of conventional and inflation-linked government bonds held by the Group for liquidity purposes.

(iv) Structural hedge limits: these metrics enhance understanding of assumption and duration risk taken within the behaviouralisation of this portfolio.

The Group has an integrated Asset and Liability Management (ALM) system which supports non traded asset and liability management of the Group. This provides a single consolidated tool to measure and manage interest rate repricing profiles (including behavioural assumptions), perform stress testing and produce forecast outputs. The Group is aware that any assumptions based model is open to challenge. A full behavioural review is performed annually, or in response to changing market conditions, to ensure the assumptions remain appropriate and the model itself is subject to annual re-validation, as required under the Group Model Governance Policy. The key behavioural assumptions are: (i) embedded optionality within products; (ii) the duration of balances that are contractually repayable on demand, such as current accounts and overdrafts, together with net free reserves of the Group; and (iii) the re-pricing behaviour of managed rate liabilities namely variable rate savings.

A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group’s risk appetite.

Table 1.45 below shows, split by material currency, the Group's market value sensitivities to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.45: Banking activities: market value sensitivity

	2017				2016			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Sterling	**(9.9)**	**10.1**	**(38.7)**	**22.1**	(11.4)	11.5	(45.1)	31.6
US Dollar	**(3.6)**	**3.7**	**(14.2)**	**15.3**	3.2	(3.2)	12.6	(13.7)
Euro	**2.2**	**(0.7)**	**8.9**	**0.9**	(6.0)	(3.7)	(23.2)	(12.1)
Other	**(0.1)**	**0.2**	**(0.5)**	**0.6**	(0.2)	0.2	(0.9)	0.6
Total	**(11.4)**	**13.3**	**(44.5)**	**38.9**	(14.4)	4.8	(56.6)	6.4

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The market value sensitivity is driven by temporary customer flow positions not yet hedged plus other positions occasionally held, within limits, by the Group's wholesale funding desks in order to minimise overall funding and hedging costs. The level of risk is low relative to the size of the total balance sheet.

Table 1.46 below shows supplementary value sensitivity to a steepening and flattening (c. 100 basis points around the 3 year point) in the yield curve. This ensures there are no unintended consequences to managing risk to parallel shifts in rates.

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Table 1.46: Banking activities: market value sensitivity to a steepening and flattening of the yield curve

	2017		2016	
	Steepener	**Flattener**	Steepener	Flattener
	£m	**£m**	£m	£m
Sterling	**(1.1)**	**(16.5)**	(5.8)	(13.2)
US Dollar	**7.1**	**(8.9)**	0.7	(1.3)
Euro	**(3.8)**	**7.9**	(15.3)	(12.8)
Other	**(0.2)**	**0.2**	(0.2)	0.2
Total	**2.0**	**(17.3)**	(20.6)	(27.1)

The table below shows the banking book income sensitivity to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.47: Banking activities: net interest income sensitivity

	2017				2016			
	Up 25bps	**Down 25bps**	**Up 100bps**	**Down 100bps**	Up 25bps	Down 25bps	Up 100bps	Down 100bps
	£m	**£m**	**£m**	**£m**	£m	£m	£m	£m
Client facing activity and associated hedges	**86.1**	**(54.0)**	**370.5**	**(186.9)**	176.8	(286.1)	724.9	(408.0)

Income sensitivity is measured over a rolling 12 month basis.

The reduction in the net interest income sensitivity reflects the growth in the structural hedge throughout 2017 and the accompanying reduction in income volatility in future years.

Basis risk, foreign exchange, equity, and credit spread risks are measured primarily through scenario analysis by assessing the impact on profit before tax over a 12 month horizon arising from a change in market rates, and reported within the Board risk appetite on a monthly basis. Supplementary measures such as sensitivity and exposure limits are applied where they provide greater insight into risk positions. Frequency of reporting supplementary measures varies from daily to quarterly appropriate to each risk type.

Mitigation

The Group's policy is to optimise reward whilst managing its market risk exposures within the risk appetite defined by the Board. The Group Market Risk Policy and procedures outlines the hedging process, and the centralisation of risk from divisions into GCT, e.g. via the transfer pricing framework. GCT is responsible for managing the centralised risk and does this through natural offsets of matching assets and liabilities, and appropriate hedging activity of the residual exposures, subject to the authorisation and mandate of GALCO within the Board risk appetite. Derivative desks in CB Markets will then externalise the hedges to the market. The Group has hedge accounting solutions in place, which reduce the accounting volatility arising from the Group's economic hedging activities by utilising both LIBOR based and bank base rate assets.

The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates (including current accounts, a portion of variable rate deposits and investable equity), and is managed through the Group's structural hedge. Consistent with the Group's strategy to deliver stable returns, GALCO seeks to minimise large reinvestment risk, and to smooth earnings over a range of investment tenors. The structural hedge consists of longer term fixed rate assets or interest rate swaps and the amount and duration of the hedging activity is reviewed regularly by GALCO.

Whilst the bank faces margin compression in the current low rate environment, its exposure to pipeline and prepayment risk are not considered material, and are hedged in line with expected customer behaviour. These are appropriately monitored and controlled through divisional Asset and Liability Committees (ALCOs).

Net investment foreign exchange exposures are managed centrally by GCT, by hedging non-sterling asset values with currency borrowing. In the first half of 2017, the Group unwound the economic hedges against these positions in order to create additional offset to common equity tier 1 (CET1) movements arising from revaluation of foreign currency risk-weighted assets (see note 51 on page F-78). Economic foreign exchange exposures arising from non-functional currency flows are identified by divisions and transferred and managed centrally. The Group also has a policy of forward hedging its forecasted currency profit and loss to year end.

Monitoring

The appropriate limits and triggers are monitored by senior executive committees within the banking divisions. Banking assets, liabilities and associated hedging are actively monitored and if necessary rebalanced to be within agreed tolerances.

Defined benefit pension schemes

Exposures

The Group’s defined benefit pension schemes are exposed to significant risks from their assets and liabilities. The liability discount rate provides exposure to interest rate risk and credit spread risk, which are partially offset by fixed interest assets (such as gilts and corporate bonds) and swaps. Equity and alternative asset risk arises from direct asset holdings. Scheme membership provides exposure to longevity risk.

For further information on defined benefit pension scheme assets and liabilities please refer to note 35 on page F-44.

Measurement

Management of the schemes’ assets is the responsibility of the Trustees of the schemes who are responsible for setting the investment strategy and for agreeing funding requirements with the Group. Should a funding deficit arise, the Group will be liable for meeting it, and as part of a triennial valuation process will agree with the Trustees a funding strategy to eliminate the deficit over an appropriate period.

Longevity risk is measured using both 1-in-20 year stresses (risk appetite) and 1-in-200 year stresses (regulatory capital).

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Mitigation

The Group takes an active involvement in agreeing mitigation strategies with the schemes' Trustees. An interest rate and inflation hedging programme is in place to reduce liability risk. The schemes have also reduced equity allocation and invested the proceeds in credit assets as part of a programme to de-risk the portfolio. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

Monitoring

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees.

The surplus or deficit in the schemes is tracked on a monthly basis along with various single factor and scenario stresses which consider the assets and liabilities holistically. Key metrics are monitored monthly including the Group's capital resources of the scheme, the performance against risk appetite triggers, and the performance of the hedged asset and liability matching positions.

Insurance portfolios

Exposures

The main elements of market risk to which the Group is exposed through the Insurance business are equity, credit spread, interest rate and inflation.

- Equity risk arises indirectly through the value of future management charges on policyholder funds. These management charges form part of the value of in-force business (see note 24 on page F-36). Equity risk also arises in the with-profits funds but is less material.
- Credit spread risk mainly arises from annuities where policyholders' future cashflows are guaranteed at retirement. Exposure arises if the market value of the assets which are held to back these liabilities, mainly corporate bonds and loans, do not perform in line with expectations. Within the Group accounts a large amount of the exposure to market

value movements, but not actual default losses, is removed as accounting rules require that assets which the Insurance division has acquired from Group are maintained at the original amortised book value.

– Interest rate risk arises through holding credit and interest assets mainly in the annuity book and also to cover general insurance liabilities, capital requirements and risk appetite.

– Inflation exposure arises from a combination of inflation linked policyholder benefits and inflation assumptions used to project future expenses.

Measurement

Current and potential future market risk exposures within Insurance are assessed using a range of stress testing exercises and scenario analyses.

Risk measures include 1-in-200 year stresses used for regulatory capital assessments and single factor stresses for profit before tax.

Table 1.48 demonstrates the impact of the Group's Eurozone Credit Crunch scenario on Insurance's porfolio (with no diversification benefit, but after the impact of Group consolidation on interest rate and spread widening). This is the most onerous scenario for Insurance out of the Group scenarios. The amounts include movements in assets, liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

Table 1.48: Insurance business: profit before tax sensitivities

	Increase (reduction) in profit before tax	
	2017	2016[1]
	£m	£m
Interest rates – decrease 100 basis points	**(202)**	(387)
Inflation – increase 50 basis points	**24**	(34)
Credit spreads – 100% widening	**140**	369
Equity – 30% fall	**(1,001)**	(681)
Property – 25% fall	**(67)**	(58)

1 Restated. The most onerous scenario has changed to Eurozone Credit Crunch from UK Recession.

Further stresses that show the effect of reasonably possible changes in key assumptions, including the risk-free rate, equity investment volatility, widening of credit default spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax are set out in note 32.

Mitigation

Equity and credit spread risks are closely monitored and, where appropriate, asset liability matching is undertaken to mitigate risk. A hedging strategy is in place to reduce exposure from the with-profit funds.

Interest rate risk in the annuity book is mitigated by investing in assets whose cash flows closely 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.

Other market risks (e.g. interest rate exposure outside the annuity book and inflation) are also closely monitored and where considered appropriate, hedges are put in place to reduce exposure.

Monitoring

Market risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Monitoring includes the progression of market risk capital against risk appetite limits, as well as the sensitivity of profit before tax to combined market risk stress scenarios and in year market movements. Asset and liability matching positions and hedges in place are actively monitored and if necessary rebalanced to be within agreed tolerances. In addition market risk is controlled via approved investment policies and mandates.

Trading portfolios

Exposures

The Group's trading activity is small relative to its peers and does not engage in any proprietary trading activities. The Group's trading activity is undertaken solely to meet the financial requirements of commercial and retail customers for foreign exchange, credit and interest rate products. These activities support customer flow and market making activities.

All trading activities are performed within the Commercial Banking division. While the trading positions taken are generally small, any extreme moves in the main risk factors and other related risk factors could cause significant losses in the trading book depending on the positions at the time. The average 95 per cent 1-day trading VaR (Value at Risk: diversified across risk factors) was £0.6 million for 31 December 2017 compared to £1.3 million for 31 December 2016. The decrease in exposure was mainly due to high VaR during the first half of 2016 caused by overstatement of the interest rate risk by the VaR model. Improvements to more accurately reflect the risk were implemented in June 2016 which reduced the VaR significantly over the second half of 2016 and over 2017.

Trading market risk measures are applied to all of the Group's regulatory trading books and they include daily VaR (table 1.49), sensitivity based measures, and stress testing calculations.

Measurement

The Group internally uses VaR as the primary risk measure for all trading book positions.

Table 1.49 shows some relevant statistics for the Group's 1-day 95 per cent confidence level VaR that are based on 300 historical consecutive business days to year end 2017 and year end 2016.

The risk of loss measured by the VaR model is the minimum expected loss in earnings given the 95 per cent confidence. The total and average trading VaR numbers reported below have been obtained after the application of the diversification benefits across the five risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported at Group level.

Table 1.49: Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)

	At 31 December 2017				At 31 December 2016			
	Close £m	Average £m	Maximum £m	Minimum £m	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	0.5	0.6	2.1	0.2	0.7	1.3	7.7	0.5
Foreign exchange risk	0.1	0.1	0.4	0.0	0.1	0.3	0.8	0.1
Equity risk	–	–	–	–	–	–	–	–
Credit spread risk	0.3	0.3	0.5	0.2	0.2	0.2	0.4	0.1
Inflation risk	0.2	0.3	0.9	0.2	0.2	0.3	5.9	0.1
All risk factors before diversification	1.1	1.3	2.9	0.9	1.2	2.1	14.3	1.1
Portfolio diversification	(0.4)	(0.7)			(0.5)	(0.8)		
Total VaR	0.7	0.6	2.2	0.3	0.7	1.3	5.7	0.6

The market risk for the trading book continues to be low with respect to the size of the Group and compared to its peers. This reflects the fact that the Group's trading operations are customer-centric and focused on hedging and recycling client risks.

Although it is an important market standard measure of risk, VaR has limitations. One of them is the use of limited historical data sample which influences the output by the implicit assumption that future market behaviour will not differ greatly from the historically observed period. Another known limitation is the use of defined holding periods which assumes that the risk can be liquidated or hedged within that holding period. Also calculating the VaR at the chosen confidence interval does not give enough information about potential losses which may occur if this level is exceeded. The Group fully recognises these limitations and supplements the use of VaR with a variety of other measurements which reflect the nature of the business activity. These include detailed sensitivity analysis, position reporting and a stress testing programme.

Trading book VaR (1-day 99 per cent) is compared daily against both hypothetical and clean profit and loss. 1-day 99 per cent VaR charts for Lloyds Bank, HBOS and Lloyds Banking Group models can be found in the Group's Pillar 3 Report.

Mitigation

The level of exposure is controlled by establishing and communicating the approved risk limits and controls through policies and procedures that define the responsibility and authority for risk taking. Market risk limits are clearly and consistently communicated to the business. Any new or emerging risks are brought within risk reporting and defined limits.

Monitoring

Trading risk appetite is monitored daily with 1-day 95 per cent VaR and stress testing limits. These limits are complemented with position level action triggers and profit and loss referrals. Risk and position limits are set and managed at both desk and overall trading book levels. They are reviewed at least annually and can be changed as required within the overall Group risk appetite framework.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MODEL RISK

DEFINITION

Model risk is defined as the risk of financial loss, regulatory censure, reputational damage or customer detriment, as a result of deficiencies in the development, application or ongoing operation of models and rating systems.

Models are defined as quantitative methods that process input data into quantitative outputs, or qualitative outputs (including ordinal letter output) which have a quantitative measure associated with them. Model Governance Policy is restricted to specific categories of application of models, principally financial risk, treasury and valuation, with certain exclusions, such as prescribed calculations and project appraisal calculations.

EXPOSURES

There are over 300 models in the Group performing a variety of functions including:

– capital calculation;

– credit decisioning, including fraud;

– pricing models;

– impairment calculation;

– stress testing and forecasting; and

– market risk measurement.

As a result of the wide scope and breadth of coverage, there is exposure to model risk across a number of the Group's primary risk categories.

MEASUREMENT

The Group risk appetite framework is the key component for measuring the Group's model risk. Reported monthly to the Group Risk Committee and Board, focus is placed on the performance of the Group's most material models.

MITIGATION

The model risk management framework, established by and with continued oversight from an independent team in the Risk division, provides the foundation for managing and mitigating Model Risk within the Group. Accountability is cascaded from the Board and senior management via the Group Risk Management Framework.

This provides the basis for the Group Model Governance Policy, which defines the mandatory requirements for models across the Group, including:

– the scope of models covered by the policy;

– model materiality;

– roles and responsibilities, including ownership, independent oversight and approval; and

– key principles and controls regarding data integrity, development, validation, implementation, ongoing maintenance and validation, monitoring, and the process for non-compliance.

The above ensures models, including those involved in regulatory capital calculation, are developed consistently and are of sufficient quality to support business decisions and meet regulatory requirements.

MONITORING

The Group Model Governance Committee is the primary body for overseeing model risk. Policy requires that Key Performance Indicators are monitored for every model and all issues are escalated appropriately. Material model issues are reported to Group and Board Risk Committees monthly with more detailed papers as necessary to focus on key issues.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS

Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables

The following table sets out the book values and valuation (fair value) of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

	2017 Book value £m	**2017 Valuation £m**	2016 Book value £m	2016 Valuation £m	2015 Book value £m	2015 Valuation £m
Trading securities and other financial assets at fair value through profit or loss						
US treasury and US government agencies	1,458	1,458	1,607	1,607	663	663
Other government securities	20,562	20,562	25,125	25,125	21,454	21,454
Other public sector securities	1,527	1,527	1,325	1,325	2,039	2,039
Bank and building society certificates of deposit	222	222	244	244	135	135
Mortgage-backed securities	400	400	707	707	1,358	1,358
Other asset-backed securities	1,021	1,021	1,538	1,538	847	847
Corporate and other debt securities	19,990	19,990	19,832	19,832	20,316	20,316
Treasury bills and other bills	18	18	20	20	74	74
Equity shares	86,090	86,090	67,697	67,697	60,476	60,476
	131,288	131,288	118,095	118,095	107,362	107,362
Available-for-sale financial assets						
US treasury and US government agencies	6,760	6,760	7,564	7,564	6,349	6,349
Other government securities	27,948	27,948	41,150	41,150	18,980	18,980
Bank and building society certificates of deposit	167	167	142	142	186	186
Mortgage-backed securities	1,156	1,156	108	108	197	197
Other asset-backed securities	255	255	317	317	319	319
Corporate and other debt securities	4,615	4,615	6,030	6,030	5,808	5,808
Equity shares	1,197	1,197	1,213	1,213	1,193	1,193
	42,098	42,098	56,524	56,524	33,032	33,032
Held-to-maturity investments						
UK government	–	–	–	–	19,808	19,851
Debt securities classified as loans and receivables						
Mortgage-backed securities	2,366	2,351	2,089	2,065	2,528	2,493
Other asset-backed securities	1,260	1,225	1,290	1,227	1,234	1,173
Corporate and other debt securities	43	10	94	11	526	441
	3,669	3,586	3,473	3,303	4,288	4,107
Allowance for impairment losses	(26)	–	(76)	–	(97)	–

	3,643	3,586	3,397	3,303	4,191	4,107

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MATURITIES AND WEIGHTED AVERAGE YIELDS OF INTEREST-BEARING SECURITIES

The weighted average yield for each range of maturities is calculated by dividing the annualised interest income prevailing at 31 December 2017 by the book value of securities held at that date.

	Maturing within one year		Maturing after one but within five years		Maturing after five but within ten years		Maturing after ten years	
	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %	Amount £m	Yield %
Trading securities and other financial assets at fair value through profit or loss								
US treasury and US government agencies	2	0.00	222	0.59	226	2.26	1,009	2.48
Other government securities	694	2.60	3,188	2.87	2,732	2.08	13,947	2.60
Other public sector securities	3	5.00	380	2.08	91	4.35	1,053	2.91
Bank and building society certificates of deposit	222	1.50	–	–	–	–	–	–
Mortgage-backed securities	19	0.00	170	1.16	65	5.23	146	3.76
Other asset-backed securities	28	1.61	107	2.33	393	1.01	493	1,80
Corporate and other debt securities	1,424	1.74	3,265	4.72	4,202	3.91	11,099	3.99
Treasury bills and other bills	18	0.94	–	–	–	–	–	–
	2,410		7,332		7,709		27,747	
Available-for-sale financial assets								
US treasury and US government agencies	–	–	4,418	2.62	2,189	5.53	153	2.51
Other government securities	1,051	1.26	10,702	3.73	8,222	3.38	7,973	3.21
Bank and building society certificates of deposit	167	0.13	–	–	–	–	–	–
Mortgage-backed securities	–	–	–	–	–	–	1,156	2.67
Other asset-backed securities	–	–	–	–	53	1.55	202	1.17
Corporate and other debt securities	782	1.42	3,286	1.90	547	2.27	–	–
	2,000		18,406		11,011		9,484	
Debt securities classified as loans and receivables								
Mortgage-backed securities	–	–	2,264	1.4	–	–	102	1.7
Other asset-backed securities	29	0.1	861	0.6	138	1.6	232	1.3
Corporate and other debt securities	17	0.0	–	–	–	–	26	0.5
	46		3,125		138		360	

The Group’s investment holdings at 31 December 2017 include £45,899 million due from the UK government and its agencies and £8,218 million due from the US government and its agencies.

MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AT 31 DECEMBER 2017

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis at 31 December 2017. Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

All amounts are before deduction of impairment allowances. Demand loans are included in the 'maturing in one year or less' category.

	Maturing in one year or less £m	Maturing after one but within five years £m	Maturing after five years £m	Total £m
Loans and advances to banks	3,990	2,536	85	6,611
Loans and advances to customers:				
Mortgages	13,906	50,061	240,698	304,665
Other personal lending	5,229	4,759	18,769	28,757
Property companies	4,808	10,921	15,251	30,980
Financial, business and other services	35,044	13,901	8,061	57,006
Transport, distribution and hotels	7,056	4,667	2,351	14,074
Manufacturing	5,086	2,308	492	7,886
Other	9,581	14,300	7,450	31,331
Total loans	84,700	103,453	293,157	481,310
Of which:				
Fixed interest rate	34,279	41,439	139,524	215,242
Variable interest rate	50,421	62,014	153,633	266,068
	84,700	103,453	293,157	481,310

DEPOSITS

The following tables show the details of the Group's average customer deposits in each of the past three years.

	2017 Average balance £m	2017 Average rate %	2016 Average balance £m	2016 Average rate %	2015 Average balance £m	2015 Average rate %
Non-interest bearing demand deposits	66,276	–	54,379	–	45,294	–
Interest-bearing demand deposits	94,627	0.33	90,272	0.48	83,756	0.47
Savings deposits	168,013	0.23	164,155	0.57	174,239	1.00
Time deposits	86,043	1.15	111,751	1.05	122,142	0.99
Total average deposits	414,959	0.41	420,557	0.60	425,431	0.79

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits at 31 December 2017 individually in excess of US $100,000 (or equivalent in another currency) by time remaining to maturity. Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

	3 months or less £m	Over 3 months but within 6 months £m	Over 6 months but within 12 months £m	Over 12 months £m	Total £m
Certificates of deposit	3,754	3,534	2,658	50	9,996
Time deposits	26,097	6,064	6,578	2,848	41,587
Total	29,851	9,598	9,236	2,898	51,583

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SHORT-TERM BORROWINGS

Short-term borrowings are included within the balance sheet captions 'Deposits by banks', 'Customer accounts' and 'Debt securities in issue' and are not identified separately on the balance sheet. The short-term borrowings of the Group consist of overdrafts from banks, securities sold under agreements to repurchase, notes issued as part of lending securitisations, certificates of deposit issued, commercial paper and promissory notes issued and other marketable paper. Securities sold under agreements to repurchase, certificates of deposit issued, commercial paper, securitisation notes and covered bonds are the only significant short-term borrowings of the Group.

The following tables give details of these significant short-term borrowings of the Group for each of the past three years.

	2017 £m	2016 £m	2015 £m
Liabilities in respect of securities sold under repurchase agreements			
Balance at the year end	25,813	9,741	7,061
Average balance for the year	18,943	8,342	5,960
Maximum balance during the year	25,813	12,734	9,467
Average interest rate during the year	0.6 %	0.5 %	0.6 %
Interest rate at the year end	1.4 %	0.6 %	0.6 %
Certificates of deposit issued			
Balance at the year end	9,999	8,077	11,101
Average balance for the year	10,284	11,200	11,708
Maximum balance during the year	11,354	13,712	13,925
Average interest rate during the year	0.7 %	0.6 %	0.4 %
Interest rate at the year end	0.7 %	0.7 %	0.2 %
Commercial paper			
Balance at the year end	3,241	3,281	6,663
Average balance for the year	3,653	4,666	5,286
Maximum balance during the year	4,351	7,646	12,700
Average interest rate during the year	1.3 %	0.9 %	0.6 %
Interest rate at the year end	0.0 %	0.0 %	0.0 %
Securitisation notes			
Balance at the year end	3,660	7,253	7,763
Average balance for the year	5,194	7,131	10,362
Maximum balance during the year	7,253	7,436	12,155
Average interest rate during the year	2.5 %	2.5 %	2.4 %
Interest rate at the year end	2.8 %	2.2 %	2.7 %
Covered bonds			
Balance at the year end	26,132	30,521	27,200
Average balance for the year	26,765	30,625	26,503

Maximum balance during the year	30,521	32,444	27,200
Average interest rate during the year	3.2 %	3.5 %	4.2 %
Interest rate at the year end	2.8 %	3.0 %	3.7 %

MANAGEMENT AND EMPLOYEES

DIRECTORS AND SENIOR MANAGEMENT

The Group is led by the Board comprising a Chairman (who was independent on appointment), independent Non-Executive Directors and Executive Directors with a wide range of experience. The appointment of directors is considered by the Nomination and Governance Committee and approved by the Board. Following the provisions in the articles of association, directors must stand for election by the shareholders at the first annual general meeting following their appointment. In line with UK Corporate Governance best practice, all Directors are subject to annual re-election by shareholders at each annual general meeting thereafter. Independent Non-Executive Directors are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Their appointment may be terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

The Board meets regularly. In 2017, a total of 10 Board meetings were held, 10 of which were scheduled at the start of the year.

The roles of the Chairman, the Group Chief Executive and the Board and its governance arrangements, including the schedule of matters specifically reserved to the Board for decision, are reviewed annually. The matters reserved to the Board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group's budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisational structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company's main professional advisers and their fees (where significant); and the determination of Board and Committee structures, together with their size and composition.

According to the articles of association, the business and affairs of the Company are managed by the Directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the Group's expense, where they judge it necessary to discharge their duties as directors.

The Chairman has a private discussion at least once a year with each Director on a wide range of issues affecting the Group, including any matters which the Directors, individually, wish to raise.

There is an induction programme for all Directors, which is tailored to their specific requirements having regard to their specific role on the Board and their skills and experience to date.

The Directors and senior management of Lloyds Banking Group plc are:

NON-EXECUTIVE DIRECTORS

Lord Blackwell Chairman

Age: 65

Chairman of the Nomination and Governance Committee, member of the Remuneration Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: June 2012 (Board), April 2014 (Chairman)

Skills and experience:

Deep financial services knowledge including in insurance and banking

Significant experience with strategic planning and implementation

Regulatory and public policy experience gained from senior positions in Downing Street, Regulators and a wide range of industries

Credibility with key stakeholders

Strong leadership qualities

Lord Blackwell initially joined the Board as Chairman of Scottish Widows Group. He was previously Senior Independent Director and Chairman of the UK Board for Standard Life and Director of Group Development at NatWest Group. His past Board roles have included Chairman of Interserve plc, and Non-Executive Director of Halma plc, Dixons Group, SEGRO and Ofcom. He was Head of the Prime Minister’s Policy Unit from 1995 to 1997 and was appointed a Life Peer in 1997. He has an MA in Natural Sciences from the University of Cambridge, a Ph.D in Finance and Economics and an MBA from the University of Pennsylvania.

External appointments: Governor of the Yehudi Menuhin School and a member of the Governing Body of the Royal Academy of Music.

Anita Frew Deputy Chairman and Senior Independent Director

Age: 60

Chairman of the Remuneration Committee, member of the Audit Committee, the Nomination and Governance Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: December 2010 (Board), May 2014 (Deputy Chairman), May 2017 (Senior Independent Director)

Skills and experience:

Significant board, financial and general management experience

Experience across a range of sectors, including banking, asset and investment management, manufacturing and utilities

Extensive experience as chairman in a range of industries

Strong board governance experience, including investor relations and remuneration

Anita was previously Chairman of Victrex plc, the Senior Independent Director of Aberdeen Asset Management and IMI plc, an Executive Director of Abbott Mead Vickers, a Non-Executive Director of Northumbrian Water and has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland. She has a BA (Hons) in International Business from the University of Strathclyde, a MRes in Humanities and Philosophy from the University of London, an Honorary DSc for contribution to industry and finance from the University of Cranfield and an Honorary Doctorate in Management and Finance from the University of Aberdeen.

External appointments: Chairman of Croda International Plc and a Non-Executive Director of BHP Billiton.

Alan Dickinson Independent Director

Age: 67

Chairman of the Board Risk Committee, member of the Audit Committee, the Nomination and Governance Committee and the Remuneration Committee.

Appointed: September 2014

Skills and experience:

Highly regarded retail and commercial banker

Strong strategic, risk and core banking experience

Regulatory and public policy experience

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MANAGEMENT AND EMPLOYEES

Alan has 37 years' experience with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK. More recently, Alan was a Non-Executive Director of Willis Limited and Chairman of its Risk Committee. He was formerly Chairman of Brown, Shipley & Co. Limited and a Non-Executive Director of Nationwide Building Society where he was Chairman of its Risk Committee. He is a Fellow of the Chartered Institute of Bankers and the Royal Statistical Society and has an MBA from the Manchester Business School and a BSc from the University of Birmingham.

External appointments: Chairman of Urban&Civic plc and a Governor of Motability.

Simon Henry Independent Director

Age: 56

Chairman of the Audit Committee and a member of the Board Risk Committee.

Appointed: June 2014

Skills and experience:

Deep international experience in board level strategy and execution

Extensive knowledge of financial markets, treasury and risk management

Qualification as an Audit Committee Financial Expert

Strong board governance experience, including investor relations and remuneration

Until recently Simon was Chief Financial Officer and Executive Director of Royal Dutch Shell plc. He was previously Chair of the European Round Table CFO Taskforce and a Member of the Main Committee of the 100 Group of UK FTSE CFOs. He has a BA in Mathematics, an MA from the University of Cambridge and is a fellow of the Chartered Institute of Management Accountants (CIMA).

External appointments: Non-Executive Director of Rio Tinto plc and Rio Tinto Limited, Independent Director of PetroChina Company Limited, Member of the Defence Board and Chair of the Defence Audit Committee, UK

Government, Member of the Advisory Panel of CIMA and of the Advisory Board of the Centre for European Reform.

Lord Lupton CBE Independent Director and Chairman of Lloyds Bank Corporate Markets plc

Age: 62

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2017

Skills and experience:

Extensive international corporate experience, especially in financial markets

Strong board governance experience, including investor relations and remuneration

Regulatory and public policy experience

Significant experience in strategic planning and implementation

Lord Lupton was Deputy Chairman of Baring Brothers, co-founded the London office of Greenhill & Co., and was Chairman of Greenhill Europe until May 2017. He was previously a Trustee of the British Museum, Governor of Downe House School and a member of the International Advisory Board of Global Leadership Foundation. He became a Life Peer in October 2015 and is a former Treasurer of the Conservative Party. He served on the House of Lords Select Committee on Charities. He read Jurisprudence at Lincoln College, Oxford and is a qualified solicitor.

External appointments: Senior Advisor to Greenhill Europe and Chairman of the Trustees of the Lovington Foundation.

Deborah McWhinney Independent Director

Age: 62

Member of the Audit Committee and the Board Risk Committee.

Appointed: December 2015

Skills and experience:

Extensive executive background in managing technology, operations and new digital innovations across banking, payments and institutional investment

International business and management experience

Experience in consumer analysis, marketing and distribution

Deborah is Chair of the Board Risk Committee's IT Resilience and Cyber Sub-Committee. She is a former Chief Executive Officer, Global Enterprise Payments and President, Personal Banking and Wealth Management at Citibank. Deborah was previously President of Institutional Services at Charles Schwab Corporation and held executive roles at Engage Media Services Group, Visa International and Bank of America, where she held senior roles in Consumer Banking. She holds a BSc in Communications from the University of Montana.

External appointments: Member of the Supervisory Board of Fresenius Medical Care AG & Co. KGaA, Independent Director of Fluor Corporation and IHS Markit Ltd, a Trustee of the California Institute of Technology and of the Institute for Defense Analyses.

Nick Prettejohn Independent Director and Chairman of Scottish Widows Group

Age: 57

Member of the Audit Committee and the Board Risk Committee.

Appointed: June 2014

Skills and experience:

Deep financial services experience, particularly in insurance

In-depth regulatory knowledge and experience

Governance experience and strong leadership qualities

Significant experience in strategic planning and implementation

Nick has served as Chief Executive of Lloyd's of London, Prudential UK and Europe and Chairman of Brit Insurance. He is a former Non-Executive Director of the Prudential Regulation Authority and of Legal & General Group Plc as well as Chairman of the Financial Services Practitioner Panel and the Financial Conduct Authority's Financial Advice Working Group. He was previously a Member of the BBC Trust and Chairman of the Britten-Pears Foundation. Nick has a First Class Degree in Philosophy, Politics and Economics from Balliol College, University of Oxford.

External appointments: Chairman of the Royal Northern College of Music, Non-Executive Director and the Chairman designate of Trinity Mirror plc with effect from 6 March 2018, and a member of the Board of Opera Ventures.

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MANAGEMENT AND EMPLOYEES

Stuart Sinclair Independent Director

Age: 64

Member of Remuneration Committee, the Responsible Business Committee and the Board Risk Committee.

Appointed: January 2016

Skills and experience:

Extensive experience in retail banking, insurance and consumer finance

Governance and regulatory experience

Significant experience in strategic planning and implementation

Experience in consumer analysis, marketing and distribution

Stuart is a former Non-Executive Director of TSB Banking Group plc, TSB Bank plc, LV Group, Virgin Direct and Vitality Health (formerly Prudential Health). He was also a Senior Independent Director of Swinton Group Limited. In his executive career, he was President and Chief Operating Officer of Aspen Insurance after spending nine years with General Electric, as Chief Executive Officer of the UK Consumer Finance business then President of GE Capital China. Before that he was Chief Executive Officer of Tesco Personal Finance and Director of UK Retail Banking at the Royal Bank of Scotland. He was a Council member of The Royal Institute for International Affairs (Chatham House). He has an MA in Economics from the University of Aberdeen and an MBA from the University of California.

External appointments: Interim Chairman of Provident Financial Plc with effect from 2 February 2018 (previously Senior Independent Director) and Chair of their Risk Advisory Committee, Senior Independent Director and Chair of Risk at QBE Insurance (Europe) Limited.

Sara Weller CBE Independent Director

Age: 56

Chairman of the Responsible Business Committee, member of the Nomination and Governance Committee, the Remuneration Committee and the Board Risk Committee.

Appointed: February 2012

Skills and experience:

Background in retail and associated sectors, including financial services

Strong board governance experience, including investor relations and remuneration

Passionate advocate of customers, the community, financial inclusion and the development of digital skills

Considerable experience of boards at both executive and non-executive level

Sara's previous appointments include Managing Director of Argos, various senior positions at J Sainsbury including Deputy Managing Director, Chairman of the Planning Inspectorate, Lead Non-Executive Director at the Department of Communities and Local Government, a Non-Executive Director of Mitchells & Butlers as well as a number of senior management roles for Abbey National and Mars Confectionery. She has an MA in Chemistry from Oxford University.

External appointments: Non-Executive Director of United Utilities Group and Chair of their Remuneration Committee and a member of their Nomination Committee, Lead Non-Executive Director at the Department for Work and Pensions, a Governing Council Member of Cambridge University, Board member at the Higher Education Funding Council and Trustee of Lloyds Bank Foundation for England and Wales, with effect from 1 February 2018.

EXECUTIVE DIRECTORS

António Horta-Osório Executive Director and Group Chief Executive

Age: 54

Appointed: January 2011 (Board), March 2011 (Group Chief Executive)

Skills and experience:

Extensive experience in, and understanding of, both retail and commercial banking built over a period of more than 30 years, working both internationally and in the UK

Drive, enthusiasm and commitment to customers

Proven ability to build and lead strong management teams

António previously worked for Citibank, Goldman Sachs and held various senior management positions at Grupo Santander before becoming its Executive Vice President and member of the Group's Management Committee. He was a Non-Executive Director of Santander UK and subsequently its Chief Executive. He is also a former Non-Executive Director of the Court of the Bank of England. António has a Degree in Management & Business Administration from the Universidade Católica Portuguesa, an MBA from INSEAD and has completed the Advanced Management Program at Harvard Business School.

External appointments: Non-Executive Director of EXOR N.V., Fundação Champalimaud and Sociedade Francisco Manuel dos Santos in Portugal, a member of the Board of Stichting INPAR and Chairman of the Wallace Collection.

George Culmer Executive Director and Chief Financial Officer

Age: 55

Appointed: May 2012 (Board)

Skills and experience:

Extensive operational and financial expertise including strategic and financial planning and control

Worked in financial services in the UK and overseas for over 25 years

George was an Executive Director and Chief Financial Officer of RSA Insurance Group, the former Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations as well as holding various senior management positions at Prudential. He is a Non-Executive Director of Scottish Widows.

George is a Chartered Accountant and has a history degree from the University of Cambridge.

External appointments: None.

Juan Colombás Executive Director and Chief Operating Officer

Age: 55

Appointed: November 2013 (Board), January 2011- September 2017 (Chief Risk Officer), September 2017 (Chief Operating Officer)

Skills and experience:

Significant banking and risk management experience

International business and management experience

Juan was appointed to the role of Chief Operating Officer in September 2017 and is responsible for leading a number of critical Group functions and driving the transformation activities across the Group in order to build the Bank of the Future. Prior to this he served as the Group's Chief Risk Officer and was responsible for developing the Group's risk framework, recommending the Group's risk appetite and ensuring that all risks generated by the business were measured, reviewed and monitored on an ongoing basis. He was previously the Chief Risk Officer and an Executive Director of Santander's UK business. Prior to this, he held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group. Until September 2017 he was the Vice Chairman of the International Financial Risk Institute. Juan has a BSc in Industrial Chemical Engineering from the Universidad Politécnica de Madrid, a Financial Management degree from ICADE School of Business and Economics and an MBA from the Institute de Empresa Business School.

External appointments: None.

EMPLOYEES

As at 31 December 2017, the Group employed 67,905 people (on a full-time equivalent basis), compared with 70,433 at 31 December 2016 and 75,306 at 31 December 2015. At 31 December 2017, 67,172 employees were located in the UK, 367 in continental Europe, 307 in the Americas, and 59 in the rest of the world. At the same date, 31,761 people were employed in Retail, 6,662 in Commercial Banking, 6,095 in Insurance and Wealth, and 23,387 in other functions.

The Group has Codes of Responsibility which apply to all employees. The Codes of Responsibility can be found at: www.lloydsbankinggroup.com/ Responsible-Business.

COMPENSATION

REMUNERATION COMMITTEE

The Committee strongly believes that the Group's remuneration approach, guided by four key reward principles, contributes significantly to the delivery of the Group's strategic priorities.

I am very grateful for the continued support and engagement we have had with shareholders, their representative bodies and our wider stakeholder group. I believe this is reflected in the positive voting outcome we received at the AGM in 2017 for our new remuneration policy. No changes are proposed to that policy.

Simplification

We made changes in 2017 in a drive towards further simplification of remuneration structures, removing complexity, and ensuring a focus on rewarding longer-term, sustainable performance. The Group Performance Share plan was introduced in 2017. The plan outcome is determined on a 'top down' basis, as a percentage of the Group's underlying profit, replacing the previous complex bonus pool methodology driven by aggregated divisional and functional bonus outcomes. There are enhancements to the levels of disclosure within this report, with the aim to provide additional clarity and transparency, particularly relating to the performance assessments that underpin the Group Performance Share outcome both at Group level, and for individual Executive Directors.

From 2018, the Group no longer operates specific incentive arrangements for customer-facing colleagues. Instead, colleagues now participate only in the Group Performance Share plan. Approximately 28,000 customer-facing colleagues have transitioned plans during 2017.

In my last report, I announced that all colleagues in the Group had received an award of Colleague Group Ownership Shares, with the aim of achieving 100 per cent share ownership among colleagues and building a colleague-wide long-term ownership culture. I am pleased to confirm that this award will be repeated in 2018.

Taking into consideration stakeholders' views

The Committee remains acutely aware that the topic of remuneration, alongside corporate culture and working practices, continues to generate a high level of focus and that the role of the Committee is to ensure that the interests of colleagues, shareholders and other key stakeholders are considered fairly, and in the context of wider societal expectations.

I have set a broad agenda for the Committee in 2017, further details of which can be found on page 132. The Committee remit is dynamic and extends beyond executive remuneration, believing that all colleagues should be represented in its consideration. It is our aim to ensure that the remuneration policy framework and guiding principles can be applied consistently to all colleagues. This recognises the importance of colleagues working together, sharing collectively in the Group's success and building a culture of acting as stewards of the long-term interests of the Group.

The Committee remains mindful of the relationship between pay for Executive Directors and all other colleagues. To ensure that the Committee understands wider stakeholder views, I have engaged directly with the Group's recognised unions (Accord and Unite) who represent the interests of around 30,000 colleagues. Feedback from the unions is provided to the Committee

Our key priorities

Simplifying the Group's remuneration policy and principles, with a focus on long-term share ownership

Ensuring remuneration outcomes are fair for all colleagues

Rewarding individual performance and collective success

Providing alignment to the Group's future strategic priorities

Enhancing levels of disclosure and corporate governance

COMPENSATION

Rewarding all colleagues fairly

Group Ownership Share awards	**Direct engagement with unions**	**Our balanced scorecard**	**A single pay budget with higher awards for more junior colleagues**
We aim to achieve 100 per cent share ownership among our colleagues.	Feedback is sought from Accord and Unite on specific matters.	Pay linked to performance on the basis of both 'what' was achieved and 'how' it was delivered.	Increases to base salary for Directors below the Group pay budget.

on specific matters under consultation, for example, in setting the annual pay budget for colleagues and any changes to benefits arrangements. I have also actively engaged with the Group's customers, regulators and my other Board members (including directly with the Responsible Business Committee). In addition, our independent advisers have provided regular updates on market context and emerging topics in remuneration.

Rewarding all colleagues fairly

The Group is committed to offering all colleagues a reward package that is competitive, performance-driven and fair.

In discussions with the Group's recognised unions, a 2018 pay budget of 2.7 per cent was agreed, including additional funding to ensure a minimum pay award of £600 for eligible colleagues. Colleagues in lower pay ranges receive higher awards to support pay progression, together with colleagues who receive stronger performance ratings in recognition of their contribution to the Group. The majority of

Summary of 2017 remuneration outcomes

The 'Remuneration at a glance' section on the following pages provides a summary of the remuneration outcomes for Executive Directors and the key measures against which the Committee determined these outcomes.

I should like to draw attention to the following key messages:

Underlying profit increased to £8,493 million in 2017, exceeding budget by 8.2 per cent. Taking into consideration this financial performance, the Committee agreed an overall Group Performance Share of 5.1 per cent of underlying profit. This was adjusted both positively and negatively to reflect strong performance against stretching Group strategic objectives and conduct provisions impacting negatively on profitability and shareholder returns. In reaching its decision, the Committee considered the impact on customers, conduct and the Group's reputation. The overall outcome determined by the Committee was £414.7 million, approximately 5.5 per cent higher than the equivalent bonus outcome for 2016. The total overall outcome, following the

The Long-Term Incentive Plan (LTIP) awards made in 2015 are vesting at 66.3 per cent, reflecting the Group's strong performance since 2015, balanced against uncertainty in the economic and political environment. In particular, this has impacted negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component.

In line with shareholder views, changes to the measures in the 2018 Group Ownership Share awards have been minimised to provide consistency with the 2017 plan, while aligning to the key strategic priorities as set out in the third Group Strategic Review. Further detail is provided on page 130.

colleagues' pay is determined consistently using fixed pay matrices aligned to the external market and designed to help recruit and retain colleagues with the skills, behaviours and motivation to deliver the Group's strategic aims. This approach supports the Group's commitment to the Living Wage Foundation.

The Committee proposes salary increases for the Group Chief Executive and the Chief Financial Officer set below the budget for the wider colleague population, at 2 per cent. Juan Colombás took on a new role of Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer.

The Committee considers that pay ratios provide a useful reference point. However, there remains uncertainty and potential confusion how these should be calculated and disclosed. The Committee has therefore chosen not to publish the CEO to colleague pay ratio data alongside this report and will instead comply with the government proposals when these are finalised.

adjustments applied above, is 4.7 per cent of underlying profit before tax which remains significantly lower than the funding limit of 10 per cent. Further detail is provided on page 122, including the detailed metrics in the Group's balanced scorecard.

The approach to determining individual Group Performance Share awards for Executive Directors is consistent with other colleagues. The Committee determined that awards of between 77 per cent and 80 per cent of maximum should be made to the Executive Directors. These awards reflect individual performance assessed on the basis of whole job contribution, both what was achieved and how it was delivered. The average annual Group Performance Share award for colleagues increased by 9.3 per cent relative to 2016, which compares favourably to the average increase in individual awards for Executive Directors of 4 per cent, excluding the Group Chief Executive. The award for the Group Chief Executive increased by 8.4 per cent relative to 2016, reflecting the increase in the base salary against which the award level is determined. The 2017 award is the same percentage of salary as 2016.

COMPENSATION

REMUNERATION AT A GLANCE

HOW WE PERFORMED, AND OUR POLICY

How Executive Directors' remuneration works

Fixed remuneration	l Base salary	**See page 133**	**Variable remuneration**	l Short-term plan	**See page 134**
	l Fixed share award	**See page 133**		l Long-term plan	**See page 134**
	l Pension	**See page 133**			
	l Benefits	**See page 133**			

l **Group Performance Share (GPS) plan**

The Committee determined that the GPS outcome would be **£414.7 million**, based on the following performance outcomes.

1 Excludes MBNA.

2 The underlying profit of £8,493 million has been adjusted by the £74 million incremental difference between the Prudential Value Adjustment (PVA) at year-end 2016 to year-end 2017, in line with regulatory requirements.

3 The underlying profit of £7,867 million has been adjusted (reduced) by the £126 million incremental difference between the PVA at year-end 2015 to year-end 2016.

Group Balanced Scorecard (BSC) performance

BSC category	Rating
Customer	**Strong+**
People	**Strong+**
Control environment	**Strong+**
Building the business	**Strong**
Finance	**Strong**

Collective performance adjustment

The Committee considered the conduct-related provisions, including an additional PPI provision. This led to a downward adjustment of £109.6 million, or 21 per cent.

GPS award versus shareholder returns (% of underlying profit)

The total GPS award as a percentage of underlying profit before tax and GPS allocation decreased from 4.8 per cent in 2016 to 4.7 per cent in 2017. This compares favourably to shareholder return from dividend payments and share buyback over the same period which increased to 36 per cent of underlying profit. The GPS allocation for 2017 remains significantly lower than the Group's funding limit of 10 per cent of underlying profit.

l **Long-term incentive plan**

LTIP awards made in 2015 are vesting at 66.3 per cent, as detailed in the table below. This reflects the Group's strong performance over the three financial years ended 31 December 2017, balanced against uncertainty in the economic and political environment. In particular, this has impacted

negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component. Executive Directors are required to retain any vested shares for a further two years after vesting.

Weighting	Measure	Threshold	Maximum	**Actual**	**Vesting**
30%	Absolute total shareholder return (TSR)	8% p.a.	16% p.a.	**(1.7%)**	**0%**
25%	Economic profit	£2,870m	£3,587m	**£3,987m**	**25%**
10%	Cost:income ratio[1]	45.6%	44.5%	**44.9%**	**6.3%**
10%	Customer complaint handling[2]	0.79	0.73	**0.53**	**10%**
	(FCA reportable complaints / FOS uphold rate)	=<32%	=<28%	**15%**	
10%	Net promoter score	3rd	1st	**1st**	**10%**
7.5%	Digital active customer base	12.7m	13.3m	**13.4m**	**7.5%**
7.5%	Colleague engagement score	62	70	**76**	**7.5%**
			LTIP (% maximum) vesting 66.3%		

1 Adjusted total costs.

2 The FCA changed the approach to complaint classification and reporting from 30 June 2016. The Committee determined that the original target should be translated on a like-for-like basis into the new reporting requirement. The Committee was satisfied that the revised targets, set on a mechanical basis, were no less stretching.

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COMPENSATION

Single total figure of remuneration

The charts below summarise the Executive Directors' remuneration for the 2016 and 2017 performance years.

António Horta-Osório Group Chief Executive

£000

George Culmer Chief Financial Officer

£000

Juan Colombás Chief Operating Officer (formerly Chief Risk Officer)[3]

£000

1 2017 Group Performance Share, awarded in March 2018.

2 The LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 19 February 2018. The average share price between 1 October 2017 and 31 December 2017 (66.75 pence) has been used to indicate the value. The shares were awarded in 2015 based on a share price of 79.93 pence.

3 Juan Colombás took up the role of Chief Operating Officer on 4 September 2017.

2018 policy implementation overview

The detailed policy implementation table containing all elements of remuneration can be found on page 129.

l Base salary	The Group has applied a total pay budget of 2.7 per cent for the wider colleague population. Salary increases for the Group Chief Executive (GCE) and the Chief Financial Officer (CFO) are set below this budget, at 2 per cent. Juan Colombás took on a new role of Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer. Salaries will be as follows, effective dates shown below: GCE: £1,244,400 (1 January 2018) CFO: £779,351 (1 April 2018) COO: £779,351 (1 January 2018)
l Fixed share award	The levels of award set for 2018 remain unchanged and are as follows: GCE: £900,000 CFO: £504,000 COO: £497,000
l Group Performance	The maximum Group Performance Share opportunity is 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors (no change).

Share plan	Malus/clawback provisions and holding period apply in line with regulatory requirements.
l Group Ownership Share plan	The maximum annual Group Ownership Share award for Executive Directors is 300 per cent of salary (no change). Awards in 2018, based on individual performance in 2017, are made as follows: GCE: 300 per cent of base salary CFO: 275 per cent of base salary COO: 275 per cent of base salary Malus/clawback provisions and holding period apply in line with regulatory requirements and market practice.

COMPENSATION

ANNUAL REPORT ON REMUNERATION

Single total figure of remuneration (audited)

The following table summarises the total remuneration delivered during 2017 in relation to service as an Executive Director.

	António Horta-Osório		**George Culmer**		**Juan Colombás**		**Totals**	
£000	**2017**	2016	**2017**	2016	**2017**	2016	**2017**	2016
Base salary	**1,220**	1,125	**760**	745	**753**	739	**2,733**	2,609
Fixed share award	**900**	900	**504**	504	**497**	497	**1,901**	1,901
Benefits	**156**	143	**46**	42	**71**	70	**273**	255
Group Performance Share	**1,323**	1,220	**599**	574	**599**	578	**2,521**	2,372
Long-term incentive (LTIP)[1]	**2,257**	1,834	**1,221**	992	**1,204**	883	**4,682**	3,709
Pension allowance	**565**	568	**190**	186	**188**	185	**943**	939
Other remuneration[2]	**1**	1	**1**	1	**1**	1	**3**	3
Total remuneration	**6,422**	5,791	**3,321**	3,044	**3,313**	2,953	**13,056**	11,788

1 The LTIP vesting at 66.3 per cent and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 19 February 2018. The total number of shares vesting were 3,035,880 and 346,087 shares delivered in respect of dividend equivalents for António Horta-Osório, 1,642,361 shares vesting and 187,227 shares delivered in respect of dividend equivalents for George Culmer and 1,619,551 shares vesting and 184,627 shares delivered in respect of dividend equivalents for Juan Colombás. The average share price between 1 October 2017 and 31 December 2017 (66.75 pence) has been used to indicate the value. The shares were awarded in 2015 based on a share price of 79.93 pence. LTIP and dividend equivalent figures for 2016 have been adjusted to reflect the share price on the date of vesting (67.51 pence) instead of the average price (58.30 pence) reported in the 2016 report.

2 Other remuneration payments comprise income from all employee share plans, which arises through employer matching or discounting of employee purchases.

Pension and benefits (audited)

Pension/Benefits £	**António Horta-Osório**	**George Culmer**	**Juan Colombás**
Cash allowance in lieu of pension contribution	**565,000**	**190,081**	**188,364**
Car or car allowance	**12,000**	**15,313**	**12,000**

Flexible benefits payments	**45,000**	**29,964**	**29,547**
Private medical insurance	**35,167**	**760**	**15,985**
Tax preparation	**24,000**	**–**	**10,680**
Transportation	**39,389**	**–**	**2,649**

Defined benefit pension arrangements (audited)

António Horta-Osório has a conditional unfunded pension commitment, subject to share price performance. This was a partial buy-out of a pension forfeited on joining from Santander Group. It is an Employer-Financed Retirement Benefits Scheme (EFRBS). The EFRBS provides benefits on a defined benefit basis at a normal retirement age of 65. The benefit in the EFRBS accrued during the six years following commencement of employment, therefore ceasing to accrue as of 31 December 2016.

The EFRBS was subject to performance conditions. It provides a percentage of the GCE's base salary or reference salary in the 12 months before retirement or leaving. No additional benefit is due in the event of early retirement. The rate of pension accrued in each year depended on share price conditions being met and the total pension due is 6 per cent of the reference salary of £1,220,000 or £73,200.

There are no other Executive Directors with defined benefit pension entitlements.

Under terms agreed when joining the Group, Juan Colombás is entitled to a conditional lump sum benefit of £718,996 either (i) on reaching normal retirement age of 65 unless he voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death.

COMPENSATION

Executive Directors' Group Performance Share outcome for 2017 (audited)

The annual Group Performance Share (GPS) outcome is based on a percentage of the Group's underlying profit, adjusted by a strategic modifier based on the Group's Balanced Scorecard (BSC) metrics and collective and discretionary adjustments to reflect risk matters and other factors.

The Committee determined that the GPS outcome would be £414.7 million, based on the following performance outcomes.

1 Excludes MBNA.

2 The underlying profit of £8,493 million has been adjusted by the £74 million incremental difference between the Prudential Value Adjustment (PVA) at year-end 2016 to year-end 2017, in line with regulatory requirements.

3 The underlying profit of £7,867 million has been adjusted (reduced) by the £126 million incremental difference between the PVA at year-end 2015 to year-end 2016.

The Committee determined that the share of underlying profit should be 5.1 per cent. In reaching this decision, the Committee took into account the Group's actual performance against budget where outperformance was 8.2 per cent and distributions to shareholders which have increased by 46.9 per cent. Due consideration was also given to market levels of variable remuneration on both an individual basis and for the total GPS outcome overall.

Group Balanced Scorecard modifier

A balanced scorecard approach with clearly identified performance descriptors is used to assess Group performance in key areas. Stretching objectives for each division and function were approved by the Committee around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: customer, people, control environment, building the business and finance.

The Balanced Scorecard (BSC) is not intended to be a purely mechanical approach to performance assessment, but designed to support the Committee in exercising judgement. It was noted that while there were a diverse range of outcomes, on balance despite challenging economic and external market conditions, the Group had delivered outperformance against 10 of the 20 BSC metrics, with only two falling below the target level; the progress on the creation of the non ring-fenced bank and return on required equity. The Committee discussed a number of key performance factors, noting in particular the Group's outperformance in customer complaints management, colleague engagement despite the significant structural changes during 2017, and strong balance sheet management and capital generation.

The Committee approved the final Group BSC performance outcome at Strong Plus (as detailed in table 'Group Balanced Scorecard performance' on page 123), with the view that while the mechanical BSC assessment was marginal in some areas, on balance there were other qualitative factors that provided the Committee with assurance that the recommendation was fair and justified. Key factors were: the Group's return to full private ownership; significant additional cost reductions; the completion of the successful acquisition of MBNA; and continued focus on commitments to the UK economy through the Helping Britain Prosper strategy.

Under	**Developing**	**Good**	**Strong**	**Strong Plus**	**Top**
0	**0.55**	**1.00**	**1.15**	**1.20**	**1.30**

Collective performance adjustment

Consideration was given to items not factored into the Group underlying profit or the Group BSC. The Committee considered adjustments reflecting 2017 conduct-related provisions, including the additional PPI provision and other non-PPI provisions. In arriving at the adjustment, the Committee considered factors such as customer impact and reputation.

As a result of these items, the Committee approved an overall collective adjustment of £109.6 million (or approximately 21 per cent of the modified GPS outcome) which reduced the total GPS outcome.

COMPENSATION

Group Balanced Scorecard performance

Performance range/outcome2 Objective Measure Under Top **Customer** Creating the best customer experience Customer dashboard The Group has performed below expectations in terms of customer perception of brand, service, products and complaints. The Group has exceeded expectations in terms of customer perception of brand, service, products and complaints. Best customer experience: end-to-end customer journeys The Group has not improved the operation and/or service of its key customer journeys. The Group has significantly improved the operation or service of its key customer journeys. Reportable complaints Total FCA complaints per '000 3.24 > 4.95 ≤ 3.09 Formally closed FCA complaints per '000 0.52 > 0.71 ≤ 0.50 FOS uphold rate (ex PPI) 15% > 30% ≤ 25% **People** Best team: engaged and customer focused colleagues Culture – Best Bank for Customers Index scores 80 ≤ 68 ≥ 84 People colleague engagement – EEI 76 ≤ 57 ≥ 73 People colleague engagement – PEI 83 ≤ 60 ≥ 81 Inclusion & Diversity – F+ Females 34 < 32.4% > 34.3% **Control environment** Maintain a strong control, governance and compliance structure in line with the Risk Management Framework Board risk appetite The Group has not managed its key risk measures to ensure the safe guarding of the Group. The Group has strongly managed its key risk measures to ensure the safe guarding of the Group. Regulatory management The regulatory bodies (FCA and PRA) are concerned about the Group's approach to regulatory matters. The regulatory bodies (FCA and PRA) are comfortable with the Group's approach to regulatory matters and recognise this as an area of strength. **Building the business** Actively manage key stakeholders Simpler and more efficient: Simplification savings The Group has not managed to improve its operational and strategic processes through simplification initiatives and delivered below target savings. The Group has successfully managed to improve its operations and strategic processes through simplification initiatives and delivered above target savings. Best customer experience: Digital active customer growth 13.44m < 13.26m ≥ 13.38m Reputation with external stakeholders – composite (excluding regulators) Poor relationships with key external stakeholders. Strong relationships with key external stakeholders. Deliver Helping Britain Prosper Plan targets (Group) < 50% of Helping Britain Prosper Plan metrics are Green 90%+ of Helping Britain Prosper Plan metrics are Green and none of the Helping Britain Prosper metrics are Red. Establishment of the non ring-fenced bank Key mobilisation milestones are not on track for the separation of the commercial and personal banking customers in line with the regulatory non ring-fenced Bank requirements. Key mobilisation milestones are ahead of schedule and comfortably on track for the separation of the commercial and personal banking customers in line with the regulatory non ring-fenced Bank requirements. Finance Maintain prudent reserves to withstand unexpected shocks Cost:income ratio (Group)1 47.3% Strong > 49.8% < 47.3% Underlying profit before tax (Group)1 8,298m < 7,061m > 8,238m Total return on required equity (Group) 8.1% < 7.0% > 10.5% Underlying Common Equity Tier 1 generation (Group) 245bps < 140bps > 200bps PRA stress test (Group) Failed the annual Prudential Regulation Authority (PRA) stress test due to the Group's capital position and negative feedback on quality of submissions and ranked significantly below peers. Passed the annual Prudential Regulation Authority (PRA) stress test with a strong capital position and very positive feedback on quality of submissions and ranked highly against peers.

1 Excludes MBNA.

2 Where the performance assessment is qualitative the position against threshold and maximum (Under and Top) is shown. Where internal dashboards are used in reaching the assessment of performance, the Committee is provided

with underlying data points and additional commentary to inform its judgement.

COMPENSATION

The individual GPS awards for Executive Directors are determined in the same way as for colleagues across the Group, based on individual performance and the level of GPS outcome determined by the Committee following consideration of the factors set out on pages 122–123. Individual performance is assessed on the basis of 'whole job' contribution, both 'what' has been achieved against BSC objectives, role requirements and personal objectives and 'how' it has been delivered. Judgement is applied in reaching the overall assessment. Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

In reaching their decision on individual awards for Executive Directors, the Committee considered formulaic payout ranges set around the expected outcome for each performance rating, based on a percentage of base salary (see graphs below for each Executive Director). The percentage of base salary applied within the relevant range was determined by reference to the individual performance rating for each Executive Director.

António
Horta-Osório
Group Chief
Executive
(GCE)

The GCE's individual performance assessment for 2017 reflected the Group's objectives, assessed as Strong Plus as outlined on page 123 and a number of other considerations, including:

Successful delivery of the second Group Strategic Review, with improved customer service, market leading digital proposition, targeted lending growth and simplification savings ahead of target. Completed acquisition of MBNA's prime credit card business.

Next phase of strategy defined to further transform the business for success in a digital world and deliver additional sources of competitive advantage, positioning the Group well to meet changing customer needs.

Restructured the business and reorganised the team ready for the next stage of the Group's strategic journey.

Continued strong underlying financial performance with continued improvement in profit (£8.5 billion, up 8 per cent) and returns (RoTE of 15.6 per cent). Market leading cost:income ratio improving to 46.8 per cent.

Credit and asset quality remain strong. CET1 ratio of 15.5 per cent pre capital return comfortably above requirements. Moody's upgraded Lloyds Bank's credit rating to Aa3 and S&P improved outlook to 'positive'.

Increase in ordinary dividend to 3.05 pence per share (2016: 2.55 pence plus special dividend

0.5 pence per share), in line with the Group's progressive and sustainable dividend policy, with a share buyback of up to £1 billion.

Employee engagement survey results further strengthened, exceeding UK high-performing benchmarks.

Expansion of enhancement to key customer journeys leading to improved customer feedback and trust scores. Total complaints reduced by 18 per cent.

Largest digital bank in the UK, with over 13.4 million digitally active customers, providing best-in-class customer experience (number 1 rated mobile app since 2015).

Significant progress made against Helping Britain Prosper targets with more than £47 billion of lending to first-time buyers since 2014, and 15 per cent increase in lending to SMEs since 2014 (versus market increasing by only 1 per cent). Over 700,000 individuals, businesses and charities trained in digital skills.

Successful return of the Group to full private ownership, repaying the taxpayer £20.3 billion plus an additional £900 million.

BSC category	**Rating**
Customer	**Strong+**
People	**Strong+**
Control environment	**Strong+**
Building the business	**Strong**
Finance	**Strong**

The individual rating of Strong Plus results in a GPS award of £1,322,520 (108 per cent of salary and 77 per cent of maximum).

George Culmer
Chief Financial Officer (CFO)

The CFO's individual performance assessment for 2017 reflected the Finance division's objectives. During 2017, the Group undertook a significant structural change with the responsibility for Legal and Strategy transferring to the CFO from September 2017. The individual performance assessment of the CFO was Strong Plus for full year 2017, informed by the rating for the Finance, Legal and Strategy division at Q4 2017 and a number of other considerations, including:

Strong financial performance delivered in challenging environment with low interest rates and Brexit uncertainty creating downward pressure on the UK economy. Improvements in profit and returns.

Continued improvement in the Group's market leading cost:income ratio to 46.8 per cent (2016: 48.7 per cent). CET1 capital generation of 245 basis points, with CET1 ratio of 15.5 per cent pre capital return, 14.4 per cent pre-buyback, comfortably above requirements.

Continued to build strong relationships with key external stakeholders, including debt and equity investors, regulators, and credit rating agencies.

Effectively managed development of the next phase of the Group's strategy whilst successfully completing delivery of the second Group Strategic Review.

Established the new Finance, Legal and Strategy division effectively, with excellent employee engagement scores and retention of talent.

BSC category	**Rating**
Customer	Strong+
People	Strong
Control environment	Strong+
Building the business	Strong–
Finance	Strong–

The individual rating of Strong Plus results in a GPS award of £599,000 (78 per cent of maximum).

COMPENSATION

Juan Colombás
Chief Operating Officer (COO) (formerly Chief Risk Officer)

The COO's individual performance assessment for 2017 reflected the Risk division's objectives and the newly created Chief Operating Office from September 2017. The individual performance assessment of the COO was Strong Plus for full year 2017, informed by the rating for the Risk division at Q3 2017 and a number of other considerations, including:

The Group continues to remain comfortably within the risk appetite set by the Board. Continued to drive a prudent risk culture and control framework to ensure low risk model maintained, positioning the Group well for market developments and uncertainties. Moody's upgraded Lloyds Bank's credit rating to Aa3 and S&P improved outlook to 'positive'.

Further strengthening of operational risk management through enhanced reporting framework. Material reductions in operational losses and events.
Support to the business in development of frameworks and controls to mitigate emerging and evolving risks, such as cyber risks.

Development and maintenance of a high cadre of risk professionals, with employee engagement scores above the high performing norms and strong retention of talent.

Fully supported successful transition to revised Group organisation structure and mobilisation of the new Chief Operating Office function.

Effective implementation of the supporting infrastructure required to drive the transformation activities across the Group to build Bank of the Future.

BSC category	**Rating**
Customer	**Good**
People	**Strong-**
Control environment	**Strong+**
Building the business	**Good+**
Finance	**Top**

The individual rating of Strong Plus results in a GPS award of £599,000 (80 per cent of maximum).

Deferral

The 2017 GPS for all Executive Directors is awarded in a combination of cash and shares. 40 per cent of the GPS will be released in 2018 (£2,000 cash in March, the remainder in shares), 40 per cent will be released in 2019 and the remaining 20 per cent will be released in 2020, subject to remaining in the Group's employment. Any shares released are subject to a further holding period in line with regulatory requirements.

The Group's malus and clawback provisions cover all material risk takers, in line with regulatory requirements. Vested variable remuneration can be recovered from employees for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation. The Committee reserves the right to exercise its discretion in reducing any payment to be made, if it deems appropriate as a result of a risk matter coming to light before vesting.

2015 LTIP vesting (audited)

Awards in the form of conditional rights to free shares in 2015 were made over shares with a value of 300 per cent of reference salary for the GCE and 275 per cent of salary for the CFO and CRO (now COO). These LTIP awards are vesting at 66.3 per cent, as detailed in the table below. This reflects the Group's strong performance over the three financial years ended 31 December 2017, balanced against uncertainty in the economic and political environment. In particular, this has impacted negatively on absolute share price performance, resulting in no vesting for the Total Shareholder Return component. Executive Directors are required to retain any vested shares for a further two years after vesting.

Weighting	Measure	Threshold	Maximum	**Actual**	**Vesting**
30%	Absolute total shareholder return (TSR)	8% p.a.	16% p.a.	**(1.7%)**	**0%**
25%	Economic profit	£2,870m	£3,587m	**£3,987m**	**25%**
10%	Cost:income ratio[1]	45.6%	44.5%	**44.9%**	**6.3%**
10%	Customer complaint handling[2] (FCA reportable complaints/FOS uphold rate)	0.79 =<32%	0.73 =<28%	**0.53** **15%**	**10%**
10%	Net promoter score	3rd	1st	**1st**	**10%**
7.5%	Digital active customer base	12.7m	13.3m	**13.4m**	**7.5%**
7.5%	Colleague engagement score	62	70	**76**	**7.5%**
			LTIP (% maximum) vesting 66.3%		

1 Adjusted total costs.

2 The FCA changed the approach to complaint classification and reporting from 30 June 2016. The Committee determined that the original target should be translated on a like-for-like basis into the new reporting requirement. The Committee was satisfied that the revised targets, set on a mechanical basis, were no less stretching.

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Percentage change in remuneration levels

Figures for 'All employees' are calculated using figures for UK-based colleagues subject to the GPS plan. This population is considered to be the most appropriate group of employees for these purposes because its remuneration structure is consistent with that of the GCE. For 2017, 45,696 colleagues were included in this category.

	% change in base salary (2016 – 2017)	**% change in GPS (2016 – 2017)**	**% change in benefits (2016 – 2017)**
GCE (salary increase effective 1 January 2018)	2	8.4[1]	8.7
All employees	2.7[2]	2[2,3]	2.7[2]

1 Reflects the increase in base salary from 1 January 2017 against which the award is determined.

2 Adjusted for movements in staff numbers and other impacts to ensure a like-for-like comparison. Salary increases effective 1 April 2018.

3 Average awards for colleagues participating in the Group annual GPS increased by 9.3 per cent.

Relative importance of spend on pay (£m)	**Dividend and share buyback[1]** £m	**Salaries and performance-based compensation[2]** £m
The graphs illustrate the total remuneration of all Group employees compared with distributions to shareholders in the form of dividends and share buyback.	1 2017: Ordinary dividend in respect of the financial year ended 31 December 2017, partly paid in 2017 and partly to be paid in 2018 and intended share buyback. 2016: Ordinary and special dividend in respect of the financial year ended 31 December 2016, partly paid in 2016 and partly paid in 2017.	2 In addition to the annual bonus of £414.7 million awarded in respect of 2017 performance, the Group made Group Ownership Share awards of £46.7 million and paid approximately £64.1 million under variable pay arrangements used to incentivise customer-facing colleagues, primarily in the Community Banking and Commercial Banking divisions.

Loss of office payments and payments within the reporting year to past Directors (audited)

There were no payments for the loss of office or any other payments made to former Directors during 2017.

External appointments

António Horta-Osório – During the year ended 31 December 2017, the GCE served as a Non-Executive Director of Exor, Fundação Champalimaud, Stichting INPAR and Sociedade Francisco Manuel dos Santos for which he received fees of £323,688 in total.

Chairman and Non-Executive Directors (audited)

	Fees £000		Total £000	
	2017	2016	**2017**	2016
Chairman and current Non-Executive Directors				
Lord Blackwell[1]	**728**	714	**740**	726
Alan Dickinson	**248**	195	**248**	195
Anita Frew	**364**	295	**364**	295
Simon Henry	**166**	135	**166**	135
Lord Lupton	**161**	–	**161**	–
Deborah McWhinney	**142**	135	**142**	135
Nick Prettejohn	**441**	412	**441**	412
Stuart Sinclair	**152**	135	**152**	135
Sara Weller	**190**	171	**190**	171
Former Non-Executive Directors				
Dyfrig John (retired May 2016)	**–**	49	**–**	49
Anthony Watson (retired May 2017)	**91**	230	**91**	230
Nick Luff (retired May 2017)	**69**	165	**69**	165
Total	**2,752**	2,636	**2,764**	2,648

1 Benefits: car allowance (£12,000).

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Comparison of returns to shareholders and GCE total remuneration

The chart below shows the historical total shareholder return (TSR) of Lloyds Banking Group plc compared with the FTSE 100 as required by the regulations. The FTSE 100 index has been chosen as it is a widely recognised equity index of which Lloyds Banking Group plc has been a constituent throughout this period.

TSR indices – Lloyds Banking Group and FTSE 100

GCE	Dec 2008	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Dec 2013	Dec 2014	Dec 2015	Dec 2016	Dec 2017
GCE single figure of remuneration £000										
J E Daniels		1,121	2,572	855	–	–	–	–	–	–
António Horta-Osório		–	–	1,765	3,398	7,475	11,540	8,704	5,791	6,422
Annual bonus/GPS payout (% of maximum opportunity)										
J E Daniels		Waived	62%	0%	–	–	–	–	–	–
António Horta-Osório		–	–	Waived	62%	71%	54%	57%	77%	77%
Long-term incentive vesting (% of maximum opportunity)										
J E Daniels		0%	0%	0%	–	–	–	–	–	–
António Horta-Osório		–	–	0%	0%	54%	97%	94.18%	55%	66.3%

Notes: J E Daniels served as GCE until 28 February 2011; António Horta-Osório was appointed GCE from 1 March 2011. J E Daniels declined to take a bonus in 2009 and António Horta-Osório declined to take a bonus in 2011.

Directors' share interests and share awards

Directors' interests (audited)

	Number of shares	Number of options	Total shareholding[1]	Value

	Owned outright	Unvested subject to continued employment	Unvested subject to performance	Unvested subject to continued employment	Vested unexercised	Totals at 31 December 2017	Totals at 23 February 2018	Expected value at 31 December 2017 (£000s)[2]
Executive Directors								
António Horta-Osório	**21,611,593**	**3,228,463**	**14,912,901**	**51,277**	**–**	**39,804,234**	**39,804,808[6]**	**22,015**
George Culmer	**12,620,524**	**1,133,621**	**8,238,141**	**29,549**	**–**	**22,021,835**	**22,022,336[6]**	**12,184**
Juan Colombás	**7,937,630**	**1,127,750**	**8,123,722**	**29,109**	**–**	**17,218,211**	**17,218,711[6]**	**8,954**
Non-Executive Directors								
Lord Blackwell	**100,000**	**–**	**–**	**–**	**–**	**100,000**	**n/a[6]**	**n/a**
Alan Dickinson	**200,000**	**–**	**–**	**–**	**–**	**200,000**	**n/a[6]**	**n/a**
Anita Frew	**450,000**	**–**	**–**	**–**	**–**	**450,000**	**n/a[6]**	**n/a**
Simon Henry	**200,000**	**–**	**–**	**–**	**–**	**200,000**	**n/a[6]**	**n/a**
Nick Luff[4]	**400,000**	**–**	**–**	**–**	**–**	**400,000**	**n/a[6]**	**n/a**
Lord Lupton	**550,000**	**–**	**–**	**–**	**–**	**550,000**	**n/a[6]**	**n/a**
Deborah McWhinney[3]	**250,000**	**–**	**–**	**–**	**–**	**250,000**	**n/a[6]**	**n/a**
Nick Prettejohn[5]	**69,280**	**–**	**–**	**–**	**–**	**69,280**	**n/a[6]**	**n/a**
Stuart Sinclair	**–**	**–**	**–**	**–**	**–**	**–**	**n/a[6]**	**n/a**
Anthony Watson[4]	**576,357**	**–**	**–**	**–**	**–**	**576,357**	**n/a[6]**	**n/a**
Sara Weller	**340,000**	**–**	**–**	**–**	**–**	**340,000**	**n/a[6]**	**n/a**

1 Including holdings of connected persons.

2 Awards subject to performance under the LTIP had an expected value of 50 per cent of face value at grant (in line with the Remuneration Policy). Values are based on the 31 December 2017 closing price of 68.06 pence. Full face value of awards are £27,090,761 for António Horta-Osório, £14,988,060 for George Culmer and £11,718,714 for Juan Colombás.

3 Shareholdings held by Deborah McWhinney are either wholly or partially in the form of ADRs.

4 Shares held as at date of resignation/retirement.

5 In addition, Nick Prettejohn held 400 6.475% preference shares at 1 January 2017 and 31 December 2017.

6 The changes in beneficial interests for António Horta-Osório (574 shares), George Culmer (501 shares) and Juan Colombás (500 shares) relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2017 and 23 February 2018. There have been no other changes up to 23 February 2018.

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Shareholding requirement (audited)

From 1 January 2017 the shareholding requirement has been focused on base salary only (previously: base salary plus fixed share award) to provide greater transparency in the measurement of the shareholding requirements. This resulted in an increase in the percentage required as a multiple of salary. The new requirements are 350 per cent of base salary for the GCE and 250 per cent of base salary for the other Executive Directors.

In addition to the Group's shareholding requirements, shares vesting are subject to holding periods, in line with regulatory requirements.

António Horta-Osório	Shareholding requirement
	Actual shareholding[1]
George Culmer	Shareholding requirement
	Actual shareholding[1]
Juan Colombás	Shareholding requirement
	Actual shareholding[1]

1 Calculated using the average share price for the period 1 January 2017 to 31 December 2017 (66.85 pence). Includes shares owned outright reduced by forfeitable 'matching' shares under the Share Incentive Plan.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

Outstanding share plan interests (audited)

	At 1 January 2017	Granted/ awarded	Dividends awarded	Vested / released / exercised	Lapsed	**At 31 December 2017**	Exercise price	**Exercise periods** From	To	Notes
António Horta-Osório										
LTIP 2014-2016	**4,640,077**	–	164,563	2,552,042	2,088,035	**–**				1, 2, 3
LTIP 2015-2017	**4,579,006**	–	–	–	–	**4,579,006**				3

LTIP 2016-2018	**5,015,210**	–	–	–	–	**5,015,210**				3
GOS 2017-2019		5,318,685	–	–	–	**5,318,685**				3, 4
Deferred GPS awarded in 2017		1,417,778	–	354,443	–	**1,063,335**				5
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave	**14,554**	–	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	
2017 Sharesave		21,728	–	–	–	**21,728**	51.03p	01/01/2021	30/06/2021	6
George Culmer										
LTIP 2014-2016	**2,510,205**	–	89,026	1,380,612	1,129,593	**–**				1, 2, 3
LTIP 2015-2017	**2,477,167**	–	–	–	–	**2,477,167**				3
LTIP 2016-2018	**2,767,409**	–	–	–	–	**2,767,409**				3
GOS 2017-2019		2,993,565	–	–	–	**2,993,565**				3, 4
Deferred GPS awarded in 2017		667,685	–	166,920	–	**500,765**				5
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave	**14,554**	–	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	
Juan Colombás										
LTIP 2014-2016	**2,234,780**	–	79,257	1,229,129	1,005,651	**–**				1, 2, 3
LTIP 2015-2017	**2,442,762**	–	–	–	–	**2,442,762**				3
LTIP 2016-2018	**2,728,973**	–	–	–	–	**2,728,973**				3
GOS 2017-2019		2,951,987	–	–	–	**2,951,987**				3, 4
Deferred GPS awarded in 2017		671,579	–	167,894	–	**503,685**				5
2016 Sharesave	**29,109**	–	–	–	–	**29,109**	47.49p	01/01/2020	30/06/2020	

1 The shares awarded in March 2014 vested on 6 March 2017. The closing market price of the Group's ordinary shares on that date was 67.51 pence. Shares vested are subject to a further two-year holding period.

2 2014 LTIP award was eligible to receive an amount equal in value to any dividends paid during the performance period. Dividend equivalents have been paid based on the number of shares vested and have been paid in shares. The

dividend equivalent shares were paid on 6 March 2017. The closing market price of the Group's ordinary shares on that date was 67.51 pence. The dividend equivalent shares are not subject to any holding period.

3 All LTIPs have performance periods ending 31 December at the end of the three-year period. Awards were made in the form of conditional rights to free shares.

4 Awards (in the form of conditional rights to free shares) in 2017 were made over shares with a value of 300 per cent of reference salary for António Horta-Osório (5,318,685 shares with a face value of £3,660,000); 275 per cent for George Culmer (2,993,565 shares with a face value of £2,059,992); and 275 per cent for Juan Colombás (2,951,987 shares with a face value of £2,031,381). The share price used to calculate face value is the average price over the five days prior to grant (27 February to 3 March 2017), which was 68.814 pence. This was the average share price used to determine the number of shares awarded. Performance conditions for this award are set out in the table below.

5 GPS is deferred into shares. The face value of the share awards in respect of GPS granted in March 2017 was £975,630 (1,417,778 shares) for António Horta-Osório; £459,461 (667,685 shares) for George Culmer; and £462,141 (671,579 shares) for Juan Colombás. The share price used to calculate the face value is the average price over the five days prior to grant (27 February to 3 March 2017), which was 68.814 pence.

6 Sharesave options granted on 29 September 2017.

COMPENSATION

2017 GOS performance measures

Strategic priorities	Measure	Basis of payout range	Metric	Weighting
Creating the best customer experience	FCA total reportable complaints and Financial Ombudsman Service (FOS) uphold rate (excluding PPI)	Set relative to 2019 targets	Threshold: 3.52 complaints per 1,000 accounts Maximum: 3.18 complaints per 1,000 accounts	10%
		Average rate over 2019	Threshold: =<29% Maximum: =<25%	
	Net promoter score	Major Group average ranking over 2019	Threshold: 3rd Maximum: 1st	10%
	Digital active customer base	Set relative to 2019 targets	Threshold: 14.3m Maximum: 14.9m	7.5%
Becoming simpler and more efficient	Economic profit[1]	Set relative to 2019 targets	Threshold: £3,074m Maximum: £3,769m	25%
	Cost:income ratio	Set relative to 2019 targets	Threshold: 47.2% Maximum: 45.7%	10%
Delivering sustainable growth	Absolute total shareholder return (TSR)	Growth in share price including dividends over 3-year period	Threshold: 8% p.a. Maximum: 16% p.a.	30%
Building the best team	Employee engagement index	Set relative to 2019 targets	Threshold: 67 Maximum: 73	7.5%

1 A measure of profit taking into account Expected Losses, tax and a charge for equity utilisation.

None of the other Directors at 31 December 2017 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

Implementation of the policy in 2018

It is proposed to operate the policy in the following way in 2018:

1**Base salary**

The Group has applied a total pay budget of 2.7 per cent including additional funding to ensure a minimum pay award of £600 for eligible colleagues. Salary increases for the Group Chief Executive (GCE) and the Chief Financial Officer (CFO) are set below the budget for the wider colleague population, at 2 per cent. Juan Colombás took on a new role of

Chief Operating Officer (COO) in September 2017 and accordingly it is proposed he receive a salary increase of 3.4 per cent to reflect the fact that the COO role is larger than his previous role as the Chief Risk Officer.

Salaries will therefore be as follows:

GCE: £1,244,400 (1 January 2018)

CFO: £779,351 (1 April 2018)

COO: £779,351 (1 January 2018)

l**Fixed share award**

The levels of the 2018 award are unchanged from 2017:

GCE: £900,000

CFO: £504,000

COO: £497,000

Shares will be released in equal tranches over a five year period.

l**Pension**

The level of pension allowances is unchanged from 2017:

GCE: 50 per cent of base salary less flexible benefits allowance

CFO: 25 per cent of base salary

COO: 25 per cent of base salary

l**Benefits**

For 2018, the benefits provided to Executive Directors include a car allowance, transportation, private medical insurance, life assurance and other benefits selected through the flexible benefits allowance which is currently capped at 4 per cent of base salary (unchanged from 2017).

l**Group Performance Share plan**

The maximum Group Performance Share opportunity will be unchanged from 2017 at 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors. The threshold is set at 20 per cent below the Group's underlying profit target.

For 2018, the Group Performance Share will be based on a percentage of the Group's underlying profit, adjusted by a strategic modifier of up to 130 per cent based on the Group's Balanced Scorecard (BSC) metrics and collective and discretionary adjustments to reflect risk matters and other factors. At least 75 per cent of performance is weighted towards a financial measure.

Individual awards will be adjusted to reflect a balanced scorecard approach with clearly identified performance metrics used to assess Group performance in key areas. Stretching objectives for the Group are approved around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: Customer, People, Control environment, Building the business and Finance. Each measure in the Group BSC is assigned targets aligned to a five-point rating scale. BSC ratings are based on a scale ranging from 'Under' (at the lowest level), through 'Developing', 'Good', 'Strong' and up to 'Top'. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'.

The Committee considers the targets that apply to these measures to be commercially sensitive but will provide information on the level of payout relative to the performance achieved in next year's annual report on remuneration.

The Committee applies its judgement to determine the payout level commensurate with Group, business and/or individual performance.

For the 2018 performance year, the Group Performance Share opportunity will be awarded in March 2019 in a combination of cash (up to 50 per cent) and shares. 40 per cent will be released in the first year following award, 40 per cent will be released in the second year and the remaining 20 per cent will be released in the third year. Any shares released are subject to a further 12-month holding period in line with regulatory requirements.

The Committee may consider the application of malus and clawback as outlined in the performance adjustment section below.

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l**Group Ownership Share plan**

The maximum Group Ownership Share award for Executive Directors is 300 per cent of salary (unchanged from 2017).

Awards in 2018 are being made as follows:

GCE: 300 per cent of base salary

CFO: 275 per cent of base salary

COO: 275 per cent of base salary

As regulations prohibit the payment of dividend equivalents on awards in 2018 and subsequent years, the number of shares subject to the award has been determined by applying a discount factor to the share price on grant, as previously disclosed. The Committee approved an adjustment of 25 per cent for colleagues who are senior managers, including the Executive Directors.

Awards will be subject to a three-year performance period with vesting between the third and seventh anniversary of award, on a pro-rata basis. Any shares released are subject to a further holding period in line with regulatory requirements and market practice.

Awards made in 2018 will vest based on the Group's performance against the financial and strategic measures, set out in the table below. In line with the Directors' remuneration policy, the Committee has full discretion

to amend payout levels should the award not reflect business and/or individual performance. Business performance includes, but is not limited to, consideration of returns to shareholders.

In line with shareholder views, changes to strategic measures have been minimised to provide consistency with the 2017 plan, while aligning to the key strategic priorities as set out in the third Group Strategic Review. A new measure is proposed for the 2018 plan. The new measure will be Digital Net Promoter Score, to ensure that there is focus on maintaining customer satisfaction and quality of service. To provide alignment to the 2016 and 2017 plans, the Committee will also take into account other factors, for example the number of digitally active customers, when making its overall assessment of performance. Economic profit has been based on statutory profit after tax, not underlying profit, to align more closely with shareholder experience, while maintaining focus on capital efficiency. The targets for this revised measure are considered stretching. For reference, the equivalent outcome in 2017 would be £798 million (including PPI), compared to the 2020 threshold of £2.3 billion. The cost: income ratio measure is inclusive of conduct-related provisions (excluding PPI). The Committee believes that these measures appropriately capture risk management and long-term sustainable growth, aligning management and shareholder interests.

The Committee may consider the application of malus and clawback as outlined in the performance adjustment section below.

Strategic priorities	**Measure**	**Basis of payout range**	**Metric**	**Weighting**
Creating the best Customer experience	Customer satisfaction	Major Group average ranking over 2020	Threshold: 3rd Maximum: 1st	10%
	Digital net promoter score	Set relative to 2020 targets	Threshold: 64 Maximum: 67	7.5%
	FCA total reportable complaints and Financial Ombudsman Service (FOS) uphold rate	Set relative to 2020 targets Average rates over 2020	Threshold: 2.97 Maximum: 2.69 Threshold: =<29% Maximum: =<25%	10%
Becoming simpler and more efficient	Statutory economic profit	Set relative to 2020 targets	Threshold: £2,300m Maximum: £3,451m	25%
	Cost:income ratio	Set relative to 2020 targets	Threshold: 46.4% Maximum: 43.9%	10%
Delivering sustainable growth	Absolute total shareholder return (TSR)	Growth in share price including dividends over 3-year period	Threshold: 8% p.a. Maximum: 16% p.a.	30%
Building the best team	Employee engagement index	Set relative to 2020 markets norms	Threshold: +5% vs UK Norm Maximum: +2% vs UK High Performing Norm	7.5%

ll **Performance adjustment**

Performance adjustment is determined by the Remuneration Committee and/or Board Risk Committee and may result in a reduction of up to 100 per cent of the GPS and/or GOS opportunity for the relevant period. It can be applied on a collective or individual basis. When considering collective adjustment, the Senior Independent Performance Adjustment and Conduct Committee (SIPACC) submits a report to the Remuneration Committee and Board Risk Committee regarding any adjustments required to BSCs or the overall GPS and/or GOS outcome to reflect in-year or prior year risk matters.

The application of malus will generally be considered when:

- there is reasonable evidence of employee misbehaviour or material error or that they participated in conduct which resulted in losses for the Group or failed to meet appropriate standards of fitness and propriety;
- there is material failure of risk management at a Group, business area, division and/or business unit level;
- the Committee determines that the financial results for a given year do not support the level of variable remuneration awarded; and/or
- any other circumstances where the Committee consider adjustments should be made.

Judgement on individual performance adjustment is informed by taking into account the severity of the issue, the individual's proximity to the issue and the individual's behaviour in relation to the issue. Individual adjustment may be applied through adjustments to BSC assessments and/or through reducing the GPS and/or GOS outcome.

Awards are subject to clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

The application of clawback will generally be considered when:

- there is reasonable evidence of employee misbehaviour or material error; or
- there is material failure of risk management at a Group, business area, division and/or business unit level.

COMPENSATION

Chairman and Non-Executive Director fees in 2018

The annual fee for the Chairman was increased by 2 per cent to £742,845, in line with the overall salary budget for the executive population.

The annual Non-Executive Director fees were increased by 2 per cent, in line with the base salary increase awarded to the senior management of the Group. These changes took effect from 1 January 2018.

	2018	2017
Basic Non-Executive Director fee	**£78,000**	£76,500
Deputy Chairman	**£102,000**	£100,000
Senior Independent Director	**£61,200**	£60,000
Audit Committee Chairmanship	**£71,400**	£70,000
Remuneration Committee Chairmanship	**£71,400**	£70,000
Board Risk Committee Chairmanship	**£71,400**	£70,000
Responsible Business Committee Chairmanship	**£40,800**	£40,000
Audit Committee membership	**£32,650**	£32,000
Remuneration Committee membership	**£32,650**	£32,000
Board Risk Committee membership	**£32,650**	£32,000
Responsible Business Committee membership[1]	**£15,300**	£15,000
Nomination and Governance Committee membership[2]	**£15,300**	£15,000

1 New members only.
2 Including payments to Chairmen of other Committees who are members.

Non-Executive Directors may receive more than one of the above fees.

Additional disclosures

Total remuneration of the eight highest paid senior executives[1]

The following table sets out the total remuneration of the eight highest paid senior executives (excluding Executive Directors) in respect of the 2017 performance year.

	Executive							
	8	**7**	**6**	**5**	**4**	**3**	**2**	**1**
	£000	**£000**	**£000**	**£000**	**£000**	**£000**	**£000**	**£000**
Fixed								
Cash-based	601	498	569	617	635	490	709	815
Share-based	406	100	162	422	422	810	466	500
Total fixed	1,007	598	731	1,039	1,057	1,300	1,175	1,315
Variable								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	0	0	0	0	0	0	0	0
Upfront shares	128	604	204	275	200	642	221	202
Deferred shares	195	172	309	416	303	276	335	305
Long-term incentive plan	185	247	401	157	404	524	984	1,113
Total variable pay	510	1,025	916	850	909	1,444	1,542	1,622
Pension cost[2]	160	100	125	154	167	98	177	196
Total remuneration	1,677	1,723	1,772	2,043	2,133	2,842	2,894	3,133

1 Includes members of the Group Executive Committee and Senior Executive level colleagues, employed by the Group as at 31 December 2017 (excluding colleagues on garden leave or subject to notice of termination).

2 Pension costs based on a percentage of salary according to level.

Total remuneration of employees across the Group

Total remuneration[1]	**Number of employees**
£0 to £100,000	68,299
£100,001 to £500,000	4,762
£500,001 to £1,000,000	102
Above £1,000,000	24

1 Total remuneration of UK-based colleagues. Includes base salary, bonus awards for the 2017 performance year, the estimated values of LTIP, pension and benefits.

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COMPENSATION

Remuneration Committee

Committee composition and purpose

The Committee comprises Non-Executive Directors from a wide background to provide a balanced and independent view on remuneration matters. Anthony Watson retired as an independent Non-Executive Director and as a member of the Committee on 11 May 2017. For details of full membership and attendance at meetings, please see page 141.

The purpose of the Committee is to set the remuneration for all Executive Directors and the Chairman, including pension rights and any compensation payments. It recommends and monitors the level and structure of remuneration for senior management and material risk takers. It also considers, agrees and recommends to the Board an overall remuneration policy and philosophy for the Group that is aligned with its long-term business strategy, its business objectives, its risk appetite, values and the long-term interests of the Group that recognises the interests of relevant stakeholders.

Annual effectiveness review

During 2017, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

How the Remuneration Committee spent its time in 2017

The Committee had eight scheduled meetings during 2017 to consider the following principal matters.

Committee:

– Review of committee composition

– Approval of terms of reference

– Results of the effectiveness review and suggestions for improvement

Remuneration approach and awards:

- Determination of 2016 bonus outcome
- Approval of the 2014 LTIP vesting
- Approval of the 2017 Group Performance Share plan design, methodology and performance measures
- Colleague 2017 Group Ownership Share
- Approval of the 2017 and 2018 Group Ownership Shares plan performance measures
- Incentive Plan review

Senior Executives:

- Review of performance and remuneration arrangements for Executive Directors and key senior managers
- Review and approval of material risk taker identification
- Approval of LBCM Non-Executive Fees
- Review of shareholding policy

Stakeholders:

- Feedback from the Chairman on her meeting with the PRA and shareholders
- Consideration of the BEIS Corporate Governance Report and PRA Policy and supervisory statements

Other remuneration matters:

- Approval of the 2016 Directors' Remuneration Report for publication within the annual report and Form 20-F
- Approval of the 2016 Remuneration Policy Statement
- Review of the Reward Governance Framework
- Gender pay reporting review
- Approval of the annual procedural review
- MBNA integration impacts and awards

Mercer (part of the MMC group of companies) is the appointed advisor to the Remuneration Committee. Mercer is a founding member and signatory of the Code of Conduct for Remuneration Consultants.

For more detail, please refer to the website www.remunerationconsultantsgroup.com. Mercer was appointed by the Committee in 2016 following a competitive tender process and was retained during the year. The Committee is of the view that Mercer provides independent remuneration advice to the Committee and does not have any connections with the Group that may impair its independence, and, other than advice on remuneration, no other services were provided to the Company. The broader Mercer company provides unrelated advice on accounting.

During the year, Mercer attended Committee meetings upon invitation and provided advice and support in areas such as market and best practice, regulatory and governance developments, drafting the remuneration report, and relevant comparator groups for pay and performance.

Fees payable for the provision of Remuneration Committee services in 2017 were £98,020, based on time and materials.

António Horta-Osório (Group Chief Executive), Simon Davies (Chief People, Legal and Strategy Officer) until July 2017 and Jen Tippin (Group People and Productivity Director) thereafter, Paul Hucknall (People Director, Centres of Excellence), Matt Sinnott (Group Reward Director), Chris Evans (Director, Reward Policy and Partnering), Stuart Woodward (Head of Reward Regulation and Governance) and Letitia Smith (Group Director, Conduct, Compliance & Operational Risk) provided guidance to the Committee (other than for their own remuneration).

Juan Colombás (Chief Operating Officer from September 2017 and formerly the Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk, financial and operational matters.

Statement of voting at Annual General Meeting

The table below sets out the voting outcome at the Annual General Meeting in May 2017.

	Votes cast in favour	**Votes cast against**	**Votes withheld**

	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)
Directors’ remuneration policy (binding vote)	**47,673**	**98.03%**	**959**	**1.97%**	**535**
2016 annual report on remuneration (advisory vote)	**48,113**	**97.92%**	**1,023**	**2.08%**	**31**

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COMPENSATION

DIRECTORS' REMUNERATION POLICY

The Group's remuneration policy was approved at the AGM on 11 May 2017 and took effect from that date. It is intended that approval of the remuneration policy will be sought at three-year intervals, unless amendments to the policy are required, in which case further shareholder approval will be sought; no changes are proposed for 2018. The full policy is set out in the 2016 annual report and accounts (pages 90–98) which is available at: www.lloydsbankinggroup.com/globalassets/documents/investors/2016/2016_lbg_annual_report_v2.pdf

The tables in this section provide a summary of the Directors' remuneration policy. There is no significant difference between the policy for Executive Directors and that for other colleagues.

Remuneration policy table for Executive Directors

l**Base salary**

Purpose and link to strategy

To support the recruitment and retention of Executive Directors of the calibre required to develop and deliver the Group's strategic priorities. Base salary reflects the role of the individual, taking account of market competitiveness, responsibilities and experience, and pay in the Group as a whole.

Operation

Base salaries are typically reviewed annually with any increases normally taking effect from 1 January. When determining and reviewing base salary levels, the Committee takes into account base salary increases for employees throughout the Group and ensures that decisions are made within the following two parameters:

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.

– Pay for comparable roles in comparable publicly listed financial services groups of a similar size.

Salary may be paid in sterling or other currency and at an exchange rate determined by the Committee.

Maximum potential

The Committee will make no increase which it believes is inconsistent with the two parameters above. Increases will normally be in line with the increase awarded to the overall employee population. However, a greater salary increase may be appropriate in certain circumstances, such as a new appointment made on a salary below a market competitive level, where phased increases are planned, or where there has been an increase in the responsibilities of an individual. Where increases are awarded in excess of the wider employee population, the Committee will provide an explanation in the relevant annual report on remuneration.

Performance measures

N/A

l**Fixed share award**

Purpose and link to strategy

To ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.

Operation

The fixed share award will initially be delivered entirely in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The Committee can, however, decide to deliver some or all of it in the form of cash.

Maximum potential

The maximum award is 100 per cent of base salary.

Performance measures

N/A

l**Pension**

Purpose and link to strategy

To provide cost effective and market competitive retirement benefits, supporting Executive Directors in building long-term retirement savings.

Operation

Executive Directors are entitled to participate in the Group's defined contribution scheme with company contributions set as a percentage of salary.

An individual may elect to receive some or all of their pension allowance as cash in lieu of pension contribution.

Maximum potential

The maximum allowance for the GCE is 50 per cent of base salary less any flexible benefits allowance.

The maximum allowance for other Executive Directors is 25 per cent of base salary.

All future appointments as Executive Directors will attract a maximum allowance of 25 per cent of base salary.

Performance measures

N/A

l**Benefits**

Purpose and link to strategy

To provide flexible benefits as part of a competitive remuneration package.

Operation

Benefits may include those currently provided and disclosed in the annual report on remuneration.

Core benefits include a company car or car allowance, private medical insurance, life insurance and other benefits that may be selected through the Group's flexible benefits plan.

Additional benefits may be provided to individuals in certain circumstances such as relocation. This may include benefits such as accommodation, relocation, and travel. The Committee retains the right to provide additional benefits depending on individual circumstances.

When determining and reviewing the level of benefits provided, the Committee ensures that decisions are made within the following two parameters:

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies.

– Benefits for comparable roles in comparable publicly listed financial services groups of a similar size.

Maximum potential

The Committee will make only increases in the benefits currently provided which it believes are consistent with the two parameters above. Executive Directors receive a flexible benefits allowance, in line with all other employees. The flexible benefits allowance does not currently exceed 4 per cent of base salary.

Performance measures

N/A

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l**All-employee plans**

Purpose and link to strategy

Executive Directors are eligible to participate in HMRC-approved share plans which promote share ownership by giving employees an opportunity to invest in Group shares.

Operation

Executive Directors may participate in these plans in line with HMRC guidelines currently prevailing (where relevant), on the same basis as other eligible employees.

Maximum potential

Participation levels may be increased up to HMRC limits as amended from time to time. The monthly savings limits for Save As You Earn (SAYE) is currently £500. The maximum value of shares that may be purchased under the Share Incentive Plan (SIP) in any year is currently £1,800 with a two-for-one match. Currently a three-for-two match is operated up to a maximum employee investment of £30 per month.

The maximum value of free shares that may be awarded in any year is £3,600.

Performance measures

N/A

l**Group Performance Share plan**

Purpose and link to strategy

To incentivise and reward the achievement of the Group's annual financial and strategic targets whilst supporting the delivery of long-term superior and sustainable returns.

Operation

Measures and targets are set annually and awards are determined by the Committee after the year end based on performance against the targets set. The Group Performance Share may be delivered partly in cash, shares, notes or other debt instruments including contingent convertible bonds. Where all or part of any award is deferred, the Committee may adjust these deferred awards in the event of any variation of share capital, demerger, special dividend or distribution or amend the terms of the plan in accordance with the plan rules.

Where an award or a deferred award is in shares or other share-linked instrument, the number of shares to be awarded may be calculated using a fair value or based on discount to market value, as appropriate.

The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance. The Committee may reduce the level of award (including to zero), apply additional conditions to the vesting, or delay the vesting of deferred awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of a risk matter coming to light before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

Maximum potential

The maximum Group Performance Share opportunities are 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors.

Performance measures

Measures and targets are set annually by the Committee in line with the Group's strategic business plan and further details are set out in the annual report on remuneration for the relevant year.

Measures consist of both financial and non-financial measures and the weighting of these measures will be determined annually by the Committee. The weightings of the performance measures for the 2018 financial year are set out on page 129. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance (as determined by the Committee) is not met for financial measures or the individual is rated 'Developing performer' or below. The expected value of the Group Performance Share is 30 per cent of maximum opportunity.

The Committee is committed to providing transparency in its decision making in respect of Group Performance Share awards and will disclose historic measures and target information together with information relating to how the Group has performed against those targets in the annual report on remuneration for the relevant year except to the extent that this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.

l**Group Ownership Share plan**

Purpose and link to strategy

To incentivise and reward Executive Directors and senior management to deliver against strategic objectives designed to support the long-term success of the Group and encourage working as a team. It ensures executives build an ownership interest in the Group and are motivated by delivering long-term superior and sustainable returns for shareholders.

Operation

Awards are granted under the rules of the 2016 Long-Term Incentive Plan approved at the AGM on 12 May 2016. Awards are made in the form of conditional shares or nil cost options. Award levels are set at the time of grant, in compliance with regulatory requirements, and may be subject to a discount in determining total variable remuneration under the rules set by the European Banking Authority.

The number of shares to be awarded may be calculated using a fair value or based on a discount to market value, as appropriate.

Vesting will be subject to the achievement of performance conditions measured over a period of three years, or such longer period, as determined by the Committee.

The Committee retains full discretion to amend the payout levels should the award not reflect business and/or individual performance. The Committee may reduce (including to zero) the level of the award, apply additional conditions to the vesting, or delay the vesting of awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of a risk matter coming to light before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.

Maximum potential

The maximum annual award for Executive Directors will normally be 300 per cent of salary. Under the plan rules, awards can be made up to 400 per cent of salary in exceptional circumstances.

COMPENSATION

Performance measures

Measures and targets are set by the Committee annually and are set out in the annual report on remuneration each year.

At least 60 per cent of awards are weighted towards typical market (e.g. Total Shareholder Return) and/or financial measures (e.g. economic profit), with the balance on strategic measures.

25 per cent will vest for threshold performance, 50 per cent for on-target performance and 100 per cent for maximum performance.

The measures are chosen to support the best bank for customers strategy and to align management and shareholder interests. Targets are set by the Committee to be stretching within the context of the strategic business plan. Measures are selected to balance profitability, achievement of strategic goals and to ensure the incentive does not encourage inappropriate risk-taking.

Following the end of the relevant performance period, the Committee will disclose in the annual report on remuneration for the relevant year historic measure and target information, together with how the Group has performed against those targets, unless this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.

ll **Deferral of variable remuneration and holding periods**

Operation

The Group Performance Share and Group Ownership Share plans are both considered variable remuneration for the purpose of regulatory payment and deferral requirements. The payment of variable remuneration and deferral levels are determined at the time of award and in compliance with regulatory requirements (which currently require that at least 60 per cent of total variable remuneration is deferred for seven years with pro rata vesting between the third and seventh year, and at least 50 per cent of total variable remuneration is paid in shares or other equity linked instruments subject to a holding period in line with current regulatory requirements).

A proportion of the aggregate variable remuneration may vest immediately on award. The remaining proportion of the variable remuneration is then deferred in line with regulatory requirements.

Further information on which performance measures were chosen and how performance targets are set are disclosed in the relevant sections throughout the report.

Remuneration policy table for Chairman and Non-Executive Directors

Chairman and Non-Executive Director fees

Purpose and link to strategy

To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.

Operation

The Committee is responsible for evaluating and making recommendations to the Board with regards to the Chairman's fees. The Chairman does not participate in these discussions.

The GCE and the Chairman are responsible for evaluating and making recommendations to the Board in relation to the fees of the NEDs.

When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following parameters:

– The individual's skills and experience.

– An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies.

– Fees and benefits for comparable roles in comparable publicly listed financial services groups of a similar size.

The Chairman receives an all-inclusive fee, which is reviewed periodically plus benefits including life insurance, car allowance, medical insurance and transportation. The Committee retains the right to provide additional benefits depending on individual circumstances. NEDs are paid a basic fee plus additional fees for the chairmanship/ membership of committees and for membership of Group companies/ boards/non-board level committees.

Additional fees are also paid to the senior independent director and to the deputy chairman to reflect additional responsibilities.

Any increases normally take effect from 1 January of a given year.

The Chairman and the NEDs are not entitled to receive any payment for loss of office (other than in the case of the Chairman's fees for the six month notice period) and are not entitled to participate in the Group's bonus, share plan or pension arrangements.

NEDs are reimbursed for expenses incurred in the course of their duties, such as travel and accommodation expenses, on a grossed-up basis (where applicable).

Maximum potential

The Committee will make no increase in fees or benefits currently provided which it believes is inconsistent with the parameters above.

Performance metrics

N/A

Service agreements

The service contracts of all current Executive Directors are terminable on 12 months' notice from the Group and six months' notice from the individual. The Chairman also has a letter of appointment. His engagement may be terminated on six months' notice by either the Group or him.

Letters of appointment

The Non-Executive Directors all have letters of appointment and are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Non-Executive Directors may have their appointment terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

All Directors are subject to annual re-election by shareholders.

The service contracts and letters of appointments are available for inspection at the Company's registered office.

COMPENSATION

TERMINATION PAYMENTS

It is the Group's policy that where compensation on termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured. Where it is appropriate to make a bonus payment (now known as Group Performance Share) to the individual, this should relate to the period of actual service, rather than the full notice period. Any Group Performance Share payment will be determined on the basis of performance as for all continuing employees and will remain subject to performance adjustment (malus and clawback) and deferral. Generally, on termination of employment, Group Performance Share awards, long-term incentive awards (now known as Group Ownership Share) and other rights to payments will lapse except where termination falls within one of the reasons set out below. In the event of redundancy, the individual may receive a payment in line with statutory entitlements at that time. If an Executive Director is dismissed for gross misconduct, the Executive Director will receive normal contractual entitlements until the date of termination and all deferred Group Performance Share and Group Ownership Share awards will lapse.

	Base salary	Fixed share award	Pension, benefits and other fixed remuneration
Resignation	In the case of resignation to take up new employment, paid until date of termination (including any period of leave required by the Group). In the case of resignation for other reasons, base salary will be paid in monthly instalments for the notice period (or any balance of it), offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Redundancy or termination by mutual agreement	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination unless, in the case of mutual agreement, the Committee determines that exceptional circumstances apply in which case shares may be released on termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Retirement/ill health, injury, permanent disability/death	Paid until date of retirement/death. For ill health, injury or permanent disability which results in the loss of	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be	Paid until date of death/ retirement (subject to individual benefit scheme rules). For ill health,

	employment, paid for the applicable notice period (including any period of leave required by the Group).	reduced to reflect the date of termination except for (i) death where shares are released on the date of termination; or (ii) in the case of permanent disability the Committee determines that exceptional circumstances apply, in which case shares may be released on the date of termination.	injury, permanent disability, paid for the notice period including any period of leave required by the Group (subject to individual benefit scheme rules).
Change of control or merger	N/A	Awards will be payable on the date of the Change of Control and the number of shares subject to the award will be reduced to reflect the shorter accrual period. The Committee may decide that vested awards will be exchanged for (and future awards made over) shares in the acquiring company or other relevant company.	N/A
Other reason where the Committee determines that the executive should be treated as a good leaver	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).

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COMPENSATION

	Group Performance Share(1)	Long-term incentive/Group Ownership Share(2)	Chairman and Non-Executive Director fees(3)
Resignation	Unvested deferred Group Performance Share awards are forfeited and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier), unless the Committee determines otherwise in exceptional circumstances.	Awards lapse on date of leaving (or on notice of leaving) unless the Committee determines otherwise in exceptional circumstances that they will vest on the original vesting date (or exceptionally on the date of leaving). Where award is to vest it will be subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Redundancy or termination by mutual agreement	For cases of redundancy, unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback. For termination by mutual agreement, the same approach as for resignation would apply.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Retirement/ill health, injury, permanent disability	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply	Paid until date of leaving Board.
Death	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination. Deferred Group Performance Share awards vest on death in cash, unless the Committee determines otherwise.	Awards vest on death subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will apply.	Paid until date of leaving Board.
Change of control or merger[2]	In-year Group Performance Share accrued up until date of change of control or merger (current year). Where there is a Corporate Event, deferred Group Performance Share awards vest to the extent and timing determined by the Committee in its absolute discretion.	Awards vest on date of event. Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will normally apply. Instead of vesting, awards may be exchanged for equivalent awards over	Paid until date of leaving Board.

		the shares of the acquiring company or another company.	
Other reason where the Committee determines that the executive should be treated as a good leaver	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Deferred Group Performance Share awards vest in line with normal timeframes and are subject to malus and clawback. The Committee may allow awards to vest early if it considers it appropriate.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.

1 If any Group Performance Share is to be paid to the Executive Director for the current year, this will be determined on the basis of performance for the period of actual service, rather than the full notice period (and so excluding any period of leave required by the Group).

2 Reference to change of control or merger includes a compromise or arrangement under section 899 of the Companies Act 2006 or equivalent. Fixed share awards may also be released/exchanged in the event of a resolution for the voluntary winding up of the Company; a demerger, delisting, distribution (other than an ordinary dividend) or other transaction, which, in the opinion of the Committee, might affect the current or future value of any award; or a reverse takeover, merger by way of a dual listed company or other significant corporate event, as determined by the Committee. In the event of a demerger, special dividend or other transaction which would in the Committee's opinion affect the value of awards, the Committee may allow a long-term incentive award to vest to the extent relevant performance conditions are met to that date and if the Committee so determined, on a time pro-rated basis (unless determined otherwise) to reflect the number of months of the performance period worked.

3 The Chairman is entitled to six months' notice.

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CORPORATE GOVERNANCE

STATEMENT ON US CORPORATE GOVERNANCE STANDARDS

The Board is committed to the delivery of the Group's new strategy which will transform the Group for success in a digital world. The Board's strategy is underpinned by high standards of corporate governance designed to ensure consistency and rigour in its decision making. This report explains how those standards, in particular, those laid down in the Financial Reporting Council's UK Corporate Governance Code 2016 (the UK Code), apply in practice to ensure that the Board and management work together for the long-term benefit of the Company and its shareholders. The UK Code can be accessed at www.frc.org.uk.

To assist the Board in carrying out its functions and to provide independent oversight of internal control and risk management, certain responsibilities are delegated to the Board's Committees. The Board is kept up to date on the activities of the Committees through reports from each of the Committee Chairmen. Terms of Reference for each of the Committees are available on the website at www.lloydsbankinggroup.com. Information on the membership, role and activities of the Nomination and Governance Committee, the Audit Committee, the Board Risk Committee and the Responsible Business Committee can be found on pages 153 to 163.

Further information about the work of the Remuneration Committee is included on pages 116 to 117 and 131.

As a non-US company listed on the New York Stock Exchange (NYSE) Lloyds Banking Group plc is required to disclose any significant ways in which its corporate governance practices differ from those followed by domestic US companies listed on the NYSE. As Lloyds Banking Group plc's main listing is on the London Stock Exchange, it follows the principles contained in the UK Code. The Group has complied with the provisions of the UK Code and has done so throughout 2017 regarding the provisions where the requirements are of a continuing nature. Key differences are set out below.

The NYSE corporate governance listing standards require domestic US companies to adopt and disclose corporate governance policies. For Lloyds Banking Group plc, consistent with the principles of the UK Code, the Nomination and Governance Committee sets the corporate governance principles applicable to the Company and oversees the annual evaluation of the performance of the Board, its Committees and its individual members.

Under the NYSE corporate governance listing standards, the remuneration, nomination and governance committees of domestic US companies must be comprised of entirely independent directors. However for Lloyds Banking Group plc, again consistent with the principles of the UK Code, the Remuneration Committee and the Nomination and Governance Committee include the Chairman, with all other members being independent non-executive directors.

CORPORATE GOVERNANCE

BUILDING ROBUST STAKEHOLDER RELATIONSHIPS

This report sets out our approach to governance in practice, how the Board works, how it has spent its time during the year, how it has evaluated its performance, and includes reports from each of the Board's Committees.

Good governance is vitally important as it underpins the delivery of our strategy to help Britain prosper and become the best bank for customers, colleagues and shareholders. It is essential to ensure good corporate governance and the associated values are embedded into the thinking and processes of the business, and driven by the Board.

Board changes

The Nomination and Governance Committee is responsible for reviewing the composition of the Board and its Committees and assessing whether the balance of skills, experience, knowledge and independence is appropriate to enable them to operate effectively. It went through a rigorous process leading to the appointment of Lord Lupton as a new independent Non-Executive Director with the additional role of chairing our new non ring-fenced bank. Lord Lupton joined the Board on 1 June 2017, bringing with him extensive international corporate experience (see page 114 for further details). Both Nick Luff and Anthony Watson stepped down from the Board in May 2017, having made significant contributions to the Group. As a result of the two retirements, our Deputy Chairman Anita Frew was appointed as the new Senior Independent Director, and Simon Henry succeeded Nick Luff as the Audit Committee Chairman. The names and biographies of current Directors are set out on pages 113–115. The roles and responsibilities of the Board members are set out on page 151.

The Group's strategic transformation

On 16 May 2017, the Group returned to full private ownership after the government sold its remaining stake. The sale demonstrated the successful delivery of the Group's strategy to transform itself into a simple, low risk, UK focused retail and commercial bank. Since the government first acquired shares in 2009, the Group has repaired its balance sheet, reduced its cost base, cut complexity and international exposure, built and sold TSB, and addressed legacy issues. The Group returned to profitability in 2013 and resumed paying dividends in 2014.

The sale marked the final step in the rescue and rejuvenation of Lloyds Banking Group. The combination of our strong financial performance and the progress we have made towards our strategic priorities has enabled over £21.2 billion to be returned to the government, more than repaying the amount that taxpayers invested.

However, we are not complacent. While we are proud of the progress we have made over the last few years, we recognise we now have an equally challenging task to transform Lloyds Banking Group into a bank that can deliver outstanding service for customers in the future technology environment and play our full role in helping Britain prosper. The Board has spent considerable time over the past two years working with the executive team to understand the requirements to compete successfully as the ‘Bank of the Future’, and to translate that into the new strategic plan announced with our results. The oversight of this new transformation programme, including the associated cultural changes that will be required, will be a major focus of our ongoing governance activities.

Non ring-fenced bank

One of the largest change initiatives for the Group this year is the implementation of the ring-fencing regulatory requirements which come into effect on 1 January 2019. The Group’s approach aims to minimise the impact on both colleagues and customers and for the vast majority there will be no changes. There has been significant progress during the year towards the establishment of the new non ring-fenced bank, Lloyds Bank Corporate Markets plc (‘LBCM’). The Board has played an active role in identifying and appointing members of the LBCM board, as well as helping to establish the governance framework to ensure that the framework is both fit for purpose for the new bank and complements that of the Group. An overview by the Chairman of LBCM, Lord Lupton, of the establishment and governance structures of LBCM can be found on page 143.

Board effectiveness

The Board carried out an annual evaluation of its effectiveness during the year. This was an internal evaluation overseen by the Nomination and Governance Committee. The process which was undertaken and the findings of the review are set out on pages 149–150, together with information about our progress against the 2016 review actions.

Diversity

Being able to attract, develop, fully utilise and retain top talent is highly important to us, ensuring everyone has the opportunity to progress and realise their potential. For this reason, the Group has made a commitment to be a leader in diversity, removing the barriers that stand in the way of equal opportunity.

The Board sees it as an important objective for its membership to reflect diversity in its broadest sense. A mix of different backgrounds and experience on the Board, as in the executive team, is important in providing a range of perspectives, insights and challenge needed to support good decision making.

As a Group, we have committed to maintaining at least three female Board members, and recognise the Davies/Hampton-Alexander target for FTSE companies to move towards 33 per cent female representation. We are looking to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements. The Group has also made the public commitment to increase the proportion of senior roles held by women to 40 per cent by 2020.

In addition to this, the Group recognises the importance of the diversity of colleagues, reflecting the diversity of our customers, to allow us to better understand customers' needs and create deeper relationships.

The Group's aim is to increase ethnic diversity in our workforce and unlock the potential of our ethnic minority colleagues. The Group has publicly committed to increase the proportion of senior roles held by Black, Asian and Minority Ethnic colleagues to eight per cent by 2020. This is being achieved through career development programmes, a programme of visible role models, and a focus on increasing cultural awareness to help all colleagues interact more effectively, regardless of ethnic background. Our commitment to diversity is led from the top, with Executive Committee sponsorship of the initiatives. More information on both diversity and the importance of succession planning is provided on page 155.

Development of our transformation strategy

In early 2016, following discussions with the Chairman and Board, the Group Chief Executive initiated a major exercise to explore the characteristics required to succeed as the 'Bank of the Future'. Working groups across the Group were engaged in looking forward to the likely impact of changing technology, customer needs and competition, and developing scenarios for different economic backdrops.

The emerging analysis was debated at a two day offsite session involving both the Board and Group Executive Committee in June 2016, and led to the conclusion that a major transformation would be required in evolving our customer propositions, re-engineering our core business processes to incorporate new technology, changing our ways of working and developing new skills and capabilities.

These conclusions were then developed into a programme of change initiatives which were discussed and reviewed in subsequent Board deep dive sessions and, as a whole, in the joint Board and Executive offsite meeting in June 2017.

Having agreed the key initiatives and the overall scale and pace of the transformation, the Board reviewed the more detailed plan and immediate priorities in an extended session in November 2017, placing particular emphasis on the effective management of the programme and the mitigation of potential execution risks. The final proposals were reviewed again in January and confirmed with the 2018 budget in February.

CORPORATE GOVERNANCE

OUR BOARD IN 2017

DIVERSITY, SKILLS AND COMPOSITION

Gender diversity	Skills and experience	Board tenure	Age
	(Non-Executive Directors only) Retail/Commercial Banking Financial markets/wholesale banking/corporate clients Insurance		
A. Male: 9 **B.** Female: 3	Prudential and conduct risk in financial institutions Core technology operations Government/regulatory Consumer/marketing/distribution Strategic thinking	**A.** 0-2 years: 3 **B.** 3-4 years: 4 **C.** 5-6 years: 4 **D.** 7-8 years: 1	**A.** 46-55: 3 **B.** 56-65: 8 **C.** 66-75: 1

Data as at 31 December 2017.

Board and Committee composition and attendance in 2017

Board member	Board meetings	Nomination and Governance Committee	Audit Committee	Board Risk Committee	Remuneration Committee	Responsible Business Committee
Lord Blackwell (C)	**10/10**	**8/8**	**–**	**8/8**	**7/7**	**5/5**
António Horta-Osório	**10/10**	**–**	**–**	**–**	**–**	**–**
Juan Colombás	**10/10**	**–**	**–**	**–**	**–**	**–**
George Culmer	**10/10**	**–**	**–**	**–**	**–**	**–**
Alan Dickinson	**10/10**	**8/8**	**8/8**	**8/8**	**7/7**	**–**
Anita Frew	**10/10**	**8/8**	**8/8**	**8/8**	**7/7**	**3/5**
Simon Henry	**10/10**	**–**	**8/8** [3]	**8/8**	**–**	**–**
Lord Lupton [1]	**5/5**	**–**	**4/4**	**4/4**	**–**	**–**
Nick Luff [2]	**4/5**	**4/4**	**4/4** [3]	**3/4**	**–**	**–**

Deborah McWhinney	**9/10**	**–**	**8/8**	**8/8**	**–**	**–**
Nick Prettejohn	**8/10**	**–**	**7/8**	**8/8**	**–**	**–**
Stuart Sinclair	**10/10**	**–**	**–**	**8/8**	**7/7**	**4/4** [4]
Anthony Watson [2]	**5/5**	**3/4**	**3/4**	**4/4**	**4/4**	**–**
Sara Weller	**10/10**	**4/4** [5]	**–**	**8/8**	**7/7**	**5/5**

1 Lord Lupton joined the Board and respective Committees on 1 June 2017.

2 Nick Luff and Anthony Watson retired from the Company on 10 May and 11 May respectively.

3 Simon Henry succeeded Nick Luff as Audit Committee Chairman with effect from 1 May 2017.

4 Stuart Sinclair was appointed to the Responsible Business Committee with effect from 1 April 2017.

5 Sara Weller joined the Nomination and Governance Committee on 11 May 2017.

Chairman

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CORPORATE GOVERNANCE

KEY FOCUS AREAS

The Board sets the strategy, oversees its delivery and establishes the culture, values and standards of the Group. The Board ensures that the Group manages risk effectively, monitors financial performance and reporting and ensures that appropriate and effective succession planning arrangements and remuneration policies are in place. It provides and encourages entrepreneurial leadership across the Group within this framework.

Below are details of the main topics discussed by the Board during the year.

Discussions and decisions

Regular updates	Group performance report Finance report, including budgets, forecasts and capital position Risk report Customer performance dashboard Chairman's report Reports from Committee Chairmen
Financial	2017 budget Dividend approval 5 year operating plan Draft results and presentations to analysts Funding and liquidity plans Capital plan Basel Pillar 3 disclosures Annual Report and Form 20-F
Strategy	Two strategy away days to review progress in implementing the Group's strategy 'Deep Dives' on various elements of market development and business strategy (see below) MBNA integration Consideration and approval of large transactions Cloud strategy, which supports the transformation of the Group's IT architecture
Culture and values	Helping Britain Prosper Plan Conduct, culture and values – Culture Dashboard Responsible business report
	Board effectiveness and Chairman's performance reviews

Governance and stakeholders	AGM documentation approval and subsequent voting results briefing Review and approval of the Corporate Governance Framework Review and approval of various Group policies including the Code of Responsibilities, Signing Authorities, Group Statement on Modern Slavery, and Board and GEC Members' Dealing Policy Investor relations updates Committee and meeting simplification review
Regulatory	Ring-fencing progress updates Whistleblowing updates Regulatory updates Senior Manager and Certification Regime FCA strategic review of retail banking business models
Risk management	Approval of Group risk appetite Review of Group non-traded market risk plan Cyber security briefings Review of conduct risk Review and approval of PRA and EBA stress testing results Review and approval of the Risk Management Framework

'Deep dive' sessions

The Board regularly takes the opportunity to hold 'deep dive' sessions with senior management outside formal Board meetings. The purpose of the sessions is to provide the Board with deeper insight into key areas of strategic focus, whilst providing Directors with a greater understanding and appreciation for the subject matter to help drive better quality of debate and enhance knowledge. The sessions are structured to allow plenty of opportunity for discussion and include presentations and videos.

In 2017 'deep dive' sessions were held on the following topics:

IT architecture strategy
Customer journeys
Interest only mortgages
Consumer credit
Open banking
IFRS9 implementation
Cloud strategy

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CORPORATE GOVERNANCE

GOVERNANCE IN ACTION

Overseeing strategy development

The Board held two strategy offsite meetings during the year, giving the Directors the opportunity to focus solely on strategic issues. The first of these was held in June, and concentrated on the priorities of the business and the four strategic pillars which will help the Group progress towards the 'Bank of the Future'. During the second half of the year, the priorities agreed at the first meeting were developed and the second meeting held in November provided an opportunity to discuss these further, along with financial plans.

António Horta-Osório reflected on the offsite meetings:

The Board offsite meetings are especially important in providing an opportunity to focus on strategic issues, taking a view of the longer-term outlook for the Group.

In June we debated the priorities of the business and the four strategic pillars which will help the Group progress towards the 'Bank of the Future'. It was extremely helpful to gain the input of our Board members, leveraging the broad range of experience and perspectives the Board has, resulting in a set of clear strategic priorities we will focus on.

In November the Board debated the detailed strategic priorities, associated delivery plans and financial projections. The collective experience and expertise of the Board was brought to life in challenging and scrutinising our plans ensuring we can further transform the Group and deliver sustainable value to our stakeholders over the course of the plan. The Board's focus on continuing to put the customer at the heart of everything we do, whilst recognising the increasing and critical role of technology, aligned well with the team's proposals and reinforced our aim to become the best bank for customers, colleagues and shareholders.

Integrating MBNA

In the immediate period following the Group's announcement of its milestone acquisition of MBNA in December 2016, work commenced to achieve regulatory approval from both the Competition & Markets Authority (CMA) and the Financial Conduct Authority (FCA), and also to prepare for the first day of legal ownership, known as 'Completion'. Unconditional CMA approval was achieved on 5 May 2017 and FCA approval of the Group's Change in Control application was received on 19 May 2017.

In readiness for Completion on 1 June 2017, many activities were completed to support a smooth transition of ownership from Bank of America, such as a review of some 470 IT applications to ensure services could continue, critical policy changes in MBNA to align to the Group and the introduction of a management structure and governance approach which was aligned to the Group's organisational design and risk management framework.

The 'Legal Day 1' Event completed seamlessly on 1 June 2017 with no operational issues. Since then, we have completed a detailed operating model review to identify how best we integrate the MBNA and existing Lloyds Banking Group Cards businesses to ensure we preserve and enhance areas of value creation and opportunities to improve the customer experience for all of our 8 million credit card customers.

The integration programme has moved into the delivery phase and has developed plans with Bank of America to complete the customer, systems and process integration by early 2019.

There is a rigorous governance process to oversee design decision and integration execution, which ensures appropriate and timely updates and escalations up to Board level.

Lloyds Bank Corporate Markets

On 1 June, 2017, I was appointed a Non-Executive Director of Lloyds Banking Group and also as Chairman designate of the newly created 'non ring-fenced bank subsidiary', which is called Lloyds Bank Corporate Markets plc ('LBCM'), subject to regulatory consent. Since then, we have been engaged in a complex, intense and detailed programme to meet all the conditions which the PRA and FCA have set in order to enable them to give us full authorisation to conduct the non ring-fenced activities of the Group, which are required as part of the ring-fencing regulations for UK banks.

Our first, and surely the most important task, was to appoint a Board and senior management team to LBCM. The Board comprises eight Directors, three of whom are independent Non-Executive Directors recruited from outside the Group and all of whom have wide experience of banking, two Directors Designate (Group executives serving in a non-executive capacity and subject to regulatory approval), the Chief Executive, Chief Financial Officer, and myself as Chairman. This composition supports LBCM's legal and regulatory requirements for independent decision making within the overall framework of Group policies and controls. At the same time we have made good progress in appointing the rest of the senior management team of LBCM, such as the Chief Risk Officer, Chief Operating Officer, Chief Internal Auditor and Treasurer from both within and outside the Group. The bank received authorisation from the PRA and FCA in July 2017, subject to conditions. Our current plans are to operationalise the bank, and receive full authorisation for it to commence trading during 2018, leaving us good time to complete the process before the ring-fencing regulations come into force on 1 January 2019.

Since receiving the bank's conditional authorisation in July 2017, the Board has concentrated on creating a bespoke Governance Framework, including the vital Risk Management Framework, which is fit for purpose for LBCM, but also which is consistent and fits within the Group Governance Framework. In essence, LBCM must comply with each and every governance and risk requirement of the Group, but has the right and duty to manage the non ring-fenced bank within any narrower parameters set by the LBCM Board.

CORPORATE GOVERNANCE

Lord Lupton's induction

Induction pack prepared and sent to Lord Lupton prior to and on appointment

This contained key corporate documents, such as:

Role of Director

- Group policies such as anti-bribery, expenses, gifts and hospitality, and share dealing
- The role of a director and statutory duties, including Companies Act liabilities, Listing Rules, Disclosure Guidance and Transparency Rules and SEC Rules
- Directors' and officers' liability insurance

Board and its Committees

- Directors', Executive Management and Company Secretary biographies and contact details
- Schedule of Board Committee membership
- Last Board effectiveness review
- Minutes of the last 12 months' Board meetings
- Last three Board packs

Financial and strategic

- Latest Annual Report
- Corporate history, with a summary of significant events
- Group management structure chart and business unit details
- Key performance indicators, including KPIs on which incentive plans are measured

Risk management

- Risk profile, appetite, risk management and internal control procedures

Shareholders

- Shareholder analysis/analyst reports
- Voting and shareholder feedback from the last AGM
- Notices of any general meetings held in the last three years

General

- Recent press cuttings, reports and articles concerning the Company

	Schedule of Board and Committee meetings and Board calendar	Latest Strategic plan	Glossary of Company-specific jargon/acronyms
		Guide to ring-fencing	**Training aspects**
		Governance	The use of the electronic board portal
		Corporate Governance Framework	The Senior Managers and Certification Regime
		Articles of Association	
	Meetings were held during May and June with all the GEC to discuss aspects such as:	Digital and transformation	**Meetings were also held specifically to deal with regulatory aspects, including:**
	Customer products and marketing	Group operations	Ring-fencing
	Insurance risk	Commercial Banking	Corporate governance and the Companies Act
Meetings with senior management	Retail and consumer credit risk	Corporate affairs	
	People, Legal and Strategy	Treasury	Whistleblowing
	Retail and Consumer Finance	Scottish Widows and the Insurance Board	Wholesale Banking conduct risk and remuneration rules
Ongoing programme of meetings, deep dives and	Commercial Banking	Financials (including meeting the internal and external auditors)	Site visits to the New York, Jersey and Singapore offices

training sessions developed in respect of the non ring-fenced bank, including:	Risk	Regulators	Branch visits to Jersey
	Markets	Capital management and liquidity	Floor walks and informal engagement with colleagues
	Establishing the Board and governance procedures	Culture	

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CORPORATE GOVERNANCE

ENGAGING WITH OUR STAKEHOLDERS

Shareholders

Investor Relations has primary responsibility for managing and developing the Group's external relationships with existing and potential institutional equity investors and analysts. With support from senior management, they achieved this through a combination of more than 800 meetings and various presentations in 2017. The presentations were primarily aligned to results and included content on strategic progress and financial and operational performance. In addition to this direct shareholder engagement, Investor Relations provides regular reports to the executive team and Board on key market issues and shareholder concerns.

The Company Secretary has a team dedicated to engaging with retail shareholders who, with support from the Company's registrar Equiniti Limited, deliver the Group's shareholder service strategy, including the AGM. Group Secretariat provide feedback to the Board and appropriate Committees to ensure the views of retail shareholders are received and considered.

The AGM is an opportunity for shareholders to hear directly from the Board on the Group's performance and strategic direction, and importantly, to ask questions.

– over 200 shareholders represented

– over 65 per cent of total voting rights voted

– all resolutions voted on by way of a poll.

Customers

The Group's aim is to become the best bank for customers, colleagues and shareholders. As part of this, the Board constantly reviews the strategy, receives updates on implementation and reviews progress as part of the governance process.

One of the deep dives held by the Board during the year focused on the Customer Journey. This provided the Board with an update on the progress made on the Customer Journey transformation and gave the Board the opportunity to enhance their understanding and to consider and feedback on future plans.

Further to the launch of mobile branches which serve local communities, an example was displayed at the 2017 AGM.

The Board receives regular updates and reports detailing the findings of the ongoing customer surveys and feedback programme.

Colleagues

The Group intranet is used by the Directors to communicate with colleagues. During the year, this has included:

– podcasts and videos detailing full year and half year results and details of the transformation within the Group and future plans;

– Q&A sessions with the Group Chief Executive, where selected colleagues were given the opportunity to put questions directly to him; and

– annual end of year message to all colleagues from the Chairman.

Colleague feedback sessions are arranged on a regular basis where colleagues join the Chairman for informal discussion over lunch or dinner. These took place during the year in various locations, including Dunfermline, London, Bristol, Liverpool and Jersey.

The Chairman hosts regular colleague breakfast meetings which are also attended by Non-Executive Directors.

The Board receives regular investor feedback and engages with shareholders, this includes:

– meetings between the Chairman, Senior Independent Director and Chairman of the Remuneration Committee and institutional shareholders;

– regular communications from the Group Chief Executive including correspondence with both retail and institutional shareholders;

– investor meetings, roadshows and the AGM.

Members of the Board have visited branches in various locations including Nottingham, Liverpool and Jersey during the year to help build understanding of the business and meet with colleagues.

Helping Britain Prosper LIVE event was attended by 4,000 colleagues at the ExCel centre in London in March. This event provided everyone with more details about the future of the Group and the opportunity to see first-hand how we are helping Britain prosper every day. Speeches were given by the Group Chief Executive and Chief Financial Officer, which were broadcast live.

The Chairman of the Remuneration Committee held a meeting during the year with the unions.

Members of the Board have visited several Group offices and service centres during the year including Chester, Reading, Swindon and Edinburgh.

Regulators and government

Members of the Board regularly meet with various organisations and institutions, including the Bank of England, the FCA, the PRA, CBI and accounting bodies.

Members of the Board also participate in the Bank Governance Leadership Network, which addresses key issues facing global banks and provides opportunities for discussions between leading global banks, and other stakeholders across a range of activities throughout the year. Core themes include regulation and supervision of banks risk governance and oversight, the future of the banking industry, rebuilding trust and culture and changing business models and strategic challenges.

Representatives of the regulator (both PRA and FCA) observed Board and Committee meetings in 2017.

Communities

Members of the Board met with some of the organisations which are beneficiaries of the Group's independent charitable Lloyds Bank Foundation for England and Wales and Bank of Scotland Foundation.

The Chairman also attended Lloyds Bank Foundation for England and Wales Westminster Parliamentary Reception in November, where more than 100 representatives of small and local charities were joined by MPs, government ministers and representatives from the Group. The reception highlighted the work of small and local charities tackling disadvantage across England.

The Board engages with the work of the Foundations through the Responsible Business Committee. See page 163 for more information.

Almost 260,000 hours of volunteering by colleagues were delivered in 2017, of which 44 per cent were skills-based volunteering. More than 5,000 colleagues took part in volunteering over the period of a week in the Group's Give & Gain volunteering campaign.

Lord Blackwell visits Liverpool

In July Lord Blackwell visited Liverpool, splitting his time between meeting colleagues and charities supported by the England and Wales Foundation.

Colleagues took the opportunity to present details of how they are implementing strategic priorities; an update on the apprenticeship training programme; how fraud is managed; and the impact on customers. Lord Blackwell also met representatives from the local PPI team, who discussed the end-to-end PPI complaint handling process, focusing on the key parts undertaken in Speke and Chester.

A networking lunch was held, with Lord Blackwell presenting a keynote speech to 50 colleagues. This was followed by a Q&A session at the Group's Speke office, after which he visited the Rotunda charity, an accredited training centre and community hub. The England and Wales Foundation has been supporting the charity since 2011. In 2017, Rotunda was awarded a further grant to support a pilot project which aims to demonstrate how a local community organisation can produce better services and outcomes for those with offender records and who are long term unemployed.

Whistleblowing

We encourage colleagues to speak up if they suspect wrongdoing or witness behaviours that do not meet the standards set out in our Codes of Responsibility or Group policies and procedures. This whistleblowing service is known internally as 'Speak Up' and it gives colleagues a way to raise concerns confidentially and without fear of reprisal.

The Group has an established Speak Up Champion (Anita Frew, Deputy Chairman and Senior Independent Director), a dedicated team to handle disclosures (the Colleague Conduct Management Team (CCMT)) and a third party supplier (Expolink) which colleagues can contact anonymously. There is a clear Speak Up Policy that sets out its commitment to listening to colleague concerns and protecting those who raise concerns from any detriment. The Policy provides information on how concerns can be raised and to whom. It also confirms that the Group has zero tolerance of retaliation and provides assurance around confidentiality and anonymity where required.

Whistleblowing continues to be a topic of public and regulatory concern; it is essential that colleagues feel confident reporting wrongdoing and are able to trust the process. A healthy culture encourages asking questions, raising concerns and admitting mistakes. This type of culture influences employee actions, decision-making and behaviour. In the reporting period, Speak Up has been embedded into Group culture through communication and awareness campaigns, training to all colleagues and the leadership team regularly considering speak up arrangements as part of its annual review of the system of internal control.

"As part of our helping Britain prosper plan, we have committed to supporting the committees in which we serve and it is a matter of great personal pride that the Lloyds Bank Foundation is able to support this worthy cause."

Lord Blackwell
Chairman

HOW OUR BOARD WORKS
MEETINGS, ACTIVITIES AND PROCESSES

Board meetings

A yearly planner is prepared by the Company Secretary to map out the flow of key items of business to the Board.

Start of the year

Board venues are agreed and colleagues in the areas that the Board will visit are engaged at both senior management and operational level.

The Chairman holds monthly meetings to review the draft agenda and planner with the Company Secretary and Chief of Staff, as well as quarterly meetings with a wider group of central functions, to identify emerging issues.

Agenda set

The draft Board agenda is discussed between the Chairman and the Group Chief Executive and reviewed at GEC meetings.

Matters may be added to agendas in response to external events, Non-Executive Director requests, regulatory initiatives and the quarterly Board topic review meetings.

Templates and guidelines are included within targeted training for authors of papers to ensure consistency and high quality of information.

Papers compiled and distributed

Meeting packs are uploaded and communicated to all Directors via a secure electronic board portal typically a week in advance of the meeting to ensure sufficient time to review the matters which are to be discussed and seek clarification or any additional information.

Executive meetings are held ahead of all Board and Committee meetings to ensure all matters being presented to the Board have been through a thorough discussion and escalation process.

Before the meeting	Committee meetings are held prior to Board meetings, with the Chairman of each Committee then reporting matters discussed to the Board.
	Non-Executive discussions and informal dinners are held prior to most Board meetings, some of which also include the Group Chief Executive.
Board meeting	Board meetings have certain standing items, such as a report from the Group Chief Executive and Chief Financial Officer on Group performance, reports from Committee Chairmen and updates from GEC members.
	Topics for deep dives or additional items are discussed when required and include business, governance and regulatory updates.
	The Board makes full use of technology such as video conferencing, teleconferencing, a Board portal and tablets/devices in its meeting arrangements. This leads to greater flexibility, security and efficiency in Board paper distribution and meeting arrangements.
	The Board meetings offer the Board the chance to meet colleagues within the business, and if any additional meetings are required to provide more details, these are arranged.
After the meeting	Minutes and matters arising from the meeting are produced and circulated to the Directors for review and feedback.
	Those responsible for matters arising are asked to provide updates to the next meeting by way of an update paper.

Beyond Board meetings

Non-Executive Directors see attendance at Board and Committee meetings as only one part of their role. In addition to the annual schedule of Board and Committee meetings, the Non-Executive Directors undertake a full programme of activities and engagement each year, as set out on page 145–146.

Non-Executive Directors regularly meet with senior management and spend time increasing their understanding of the business through site visits, formal briefing sessions or more informal events including breakfast meetings with senior staff. These informal meetings allow Directors greater time to discuss business in an informal setting, ensuring that there is sufficient time for the Board to discuss matters of a material nature at Board meetings.

Where further training or awareness is identified, such as new technology, regulations or sector advances, deep dives are held with the relevant field expert to provide overviews, chances to raise questions, and debate the impacts on business in an informal setting.

In April, the Board held a joint discussion with the Board of Scottish Widows Group Limited allowing in-depth focus on insurance matters.

The Executive Directors make decisions within clearly defined parameters which are documented within the Corporate Governance Framework, although where appropriate, any activities outside the ordinary course of business are brought to the full Board for their consideration, even if the matters fall within the agreed parameters. The Corporate Governance Framework helps to ensure that decisions are made by the management with the correct authority.

The right processes in place to deliver on our strategy

During the year, there were 10 scheduled Board meetings, with details of attendance shown on page 141. In addition to formal meetings, the Board meets as necessary to consider matters of a time-sensitive nature. The Chairman and the Chairmen of each Committee ensure Board and Committee meetings are structured to facilitate open discussion, debate and challenge. Through their opening remarks, the Chairmen set the focus of each meeting.

The Board is supported by its Committees which make recommendations on matters delegated to them under the Corporate Governance Framework, in particular in relation to internal control risk, financial reporting, governance and remuneration issues.

The management of all Committees is in keeping with the basis on which meetings of the Board are managed. Each of the Committee's structures facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committees to consider proposals which are put forward.

In the rare event of a Director being unable to attend a meeting, the Chairmen of the respective meetings discusses the matters proposed with the Director concerned, seeking their support and feedback accordingly. The Chairman subsequently represents those views at the meeting.

The Board recognises the need to be adaptable and flexible to respond to changing circumstances and emerging business priorities, whilst ensuring the continuing monitoring and oversight of core issues.

The Group has a comprehensive and continuous agenda setting and escalation process in place to ensure that the Board has the right information at the right time and in the right format to enable the Directors to make the right decisions. The Chairman leads the process, assisted by the Group Chief Executive and Company Secretary. The process ensures that sufficient time is being set aside for strategic discussions and business critical items.

The process of escalating issues and agenda setting is reviewed at least annually as part of the Board Effectiveness Review with enhancements made to the process, where necessary, to ensure it remains effective. Details of the meeting process are provided on page 147.

The Non-Executive Directors also receive regular updates from the Group Chief Executive's office including a weekly email which gives context to current issues. In-depth and background materials are regularly provided via a designated area on the Board portal.

A full schedule of matters reserved for the Board and Terms of Reference for each of the Committees can be found at www.lloydsbankinggroup.com

IT Resilience and cyber security

Professional development and training programme at a glance

At the Board meeting in May 2017, the Board took part in an advanced scenario testing exercise to simulate real life cyber-attack scenarios. The purpose of this was to enhance the Board's understanding of the processes and controls in place, and to rehearse the actions required from the Board at the different stages of an incident if such an event should occur in reality.

IT resilience and the dynamic threat posed by cyber risk are recognised as key risks and are a central area of focus for the Board Risk Committee.

Important and/or material issues continue to be brought to the full Board Risk Committee for information, consideration and discussion as appropriate.

During the year, the sub-committee of the Board Risk Committee dedicated to IT resilience and cyber security considered a wide range of issues including:

cyber and IT controls;

technology resilience;

cyber security; and

roles and responsibilities of the Chief Security Officer.

See page 160 for more information.

CORPORATE GOVERNANCE

ASSESSING OUR EFFECTIVENESS

How the Board performs and is evaluated

The Board is in the third year of its three year evaluation cycle. An external evaluation was conducted in 2015, facilitated by JCA Group[1], with an internal evaluation having been carried out in 2016 and this year. The annual evaluation is facilitated externally at least once every three years and an externally facilitated evaluation will be conducted in 2018. The Chairman of the Board leads the annual review of the Board's effectiveness and that of its Committees and individual Directors with the support of the Nomination and Governance Committee, which he also chairs. Performance evaluation of the Chairman is carried out by the Non-Executive Directors, led by the Senior Independent Director, taking into account the views of the Executive Directors.

2017 evaluation of the Board's performance

The 2017 evaluation was conducted internally between October 2017 and December 2017 by the Company Secretary, and was overseen by the Nomination and Governance Committee.

The 2017 review sought the Directors' views on a range of topics including: strategy; planning and performance; risk and control; Board composition and size; balance of skills and experience; diversity; culture and dynamics; the Board's calendar and agenda; the quality and timeliness of information; and support for Directors and Committees.

If Directors have concerns about the Company or a proposed action which cannot be resolved, it is recorded in the Board minutes. Also on resignation, Non-Executive Directors are encouraged to provide a written statement of any concerns to the Chairman, for circulation to the Board. No such concerns were raised in 2017 and up to the date of this report.

Internal evaluation process

OCTOBER 2017

Questionnaires issued to all Directors by the Company Secretary for completion.

OCTOBER – DECEMBER 2017

Individual meetings held between each Director and the Company Secretary to discuss responses and opportunity for Directors to raise any other matters concerning the Board or its Committees.

DECEMBER 2017 / JANUARY 2018

Report prepared by the Company Secretary based on the questionnaire results and matters raised in individual meetings.

JANUARY 2018

Draft report discussed by the Company Secretary with the Chairman.

Final report discussed at a meeting of the Board. The Board discussion was subsequently considered by the Nomination and Governance Committee.

APRIL 2018

Actions to be recommended to the Board by the Nomination and Governance Committee to reflect the Board discussion in January.

Subsequently the Board will consider the recommendations and agree an action plan.

JULY 2018

Update to be provided to both the Nomination and Governance Committee and the Board detailing progress against the agreed actions.

Highlights from the 2017 review

The reviews concluded that the performance of the Board, its Committees, the Chairman and each of the Directors continues to be effective. All Directors demonstrated commitment to their roles.

Having been Board members for more than six years, a particularly rigorous review of Anita Frew's and Sara Weller's independence was undertaken. The Nomination and Governance Committee concluded they were both still sufficiently independent.

Many Directors commented favourably on the performance of the Board as a whole, describing it as hardworking, conscientious, expert, questioning and highly engaged. Highlights mentioned by several Directors were the continued value of deep dives, the offsite strategy session (described by one Director as a 'model of open discussion'); the openness of Executives to interacting with the Board members and sharing issues, the discussion on executive succession; the process for keeping the Board aware of important issues which arise between meetings; the further development of Group Internal Audit; the usefulness of the Risk Sub-Committees and the Cyber Security Advisory Panel and the Non-Executive Director only discussions. Directors also spoke highly of the work done by the

Chairman and the Chairmen of the Committees in structuring agendas and ensuring that business is covered at the meetings.

The actions from the 2016 Board Effectiveness Review have been recognised by Directors as helpful, particularly, the requirement that 'links to strategy' are identified in Board papers. Many think that more needs to be done to make Board papers more concise and focused and that less meeting time should be used for presentations.

Points raised in the 2017 Board effectiveness review

The review identified a number of areas for improvement in the Board's effectiveness.

Board papers and presentations to the Board

The most common observation by Directors concerned the volume and content of information contained within Board papers, which was also linked to observations in favour of reducing the amount of time spent on presentations in Board meetings. Directors would like to receive more concise reports, highlighting important points and avoiding unnecessary volume and repetition, along with having fewer and shorter presentations.

Stakeholder feedback

Directors believe that they receive good information on regulatory and customer feedback. Several Directors would like to receive more feedback from stakeholders other than regulators and customers, including shareholders and bond holders. The views of shareholders on remuneration matters are well represented at the Remuneration Committee.

Responsible Business Committee Terms of Reference

A number of Directors suggested that the Terms of Reference of the Responsible Business Committee be reconsidered, now that it has been in operation for a full year, in order to avoid duplication of effort in areas covered by other Committees.

Non-Executive Director recruitment

While there was general agreement that the balance of skills within the Board was good, a number of Directors asked that the following experience be borne in mind for future recruitment of Directors (to supplement the experience of the current Directors in these areas): major change management; finance; accounting and data.

Some Directors mentioned the importance of maintaining, and enhancing, gender diversity in the Board.

1 Aside from assisting with senior recruitment, benchmarking and succession planning, JCA Group has no other connection to the Company.

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Progress against the 2016 internal Board effectiveness review

During the year, work focused particularly on the quality and quantity of papers and to the linkage of agenda items to the 'Bank of the Future' strategy. A summary of the Board's progress against the actions arising from the 2016 effectiveness review are set out below.

	Recommendations from the 2016 evaluation	**Actions taken in 2017**
Links to strategy	More frequent linkage to strategy in the regular business of the Board.	Two in-depth strategy away days held during the year; The programme of regular deep dives and discussion topics established in 2016 continues; All papers submitted to Board meetings include clear links to strategy.
Volume of Board/ Committee papers	Request from Directors to receive more concise reports with clearer signposting of the key issues.	Executive summaries have been shortened and a brief section on debate and challenge has been included; Revised Board template and clear guidance in place in respect of both papers submitted to meetings and presentations given during meetings.
Conduct of Board/ Committees	Review and continue to evolve the quality and content of Board papers to ensure effective use of meetings and improve discussions.	Continued progress on focusing material and presentations on key issues for the Board.

INTERNAL CONTROL

Board responsibility

The Board is responsible for the Group's risk management and internal control systems, which are designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. The Directors and senior management are committed to maintaining a robust control framework as the foundation for the delivery of effective risk management. The Directors acknowledge their responsibilities in relation to the Group's risk management and internal control systems and for reviewing their effectiveness.

In establishing and reviewing the risk management and internal control systems, the Directors carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency or liquidity, the likelihood of a risk event occurring and the costs of control. The process for identification, evaluation and management of the principal risks faced by the Group is integrated into the Group's overall framework for risk governance. The Group is forward-looking in its risk identification processes to ensure emerging risks are identified. The risk identification, evaluation and management process also identifies whether the controls in place result in an acceptable level of risk. At Group level, a consolidated risk report and risk appetite dashboard are reviewed and regularly debated by the Group Risk Committee, Board 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 view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite and an assessment of emerging risks which could affect the Group's performance over the life of the operating plan. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is provided within the risk management report on pages 45–108. The Board concluded that the Group's risk management arrangements are adequate to provide assurance that the risk management systems put in place are suitable with regard to the Group's profile and strategy.

Control effectiveness review

An annual control effectiveness review ('CER') is undertaken to evaluate the effectiveness of the Group's control framework with regard to its

material risks, and to ensure management actions are in place to address key gaps or weaknesses in the control framework. Business areas and head office functions assess the controls in place to address all material risk exposures across all risk types. The CER considers all material controls, including financial, operational and compliance controls. Senior management approve the CER findings which are reviewed and independently challenged by the Risk Division and Group Internal Audit and reported to the Board. Action plans are implemented to address any control deficiencies.

Reviews by the Board

The effectiveness of the risk management and internal control systems is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by the Risk Division and Group Internal Audit. The Audit Committee receives reports from the Company's auditor, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditor at least once a year without executives present, to ensure that there are no unresolved issues of concern.

The Group's risk management and internal control systems are regularly reviewed by the Board and are consistent with the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting issued by the Financial Reporting Council and compliant with the requirements of CRD IV. They have been in place for the year under review and up to the date of the approval of the annual report. The Group has determined a pathway to compliance with BCBS 239 risk data aggregation and risk reporting requirements and continues to actively manage enhancements.

Continuous improvement

The Group's Controls Frameworks are continuously improved and enhanced, addressing known issues and keeping pace with the dynamic environment. Progress continues to be made in IT, Cyber and Conduct. The 2017 CER assessment provides reasonable assurance that the Group's controls are effective or that where control weaknesses are identified, they are subject to management oversight and action plans. The Audit Committee, in conjunction with the Board Risk Committee, concluded that the assessment process was effective and recommended them to the Board for approval.

COMPLYING WITH THE UK CORPORATE GOVERNANCE CODE 2016

The UK Corporate Governance Code 2016 (the 'Code') applied to the 2017 financial year. The Group confirms that it applied the main principles and complied with all the provisions of the Code throughout the year. The Code is publicly available at www.frc.org.uk.

The statement by the Chairman of the Remuneration Committee and the Annual report on remuneration are set out on pages 116 and 137.

The Group has adopted the UK Finance Code for Financial Reporting Disclosure and its 2017 financial statements have been prepared in compliance with its principles.

A. Leadership

A1. The Board's Role The Group is led by an effective, committed unitary Board, which is collectively responsible for the long-term success of the Company. The Group's Corporate Governance Framework, which is reviewed annually by the Board, sets out a number of key decisions and matters that are reserved for the Board's approval. Further details can be found online at www.lloydsbankinggroup.com and on page 147.

	Independent	Responsibilities
Chairman Lord Blackwell		Lord Blackwell leads the Board and promotes the highest standards of corporate governance. He sets the Board's agenda and builds an effective and complementary Board. The Chairman leads Board succession planning and ensures effective communication with shareholders.
Executive Directors **Group Chief Executive** António Horta-Osório		António Horta-Osório manages and leads the Group on a day-to-day basis and makes decisions on matters affecting the operation, performance and strategy of the Group's business. He delegates aspects of his own authority, as permitted under the Corporate Governance Framework, to other members of the Group Executive Committee. He provides leadership and direction to senior management and coordinates all activities to implement the strategy and for managing the business in accordance with the Group's risk appetite and business plan set by the Board.
Chief Financial Officer George Culmer		Under the leadership of the Group Chief Executive, George Culmer and Juan Colombás make and implement decisions in all matters affecting operations, performance and strategy. They provide specialist knowledge and experience to the Board. Together with António Horta-Osório, George Culmer and Juan Colombás

design, develop and implement strategic plans and deal with day-to-day operations of the Group. During the year Juan Colombás was appointed to the role of Chief Operating Officer in September 2017. Prior to this he served as the Group's Chief Risk Officer.

Chief Operating Officer Juan Colombás	
Non-Executive Directors **Deputy Chairman and Senior Independent Director** Anita Frew	As Deputy Chairman, Anita Frew would ensure continuity of chairmanship during any change of chairmanship. She supports the Chairman in representing the Board and acting as a spokesperson. She deputises for the Chairman and is available to the Board for consultation and advice. The Deputy Chairman represents the Group's interests to official enquiries and review bodies. As Senior Independent Director, Anita Frew is also a sounding board for the Chairman and Chief Executive. She acts as a conduit for the views of other Non-Executive Directors and conducts the Chairman's annual performance appraisal. She is available to help resolve shareholders' concerns and attend meetings with major shareholders and financial analysts to understand issues and concerns.
Alan Dickinson Simon Henry Nick Luff [1] Lord Lupton[2] Deborah McWhinney Nick Prettejohn Stuart Sinclair Anthony Watson[1] Sara Weller	The Non-Executive Directors challenge constructively and help develop and set the Group's strategy. They actively participate in Board decision-making and scrutinise management performance. The Non-Executive Directors satisfy themselves on the integrity of financial information and review the Group's risk exposures and controls. The Non-Executive Directors, through the Remuneration Committee, determine the remuneration of Executive Directors.
Company Secretary Malcolm Wood	The Company Secretary advises the Board on matters such as governance and ensures good information flows and comprehensive practical support are provided to Directors. He maintains the Group's Corporate Governance Framework and organises Directors' induction and training. The Company Secretary communicates with shareholders as appropriate and ensures due regard is paid to their interests. Both the appointment and removal of the Company Secretary is a matter for the Board as a whole.

1 Nick Luff and Anthony Watson resigned from the board with effect from 10 May and 11 May 2017, respectively.
2 Lord Lupton joined the Board with effect from 1 June 2017.

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CORPORATE GOVERNANCE

A2. Division of responsibilities There is clear division of responsibility at the head of the Company, which is documented in the Group's Corporate Governance Framework.

A3. Role of the Chairman The Chairman has overall responsibility for the leadership of the Board and for ensuring its effectiveness.

Lord Blackwell was independent on appointment.

A4. Role of the Non-Executive Directors The Board has a Senior Independent Director ('SID'), Anita Frew, who acts as a sounding board to the Chairman and Group Chief Executive. She can be contacted by shareholders and other Directors as required. Anthony Watson served as SID until 11 May 2017.

The Non-Executive Directors challenge constructively and help develop and set the Group's strategy.

Meetings are held between the Non-Executive Directors in the absence of the Executive Directors, and at least once a year in the absence of the Chairman.

Further information on meeting arrangements and the responsibilities of the Directors are given on pages 147–148 and 151 respectively.

B. Effectiveness

B1. The Board's composition The balance of skills, experience, independence, and knowledge on the Board is the responsibility of the Nomination and Governance Committee, and is reviewed annually, or whenever appointments are considered.

The majority of the Board are independent Non-Executive Directors as shown on page 151.

B2. Board appointments The process for Board appointments is led by the Nomination and Governance Committee, which then makes a recommendation to the Board.

More details about succession planning can be found on page 155. More information about the work of the Nomination and Governance Committee can be found on pages 153–155.

B3. Time commitments The time commitments of the Directors are considered by the Board on appointment and annually.

The Chairman considers any new external appointments which may impact existing time commitments.

Non-Executive Directors are required to devote such time as is necessary for the effective discharge of their duties. The estimated minimum time commitment set out in the terms of appointment is 35-40 days per annum including attendance at Committee meetings. For Committee Chairmen and the SID, this increases to a minimum of 45 to 50 days. In reality, the time devoted on the Group's business by the Non-Executive Directors is considerably more than the minimum requirements.

Executive Directors are allowed to hold no more than one Non-Executive Director role in a FTSE 100 company and may not take on the Chairmanship of such a company.

The Chairman is committed to this being his primary role, limiting his other commitments to ensure he can spend as much time as the role requires.

There are no Directors whose time commitments are considered to be a matter for concern.

B4. Training and development The Chairman leads the learning and development of Directors and the Board generally and regularly reviews and agrees with each Director their individual and combined training and development needs.

Ample opportunities, support and resources for learning are provided through a comprehensive programme, which is in place throughout the year comprising both formal and informal training and information sessions.

The Chairman personally ensures that on appointment each Director receives a full, formal and tailored induction. The emphasis is on ensuring the induction brings the business and its issues alive for the new Director, taking account of the specific role they have been appointed to fulfil and the skills/experience of the Director to date. An outline of the induction programme for Lord Lupton can be found on page 144.

Directors who take on or change roles during the year attend induction meetings in respect of those new roles.

The Company Secretary maintains a training and development log for each Director.

B5. Provision of information and support The Chairman, supported by the Company Secretary, ensures that Board members receive appropriate and timely information.

The Group provides access, at its expense, to the services of independent professional advisers in order to assist Directors in the role.

Board Committees are also provided with sufficient resources to undertake their duties.

All Directors have access to the services of the Company Secretary in relation to the discharge of their duties.

B6. Board and Committee performance and evaluation An externally facilitated performance evaluation was completed in 2015, with internally facilitated evaluations having taken place in 2016 and 2017. More information can be found on pages 149–150, along with the findings, actions, and progress made during the year.

B7. Re-election of Directors At the 2017 AGM, all Directors were subject to re-election with the exception of Anthony Watson, who stepped down after the AGM and Nick Luff, who stepped down prior to the AGM. All Directors will be standing for re-election, and in the case of Lord Lupton, election by shareholders at the 2018 AGM.

C. Accountability

C1. Financial and business reporting

Information on the Company’s business model and strategy can be found on pages 5–10.

C2. Risk management and internal control systems See page 150 for more detail regarding internal control.

The Audit Committee is responsible for the effectiveness of internal controls and the Risk Management Framework. Further information can be found on pages 156–159.

The Board Risk Committee is responsible for the review of the risk culture of the Group, setting the tone from the top in respect of risk management. Further information can be found on pages 160–162.

Confirmation that the business is a going concern can be found on page 164.

C3. Role and responsibilities of the Audit Committee The Audit Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board. Full information on the Audit Committee can be found on pages 156–159.

D. Remuneration

D1. Level and elements of remuneration Remuneration Report on pages 116–137 explains the work of the Remuneration Committee and provides full details regarding the remuneration of Directors.

E. Relations with Shareholders

E1. Shareholder engagement Details of engagements with shareholders during the year can be found on page 145.

E2. Use of General Meetings The 2018 AGM will be held on 24 May 2018. The whole Board is expected to attend and will be available to answer shareholders’ questions.

To facilitate shareholder participation, electronic proxy voting and voting through the CREST proxy appointment service are available. All votes are taken by way of a poll to include all shareholder votes cast.

A webcast of the AGM is carried out to allow shareholders who cannot attend in person to view the meeting live.

NOMINATION AND GOVERNANCE

COMMITTEE REPORT

The Nomination and Governance Committee (the 'Committee') continued to keep under review the structure, size and composition of the Board and its Committees. At the core of the process is an ongoing assessment led by me of the collective Board's technical and governance skill set. These assessments provide an essential analysis of the skills and experience of the Non-Executive Directors relative to the required and desirable Board competencies to help ensure that the Board continues to have an appropriate range and depth of Non-Executive skills.

As detailed in last year's annual report and following our announcement in February 2017, Nick Luff and Anthony Watson left the Board in May 2017. These departures resulted in the positions of Senior Independent Director and Audit Committee Chairman becoming vacant. The Committee reviewed both internal and external candidates for the position of Senior Independent Director. It was subsequently agreed that Anita Frew would become the Senior Independent Director and Simon Henry would become the Chairman of the Audit Committee. Further details in respect of both of these appointments are provided below.

In addition to these changes, a thorough recruitment process was initiated and overseen by the Committee to select suitable candidates for the roles of Non-Executive Director of the Company and Chairman of Lloyds Bank Corporate Markets plc, who would provide the required skill set, experience and knowledge whilst complementing the existing Board of Lloyds Banking Group plc. As a result of this Lord Lupton was appointed to the Board in June 2017. Lord Lupton was chosen for this role as he brings not just his experience of UK banking and capital markets, but also his extensive corporate advisory experience which will be of particular value to our overall Commercial Banking activities.

During the year, the Committee dedicated a substantial part of its time to Executive succession planning, building on the progress made over the previous years. The work undertaken included additional analysis and benchmarking, which led to the establishment of development plans for identified candidates (further details can be found opposite). These were important considerations in the executive reorganisation announced in the summer.

The Group aspires to the highest standards of corporate and internal governance in accordance with the expectations of the Board, ensuring that governance is in compliance with the latest regulation. As part of this, the Board's Diversity Policy was reviewed by the Committee during the year. The review included the consideration of aspects of new and emerging best practice and regulatory developments in the area of senior management and Board diversity. This led to amendments to the existing policy explicitly to broaden the range of diversity criteria which will be taken into consideration in future appointments. Specifically, the policy now includes race, age, gender, educational and professional background as attributes.

Lord Blackwell

Chairman, Nomination and
Governance Committee

Committee purpose and responsibilities

The purpose of the Committee is to keep the Board's governance, composition, skills, experience, knowledge, independence and succession arrangements under review and to make appropriate recommendations to the Board to ensure the Company's arrangements are consistent with the highest corporate governance standards.

The Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. The Committee's terms of reference can be found at www.lloydsbankinggroup.com/our-group/ corporate-governance.

Committee composition, skills and experience

To ensure a broad representation of experienced and independent Directors, membership of the Committee comprises the Chairman, the Deputy Chairman, who is also the Chairman of the Remuneration Committee and the Senior Independent Director, the Chairman of the Board Risk Committee, and the Chairman of the Responsible Business Committee. The Group Chief Executive attends meetings as appropriate.

Details of Committee membership and meeting attendance can be found on page 58.

During the year the Committee considered a number of issues relating to the Group's governance arrangements, both internal and external. It assisted the Chairman in keeping the composition of the Board and its Committees under review and it leads the search process for nominations to the Board.

These issues are summarised on the next page.

Activities during the year

	KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Board changes and Board composition	Change in Senior Independent Director and Audit Committee Chairman	Anita Frew as Senior Independent Director – The Committee considered a range of external and internal candidates for this position (the external candidates were sourced by JCA Group[1]), and agreed that Anita's significant board, financial and investment management experience, including as a Senior Independent Director, made her ideally suited to take on the role. Simon Henry as Audit Committee Chairman – Simon had been a member of the Audit Committee since June 2014, and the Committee agreed that his background and experience enable him to fulfil the role of Audit Committee Chairman and for SEC purposes the role of Audit Committee financial expert.
	New Non-Executive Director	The external search firm JCA Group provided an extensive list of candidates. The Committee selected and shortlisted candidates, interviews were carried out with various members of the Board, and the process resulted in the appointment of Lord Lupton to the Board in June. Details of Lord Lupton's induction are provided on page 144.
	Structure and composition of the Board	From the ongoing assessment of the Board members, the Chairman creates a skills matrix which the Committee uses to track the Board's strengths and identify gaps in the desired collective skills profile of Board members, giving due weight to diversity in its broadest sense. Recommendations are made to the Board as appropriate.
Succession planning	Developing the succession plans for senior management, and establishing and agreeing development plans.	During the year, the Committee, led by the Chairman, reviewed the succession plans for key senior management roles. Full details of the process are provided on the next page.
Lloyds Bank Corporate Markets plc	Formation of Lloyds Bank Corporate Markets plc, including the establishment of the Board and its governance structures.	In addition to the appointment of Lord Lupton as Chairman of the new bank, the Committee also oversaw the selection of the Board members. This involved shortlisting external candidates for the position of independent non-executive directors with the help of an external recruitment provider, Russell Reynolds[1], meeting with the candidates on a one-to-one basis and reviewing both the individuals and overall composition of the new board before making recommendations to the Group Board. In addition to the composition of the board, the Committee has also reviewed the governance framework, including the Terms of Reference of the preparatory board. The preparatory board preceded the formation of the operating board, and was established by the Group board to oversee the establishment of the company, board and structure.
Annual effectiveness review	Performance of the annual effectiveness review of the Board and its Committees.	During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review. Full details of the review can be found on pages 149–150.
Governance		Annual review of the Corporate Governance Framework

	The Committee oversees various aspects of corporate governance, and during the year, the key activities included the following:	Helping to establish governance for the non ring-fenced bank, including agreeing the Terms of Reference to the non ring-fenced bank preparatory board Annual review of the share dealing policy for Directors and GEC Received reports from the Chairman on communications with shareholders Approved the appointment of Trustees to the Bank's Foundations Reviewed and proposed a training schedule for Non-Executive Directors Received governance reports from the Company Secretary detailing updates and changes to regulation and best practice
Diversity	The Board Diversity Policy was reviewed by the Committee during the year.	In addition to the changes noted in the Chairman's letter on page 139, Board appointments must also take into account independence and knowledge in addition to specific skills and experience to ensure a diverse Board composition. The full Diversity Policy can be found at www.lloydsbankinggroup.com.
Independence and time commitments	A review as to whether Non-Executive Directors were demonstrably independent and free of relationships and other circumstances that could affect their judgement.	The Committee conducted a review of the role, including capabilities and time commitment of all the Directors of the Company. This review was undertaken with reference to the individual performance and conduct in reaching decisions. It also took account of any relationships that had been disclosed. Based on its assessment for 2017, the Committee is satisfied that, throughout the year, all Non-Executive Directors remained independent as to both character and judgement. All Directors were considered to have appropriate roles, including capabilities and time commitments.
Training	A review of the Group's approach to the training of Non-Executive Directors.	In addition to the existing methods of training for the Directors, the Board accepted a recommendation from the Committee that Non-Executive Directors should be provided with a mandatory training programme, ideally available online, based on relevant core modules which are part of the mandatory training programme undertaken by all colleagues. Members of the Committee are currently testing training modules and will feedback comments to the Committee in spring 2018 before it is considered for roll-out to the rest of the Board.

1 Aside from assisting with senior recruitment, benchmarking and succession planning, JCA Group, Russell Reynolds, Egon Zehnder and YSC Consulting have no other connection to the Company.

CORPORATE GOVERNANCE

Succession planning in detail

Good succession planning contributes to the delivery of the Group's strategy by ensuring the desired mix of skills and experience of Board members now and in the future. The Board is also committed to recognising and nurturing talent within executive and management levels across the Group to ensure the Group creates opportunities to develop current and future leaders. The role of succession planning in promoting diversity is recognised and the Group has a range of policies which promote the engagement of under-represented groups within the business in order to build a diverse talent pipeline.

The Company continues to review and identify potential future executive talent and during the year the following activities were undertaken to develop the talent pipeline further:

Assessment of potential candidates for senior management positions undertaken by the Group Chief Executive with the Chairman, using a range of criteria and benchmarking (facilitated by executive search and board consulting firm Egon Zehnder[1]). Details of assessment criteria are provided below. External candidates were identified by executive search firm, JCA Group to provide a reference benchmark and identify where recruitment might be required.
Assessments were discussed by the Committee, also taking into consideration discussions with the Non-Executive Directors.
Individual development plans established for each internal candidate, and validated with individuals.
Development actions commenced.
Evidenced progress against the development plans reported to the Committee and PRA in the third quarter.

Assessment of candidates

Each of the potential candidates for senior management positions was assessed by the Group Chief Executive and Chairman using the following criteria with input from Egon Zehnder by way of competency, psychometric and potential assessments and market benchmarking, and in the case of non-GEC members, also with further input from YSC Consulting[1] (a premier leadership consultancy), who use a biographical assessment methodology. The results were then discussed and reviewed by the Nomination and Governance Committee and subsequently in a meeting with all Non-Executive Directors.

Assessment Criteria

Leadership:	**Breadth of banking experience:**
Strategy	Retail
People	Commercial

Delivery	Treasury/Capital
Judgement/values	Insurance
	Technology
Governance experience:	**Personal:**
Board	Drive
Investor	Resilience

Candidates were scored from 1 to 5 for each of the above categories, being 5 (very strong versus requirements), 3 (average – not a distinctive strength) and 1 (weakness/development needed).

Board Diversity Policy

The Board Diversity Policy sets out the Board of Lloyds Banking Group's approach to diversity and provides a high level indication of the Board's approach to diversity in senior management roles which is governed in greater detail through the Group's policies.

The Board places great emphasis on ensuring that its membership reflects diversity in its broadest sense. A combination of demographics, skills, experience, race, age, gender, educational and professional background and other relevant personal attributes on the Board is important in providing the range of perspectives, insights and challenge needed to support good decision making.

New appointments are made on merit, taking account of the specific skills and experience, independence and knowledge needed to ensure a rounded Board and the diversity benefits each candidate can bring to the overall Board composition.

Objectives for achieving Board diversity may be set on a regular basis. On gender diversity the Board has a specific target to maintain at least three female Board members and, recognising the emerging target for FTSE companies to move towards 33 per cent female representation, to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements.

The Board also places high emphasis on ensuring the development of diversity in the senior management roles within the Group and supports and oversees the Group's objective of achieving 40 per cent of senior roles held by female executives by 2020, along with other metrics which promote the engagement of other under-represented groups within the business. This is underpinned by a range of policies within the Group to help provide mentoring and development opportunities for female executives and to ensure unbiased career progression opportunities. Progress on this objective is monitored by the Board and built into its assessment of executive performance.

A copy of the Board Diversity Policy is available on our website at www.lloydsbankinggroup.com/responsible-business.

Female representation on the Board is currently 25 per cent (based on three female directors and nine male directors).

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AUDIT COMMITTEE REPORT

It was both an honour and a pleasure to take on the role as Chairman of the Audit Committee (the 'Committee') in May 2017, and I would like to record my thanks and recognition to Nick Luff for his excellent performance in this role in the preceding four years, on behalf of the Board and the Company.

2017 was a year of significant change and challenge for the Committee. In addition to welcoming Lord Lupton to the Committee we saw the establishment and embedding of new leadership in the internal audit function, and the first full calendar year of the new senior partner for external audit. The Committee oversaw the preparation for various new accounting standards and regulatory requirements, including IFRS 9 'Accounting for financial instruments', and the structural ring-fencing of relevant activities within the Bank.

Over half of the Committee's time is typically spent on financial reporting and integrity of information provided to external parties. In 2017 we focused on assessing judgements and outcomes relating to conduct issues, credit performance and various material accounting issues and changes. The latter included the completion and integration of the acquisition of the MBNA credit card business.

In particular we reviewed provisions for payment protection insurance (PPI), costs and provisions which had exceeded £18 billion by the end of the year. While PPI itself will be finalised as an issue by mid-2019, the Committee will continue to focus on both legacy and emerging conduct issues as a matter of priority.

The external environment for the Bank remains challenging from both a regulation and competition perspective. As a result the Bank is in the process of transforming its business model and ways of working, primarily through increasing digitisation of all its activities. This creates both risk and opportunity for financial reporting and internal controls, and the Committee has already spent significant time considering the implications of this significant level of change.

I am pleased to be able to report a successful conclusion to the planned transformation of the Group Internal Audit function, and during the year we carried out a thorough independent external quality assessment of the function. This review noted the scale and pace of improvement and also provided important recommendations

on the application of best practice. These have been incorporated in the future audit plan and in providing a fit for purpose approach for audit in the rapidly changing environment.

This report covers in more detail how the Committee operates and the issues on which we focused. Noting the environment in which we operate I am pleased to be able to report that in the opinion of the Audit Committee, your Company has met its obligations for financial reporting and disclosure and that the internal control framework is both effectively designed and operated.

Simon Henry

Chairman, Audit Committee

Committee purpose and responsibilities

The purpose of the Committee is to monitor and review the Group's financial and narrative reporting arrangements, the effectiveness of the internal controls (including over financial reporting) and the risk management framework, whistleblowing arrangements and each of the internal and external audit processes, including the statutory audit of the consolidated financial statements and the independence of the statutory auditor.

The Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. A full list of responsibilities is detailed in the Committee's terms of reference, which can be found at www.lloydsbankinggroup.com/ our-group/corporate-governance. In satisfying its purpose, the Committee undertakes the functions detailed within Disclosure and Transparency Rule 7.1.3R.

During the year the Committee considered a number of issues relating to the Group's financial reporting, these issues are summarised on the next page, including discussion of the conclusions the Committee reached, and the key factors considered by the Committee in reaching its conclusions.

In addition, the Committee considered a number of other significant issues not related directly to financial reporting, including internal controls, internal audit and external audit. These issues are also discussed in detail in the next section, including insight into the key factors considered by the Committee in reaching its conclusions.

Committee composition, skills and experience

The Committee acts independently of the executive to ensure that the interests of the shareholders are properly protected in relation to financial reporting and internal control.

All members of the Committee are independent Non-Executive Directors with competence in the financial sector and their biographies can be found on pages 113–115. With effect from 1 July 2017 the Committee welcomed Lord Lupton, who brings extensive financial experience. Simon Henry is a Chartered Global Management Accountant and has extensive knowledge of financial markets, treasury, risk management and international accounting standards. He is a member having recent and relevant financial experience for the purposes of the UK Corporate Governance Code and is the Audit Committee financial expert for SEC purposes. The members of the Committee keep their skills up to date with Board deep dives and scheduled Audit Committee training. The focus of specific Audit Committee training this year has been on IFRS 9.

During the course of the year, the Committee held separate sessions with the internal and external audit teams, without members of the executive management present. For details of how the Committee was run, see page 147.

Annually the Committee undertakes an effectiveness review. The review forms part of the Board evaluation process with Directors being asked to complete parts of the questionnaire relating to the Committees of which they were members. The findings of the review were considered by the Committee at its January meeting followed up with telephone calls from the Audit Committee chairman with each of the Committee members. On the basis of the evaluation the feedback was that the performance of the Committee continues to be effective.

Whilst the Committee's membership comprises the Non-Executive Directors noted on page 141, all Non-Executive Directors may attend meetings as agreed with the Chairman of the Committee. The Group Financial Controller, Chief Internal Auditor, the external auditor, the Group Chief Executive, the Chief Financial Officer, the Chief Risk Officer and the Chief Operating Officer also attend meetings of the Committee as appropriate. Details of Committee membership and meeting attendance can be found on page 141.

Financial reporting

During the year, the Committee considered the following issues in relation to the Group's financial statements and disclosures, with input from management, Group Internal Audit and the external auditor:

Activities for the year

	KEY ISSUES	**COMMITTEE REVIEW AND CONCLUSION**
Payment Protection Insurance (PPI)	In determining the adequacy of the provision for redress payments and administration costs in connection with the mis-selling of PPI the Group makes a number of assumptions based on management judgement. Such assumptions include the number of future complaints that will be received and the extent to which they will be upheld; average redress payments; and related administrative costs. During the year the Group provided a further £1,300 million to cover further operating costs and redress. To 31 December 2017, the Group has provided a total of £18,675 million in respect of PPI mis-selling redress and administration costs.	The Committee continued to challenge the assumptions made by management to determine the provision for PPI redress and administration costs. The Committee oversaw continued use of sensitivities reflecting the uncertainty that remains around the ultimate cost of PPI redress. The Committee reviewed management's assessment of the potential impact of the Financial Conduct Authority's ('FCA') Policy Statement which confirmed a two month extension to the industry deadline (now August 2019) for consumers to make their PPI complaints, and on the potential impact of the Plevin case. In the second half of the year, consideration was given to the application for a Judicial Review in relation to the FCA's policy statement that introduced both the August 2019 industry deadline and the concept that an undisclosed commission in excess of 50 per cent of the premium would give rise to an unfair relationship under the Consumer Credit Act. The Committee also reviewed management's assessment of the start of the related FCA media campaign. The Committee concluded that the provision for PPI redress and the Group's external disclosures were appropriate. The disclosures relating to PPI are set out in note 37: 'Other provisions' on page F-51 of the financial statements.
Other conduct provisions	The Group has also made provisions totalling £865 million in respect of other conduct matters, including £245 million for packaged bank accounts; £245 million for secured and unsecured arrears handling activities;	For packaged bank accounts, the Committee has continued to monitor the utilisation of the provision and management's assessment of both the remaining exposure and the additional provisions required. This has included reviewing the expected level of complaints and the average redress payments.

	and £100 million in respect of HBOS Reading, all largely reflecting issues caused prior to the implementation of the Group's Conduct Strategy in 2013.	The Committee has understood the basis for determining the provision in respect of the Group's secured and unsecured arrears handling activities. The provision includes the cost of both identifying and rectifying the customers affected. The Committee has reviewed management's assessment of the compensation expected to be paid to a number of customers of the HBOS Impaired Assets Office based in Reading for economic losses, ex-gratia payments and distress and inconvenience following the conviction of two former HBOS employees. The Committee was satisfied that the provisions for other conduct matters were appropriate. The disclosures relating to other conduct provisions are set out in note 37: 'Other provisions' on page F-51 of the financial statements.
Ring-fencing	The Committee discussed the accounting and control implications of the Government's structural reform programme ('ring-fencing').	The Committee discussed the accounting considerations for the planned transfer of assets and liabilities from Lloyds Bank plc and its subsidiaries to the Group's non ring-fenced bank. The issues considered included the effect of transactions between entities under common control, hedge accounting and the impact of applying the 'hold to collect' business model under IFRS 9. The Committee also considered specific financial control risks associated with the implementation of ring-fencing and the risk management framework being implemented to mitigate these risks.
Allowance for impairment losses on loans and advances	Determining the appropriateness of impairment losses requires the Group to make assumptions based on management judgement.	The Committee challenged the level of provisions made and the assumptions used to calculate the impairment provisions held by the Group. The Committee was satisfied that the impairment provisions were appropriate. The disclosures relating to impairment provisions are set out in note 51: 'Financial risk management' on page F-78 of the financial statements. The allowance for impairment losses on loans and advances to customers at 31 December 2017 was £2,201 million (31 December 2016: £2,412 million).
Recoverability of the deferred tax asset	A deferred tax asset can be recognised only to the extent that it is recoverable. The recoverability of the deferred tax asset in respect of carry forward losses requires consideration of the future levels of taxable profit in	The Committee considered the recognition of deferred tax assets, in particular the forecast taxable profits based on the Group's operating plan, the split of these forecasts by legal entity and the Group's long-term financial and strategic plans. The assessment also included the impact of the changes in Group structure that will be made to comply with

	the Group.	ring-fencing requirements.
		The Committee agreed with management's judgement that the deferred tax assets were appropriately supported by forecast taxable profits, taking into account the Group's long-term financial and strategic plans. The disclosures relating to deferred tax are set out in note 36: 'Deferred tax' on page F-49 of the financial statements. The Group's deferred tax asset at 31 December 2017 was £2,284 million (31 December 2016: £2,706 million).
One-off transactions	Determining the appropriate accounting for certain one-off transactions requires management to assess the facts and circumstances specific to each transaction.	The sale of Vocalink was considered by the Committee during the year. The Committee reviewed the accounting proposed by management and was satisfied that it was appropriate.

	KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Uncertain tax positions	The Group has open tax matters which require it to make judgements about the most likely outcome for the purposes of calculating its tax position.	The Committee took account of the respective views of both management and the relevant tax authorities when considering the uncertain tax positions of the Group. The Committee also understood the external advice obtained by management to support the views taken. The Committee was satisfied that the provisions and disclosures made in respect of uncertain tax positions were appropriate. The relevant disclosures are set out in note 47: 'Contingent liabilities and commitments' on page F-62 of the financial statements.
Retirement benefit obligations	The Group must make both financial and demographic assumptions of a judgemental nature to determine the value of the defined benefit obligation.	The Committee considered the assumptions underlying the calculation of the defined benefit liabilities. The most critical assumptions reviewed were in respect of the mortality assumptions, inflation and the discount rate, which have been updated to reflect the Group's recent experience, the latest CMI mortality tables and the results of the latest full actuarial review of the Group's main schemes. The Committee was satisfied that the Group's quantitative and qualitative disclosures made in respect of retirement benefit obligations are appropriate. The relevant disclosures are set out in note 35: 'Retirement benefit obligations' on page F-44 of the financial statements. The defined benefit obligation at 31 December 2017 was £44,384 million (31 December 2016: £45,822 million).
MBNA acquisition	The Group completed its acquisition of MBNA on 1 June 2017.	The Committee reviewed a summary of the key assumptions underlying the fair value adjustments made by management to the acquired MBNA assets and liabilities. The Committee was satisfied with the key assumptions made. The disclosures relating to the acquisition are set out in note 22: 'Acquisition of MBNA Limited' on page F-35 of the financial statements.
Value-In-Force (VIF) asset and insurance liabilities	Determining the value of the VIF asset and insurance liabilities is judgemental and requires economic and non-economic actuarial assumptions.	The Committee challenged the economic and non-economic actuarial assumptions made by management which underpin the calculation of the VIF asset and the insurance liabilities. The most significant assumptions were in respect of annuitant mortality, workplace pension persistency and expenses. The annuitant mortality assumptions were updated to recognise recent experience and for the latest industry improvement model; the assumptions for workplace pension persistency were updated to reflect the

		introduction of new pension freedom; and the Group's expense assumption was updated to reflect new outsourcing arrangements.
		The Committee was satisfied that the value of the VIF asset and insurance liabilities were appropriate. The VIF asset at 31 December 2017 was £4,839 million (31 December 2016: £5,042 million). The disclosures are set out in note 24: 'Value of in-force business' on page F-36 and note 31: 'Liabilities arising from insurance contracts and participating investment contracts' on page F-40 of the financial statements. The liability arising from insurance contracts and participating investment contracts at 31 December 2017 was £103,413 million (2017: £94,390 million).
IFRS 9	The Committee has devoted a substantial amount of time to understanding and challenging management on its IFRS 9 implementation programme. The Group adopted IFRS 9 on 1 January 2018.	The Committee has been briefed on the Group's IFRS 9 implementation programme throughout 2017 and in prior years and held a session dedicated to IFRS 9 in October 2017. IFRS 9 has three critical elements: classification and measurement, impairment, and hedging. The Group has not adopted the hedging rules within IFRS 9 at 1 January 2018 (a permitted option) and, accordingly, the Committee's focus has been on classification and measurement, and impairment. The Committee has received regular updates facilitating detailed discussion and challenge, including a dedicated extended session to review the key decisions taken by management to implement IFRS 9. During these updates, the Committee has discussed the Group's processes to assess the classification and impairment of its financial assets; the proxies and simplifications used in the data for the models, noting the Model Governance Committee's approval of the integrity, adequacy and methodology of the Group's critical models; the estimated financial and capital impact (including the Group's approach to the transitional arrangements); the industry-wide concerns raised by the PRA and the Group's response to these concerns; the key methodology decisions made by management; and the changes to the Group's key controls and governance.
Other accounting standards	The Committee has discussed the requirements of IFRS 15 (Revenue), which the Group adopted on 1 January 2018, and IFRS 16 (Leases), which the Group expects to adopt on 1 January 2019.	The Committee discussed the Group's approach to the new revenue standard (IFRS 15). The standard does not apply to transactions that are accounted for in accordance with IFRS 9 and, as a result, the impact on the Group is not significant.

IFRS 16, the new leasing standard, is not effective until 1 January 2019. The main impact on the Group will be on its property leases which will move ‘on-balance sheet’. The Group will recognise a right of use asset and a corresponding liability. The Committee has discussed the Group’s progress on its implementation plans for the standard during 2017 and will continue to discuss the Group’s plans and the impact of the standard on the Group during 2018.

Other significant issues

The following matters were also considered by the Committee during the year:

Risk management and internal control systems

Full details of the internal control and risk management systems in relation to the financial reporting process are given within the risk management section on pages 45–108. Specific matters that the Committee considered for the year included:

the effectiveness of systems for internal control, financial reporting and risk management;

the extent of the work undertaken by the Finance teams across the Group and consideration of the resources to ensure that the control environment continued to operate effectively; and

the major findings of internal investigations into control weaknesses, fraud or misconduct and management's response along with any control deficiencies identified through the assessment of the effectiveness of the internal controls over financial reporting under the US Sarbanes-Oxley Act.

The Committee was satisfied that internal controls over financial reporting were appropriately designed and operating effectively.

Group Internal Audit

In monitoring the activity, role and effectiveness of the internal audit function and their audit programme the Committee:

monitored the effectiveness of Group Internal Audit and their audit programme through quarterly reports on the activities undertaken and a report from the Quality Assurance function within Group Internal Audit;

approved the annual audit plan and budget, including resource and reviewed progress against the plan through the year;

oversaw the performance of an External Quality Assessment in line with CIIA standards and reviewed the findings and recommendations;

oversaw the process for the appointment of the Chief Internal Auditor; and

considered the major findings of significant internal audits, and management’s response.

Speak Up (the Group’s whistleblowing service)

The Committee received and considered reports from management on the Group’s whistleblowing arrangements including summaries of cases and ongoing reviews of the Whistleblowing Governance Structure. On consideration of the reports submitted, the Committee was satisfied with the actions which had been taken, the reports first having been considered and approved by the Board’s Whistleblowing Champion, Anita Frew.

Auditor independence and remuneration

Both the Board and the external auditor have safeguards in place to protect the independence and objectivity of the external auditor. The Committee continues to operate a policy approved during 2016, and amended in 2017 to regulate the use of the auditor for non-audit services to ensure compliance with the revised Ethical Standards for Auditors from the Financial Reporting Council (FRC).

In order to ensure the objectivity and independence of the external auditor, the policy sets a financial threshold above which all non-audit services provided by the external auditor must be approved in advance by the Committee, with additional provision made for the approval of non-material services which are below the threshold by certain members of senior management. The policy further formalises within the Group the restriction on the provision of non-audit services by the external auditor which the FRC considers to be prohibited.

The total amount of fees paid to the auditor for both audit and non-audit related services in 2017 is disclosed in note 11 to the financial statements on page F-24.

External auditor

The Committee oversees the relationship with the external auditor. During the year, the Committee considered the auditor's terms of engagement (including remuneration), its independence and objectivity and approved the audit plan (including methodology and risk identification processes). Mark Hannam has been PwC's senior statutory audit partner for the Group and the Company since the beginning of 2016, and attends all meetings of the Committee.

The Committee also considered the effectiveness and performance of the auditor and the audit process.

The process was largely based on an assessment of responses received to a questionnaire from the Chairman of the Audit Committee and business areas as well as Finance, Risk, Legal and Group Internal Audit. The Committee considered also the FRC's Audit Quality Inspection Report published in June 2017. Following review of the feedback from the process the Committee concluded that it was satisfied with the auditor's performance and recommended to the Board a proposal for the re-appointment of the auditor, to be approved at the Company's AGM.

Statutory Audit Services compliance

The Company and the Group confirm compliance with the provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 for the year to 31 December 2017.

PwC has been auditor to the Company and the Group since 1995, having previously been auditor to certain of the Group's constituent companies. PwC was re-appointed as auditor with effect from 1 January 2016 following a tender process conducted in 2014 in respect of the audit contract for the 2016 financial year. There will be a mandatory rotation for the 2021 audit, and a competitive tender process will be conducted in advance of this time, if not earlier.

CORPORATE GOVERNANCE

BOARD RISK COMMITTEE REPORT

I am pleased to report on how the Board Risk Committee (the 'Committee') has discharged its responsibilities throughout 2017.

The Committee has continued to give detailed consideration to existing and emerging risks, through a balanced agenda which ensures sufficient focus on standing areas of risk management, together with specific attention being given to those emerging risks which are considered to be of ongoing importance to the Group and its customers. During the year, the Committee continued to make use of dedicated sub-committees to focus on particular areas, such as IT resilience and cyber security, where the dynamic nature and significance of related risks and challenges continues to evolve.

Focus has also been given to the successful

Committee purpose and responsibilities

The purpose of the Committee is to review the risk culture of the Group, setting the tone from the top in respect of risk management. The Committee is also responsible for ensuring the risk culture is fully embedded and supports at all times the Group's agreed risk appetite, covering the extent and categories of risk which the Board considers as acceptable for the Company.

In seeking to achieve this, the Committee assumes responsibility for monitoring the Group's Risk Management Framework, which embraces risk principles, policies, methodologies, systems, processes, procedures and people. It also includes the review of new, or material amendments to risk principles and policies, and overseeing any action resulting from material breaches of such policy.

More details on the Group's wider approach to risk management can be found in the risk management section on pages 45–108. Full details of the Committee's responsibilities are set out in its terms of reference, which can be found at www.lloydsbankinggroup.com/our-group/corporate-governance

Committee composition, skills, experience and operation

Alan Dickinson, Chairman of the Committee, is a highly regarded retail and commercial banker, having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK, overseeing the group's Retail and Commercial operations in the UK. The Committee is composed of independent Non-Executive Directors, who provide core banking and risk knowledge, together with breadth of experience which brings knowledge from other sectors, and a clear awareness of the importance of putting the customer at the centre of all that the Group does.

During the year the Committee met its key objectives and carried out its responsibilities effectively. Details of Committee membership and meeting attendance can be found on page 141.

As the most senior risk committee in the Group, the Committee interacts with other related risk committees, including the Group Risk Committee. Such interaction assists with the agenda planning process, where in addition to annual agenda planning, matters considered by the Group Risk Committee are reviewed to ensure escalation of all relevant matters to the Board Risk Committee.

Matters considered by the Committee

execution of a number of significant regulatory change programmes, proactive identification and resolution of conduct issues, and the challenges and opportunities arising from the introduction of open banking and the second Payment Services Directive. Increasing levels of UK consumer indebtedness were also reviewed, and whilst overall controls were found to be robust, with management actions being taken to increase risk mitigation and to minimise customer detriment; close monitoring will continue into 2018. Progress across each of these areas will be a key ongoing focus for the Committee during 2018.

The environment within which the Group operates continues to be subject to considerable change. Uncertainties, including the EU Exit and wider geo-political risks continue to provide challenges, and the Committee will continue to monitor developments and any associated impact on the Group's risk profile.

The Committee has concluded that the

All Non-Executive Directors are members of the Board Risk Committee. The Chief Risk Officer has full access to the Committee and attends all meetings. The Chief Internal Auditor and members of the Executive also attend meetings, as appropriate.

Over the course of the year the Committee considered a wide range of risks facing the Group, both standing and emerging, across all key areas of risk management, in addition to risk culture and risk appetite, as noted above.

As part of this review, certain risks were identified which required further detailed consideration. Set out on the following pages is a summary of these risks, with an outline of the material factors considered by the Committee, and the conclusions which were ultimately reached.

During 2017, the Committee continued to utilise established sub-committees to provide additional focus on Financial Markets, IT Resilience & Cyber, and Stress Testing & Recovery Planning. These sub-committees enable members of the Committee to

Group continues to have strong discipline in the management of both emerging and existing risks, and the Committee's work continues to help support the Group in achieving its core aim of operating as a safe, low risk bank.

dedicate additional time and resource to achieving a more in-depth understanding of the topics covered, and enable further review and challenge of the associated risks.

Alan Dickinson

Chairman, Board Risk Committee

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Activities during the year

	KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
IT and cyber risk	A resilient IT environment is critical to providing reliable services to our customers and enabling sustainable growth. The dynamic cyber risk and the potential for external attacks threatens the confidentiality and integrity of electronic data or the availability of systems. These are key risks for the Group and a central area of focus for the Committee.	Given the dynamic nature and significance of IT and cyber risks, the Board Risk Committee sub-committee on IT resilience and cyber continues to enable more in depth consideration of these risks to the Group. During the year, the sub-committee gave consideration to a wide range of issues including enhanced assurance for cyber critical third parties, cyber and IT controls, Technology Resilience and Cyber Programme updates, Cyber Strategy, and roles and responsibilities of the Chief Security Officer. Alongside this an advisory panel comprised of external industry experts provides the sub-committee with an external view of current and evolving industry wide cyber security threats, challenges and developments. Conclusion: Whilst there have been significant improvements in cyber capability and the Group is within Board risk appetite in relation to its industry benchmark, the Committee will continue to challenge the Group to further improve its ability to mitigate and respond to cyber risk. Technology resilience will also remain a key focus for 2018 as the Group continues to invest in its infrastructure.
Strategy execution risk	The Committee recognises the risks associated with an extensive discretionary and regulatory change agenda. Assessments have been performed to establish achievability of its plans whilst new metrics will be introduced for ongoing risk monitoring and management.	In order to maintain and enhance the Group's strategic position, it continues to invest in new initiatives and programmes. The Group acknowledges the challenges faced with delivering this strategy alongside the extensive regulatory and legal change agenda whilst additionally enhancing systems and controls. In the development of the strategy, the Group considers these demands against the capacity of the organisation to ensure successful delivery for both customers and shareholders. Conclusion: Whilst initial planning has been undertaken to satisfy the Board that the Group can deliver against its planned change objectives, new metrics are being introduced to enable effective performance monitoring, risk management and the assessment of delivery challenges including subject matter capacity and capability. These risk metrics will be managed across the Group but reported to Board on a regular basis.

Regulatory and legal risk	Managing regulatory risk continues to be a key focus within the Group due to the significant amount of highly complex and interdependent regulatory reform that we have had to manage.	The Committee continues to focus on ensuring we have effective controls and oversight to comply with existing regulatory obligations. The Committee has also been focused on overseeing the successful execution of a number of significant, complex and interdependent regulatory change programmes including ring-fencing, EU General Data Protection Regulation, Payment Services Directive II (PSD2), Markets in Financial Instruments Directive II, and the Basel Committee on Banking Supervision (BCBS 239). Given the significance of ring-fencing, monthly programme reporting has been presented to Board and due consideration given to governance and compliance within the ring-fenced bank. Conclusion: The Group has placed significant focus on ensuring compliance with these complex regulatory changes. Regulatory risk will remain a key area of focus for the Committee in 2018 given the importance of complying with our regulatory obligations.
Operational risk	Managing operational risk continues to be a key focus within the Group due to the complexity and volume of change, the Group's IT infrastructure, cyber risk, and reliance on third party suppliers.	The Committee continues to focus on ensuring the Group has an effective framework for managing operational risk, including enhancing the use of key risk and control indicators and scenarios. The Committee has considered a number of reports in relation to the operational risk framework, cyber, IT resiliency, user access management and Cloud computing. Conclusion: The Group has made progress in enhancing its management of operational risk. The Group will continue to focus on enhancing the maturity of its operational risk framework to ensure it is proactive, forward looking and effective in managing the 21st century risks in a digital world, including execution, model, cyber/IT and third party risk.
Conduct risk	The Committee continues to focus closely on the Group's management of conduct risk.	Throughout 2017, the Committee has considered reports on the proactive identification and resolution of conduct issues which directly impact customers (customer conduct risks) and those which can undermine market integrity (market conduct risks). The pace and quality of remediation remained a focus, including root cause analysis to establish lessons learned and help prevent similar issues in the future. Consideration was also given to the conduct risks associated with the treatment of customers in vulnerable circumstances, with a particular focus on those in financial difficulties. In addition the Committee continues to consider developments in the Group's conduct culture as well as

		reports on rectification programmes, complaints and conduct risk appetite metric performance. Conclusion: Whilst good progress has been made in 2017, to continue embedding the Group's conduct strategy initiatives into business as usual, ongoing improvement in the Group's conduct risk profile will remain a priority for the Group in 2018 and will continue to be a subject of focus for the Committee.
Consumer lending indebtedness	The Committee reviewed key metrics for the motor finance, credit cards, personal loan and personal current account overdraft portfolios to understand the risks associated with persistent indebtedness.	The macroeconomic and market context was reviewed to ensure understanding of the key drivers of increased consumer lending; this included an examination of the overall market growth in consumer lending, changes in indebtedness, a comparison to pre-crisis levels and a review of the growth rate of each consumer credit product within the portfolio. The key macroeconomic drivers of credit losses including the specific impact of debt to income were also reviewed. Underwriting standards, credit quality and the programme of ongoing improvements to strengthen indebtedness and affordability controls were assessed to ensure that risk appetite for the consumer lending portfolios remains appropriate. Conclusion: Regular monitoring continues to assist the Committee in its assessment of indebtedness of the consumer lending portfolios, with management continuing to take action to mitigate potential risks associated with increased indebtedness and to continue to review the appropriate treatment of vulnerable customers.

	KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Data risk	The Committee continues to focus on the Group's risks associated with data management, including governance, control and privacy.	Given the increase in data regulation, data remains a key risk for the Group and remains a critical area of focus for the Group's regulators. The Committee has monitored and reviewed the risks associated with the introduction of PSD2, including the need to ensure there is appropriate control and ownership of data as the use of Third Party Providers (TPPs) becomes more prevalent. With the introduction of GDPR, the Committee has overseen actions within the Group to ensure clear control and management of customer data, including assessing its accuracy and how it's used. It is increasingly important for the Committee to ensure the Group has effective controls in place to manage any potential data breaches, including a defined escalation route to the FCA and the ICO. Conclusion: The Group continues to enhance the controls required to manage the data environment effectively, whilst the Committee ensures the necessary risk oversight of the delivery of required regulatory changes relating to data.
UK Secured and buy-to-let	Reviews were undertaken of the risks associated with the UK residential interest only portfolio and the Group's participation in the buy-to-let segment.	In reviewing the UK Secured portfolio, specific consideration was given to the risks associated with maturing residential interest only mortgages. The Committee reviewed repayment rates, in-life and past-term customer engagement and treatment strategies, credit risk performance including debt-to-value ratios, and the Group's risk appetite for future originations. The Group's participation in the buy-to-let segment was also reviewed, including the design and implementation of underwriting changes in response to taxation changes and new supervisory standards for portfolio landlords. Conclusion: The Committee continues to monitor closely trends in the residential interest only portfolio and the progress of management's initiatives to further enhance customer treatment. The Committee was satisfied that additional underwriting controls within buy- to-let provided adequate safeguards to support continued participation in line with the Group's risk appetite limits.
Open banking and payments	Open banking and PSD2 present strategic and operational challenges as well as opportunities and is a central area of focus for the Group.	The UK payments landscape is experiencing a period of unprecedented change. Open banking, mandated by the Competition Markets Authority, will allow TPPs to offer new services through Application Process Interface technology, providing customers with alternative means of access to their bank accounts (governed by explicit customer consent). PSD2 classifies these TPPs as Account Information Service Providers and Payment Initiation Service

		Providers. The aim of these changes is to promote competition and enhance customer choice. The changes create a number of key risks including (but not limited to) security risk, data risk and fraud risk as sensitive and confidential customer information is shared more widely than current practice. The Group is alert to the potential new vectors for fraud and risks to consumers flowing from these channels, particularly in relation to data security. Additional controls and mitigations have been developed. The Committee received updates throughout 2017 through the consolidated risk report regarding the requirements of the legislation and how the Group is planning to achieve compliance. Conclusion: Initial legislative changes required compliance in January 2018 and further regulatory requirements will come into force by the third quarter of 2019 (when strong customer authentication becomes mandatory). The Committee will continue to review progress throughout 2018 as further developments are delivered by the Group-wide programme.
EU exit	Negotiations are on-going to determine the terms of the UK's exit from the EU. The uncertainty regarding the timing and the process itself could affect the outlook for both the UK and global economy.	The key risks for the Group include adverse movements and volatility in Financial Markets, impact on our customer credit profiles and the ability to operate cross border. When reviewing the possible impacts of the EU exit, the Committee has given consideration to the Group's strong UK focus and UK-centric strategy. The Committee continues to review the effectiveness of risk management across the Group and the actions taken to better understand the impact on our customers, as well as close monitoring of positions in Financial Markets. These actions not only include continued support to all our customers, but in addition the Group has ensured our Commercial Banking customers consider their relevant trading and financial impacts. Conclusion: The EU exit plans continue to be closely monitored by the Committee via a suite of early warning indicators and risk mitigation plans, including the possible loss of passporting arrangements into Europe.
Residual value risk in Motor Finance portfolio	Residual value risk of motor finance businesses was monitored over the year.	Consideration was given to new car registrations, used vehicle prices and provision adequacy in the context of Group exposure to residual value risk in the growing motor finance businesses. The Committee also monitored exposure to residual value risk via risk appetite. Conclusion: Residual value risk exposure continues to perform in line with appetite and the Committee will continue to closely monitor trends in the used car market and automotive sector as a whole.
Model risk	The Committee recognises the importance of the Group	The Committee discussed, during the year, the current model landscape, trends in performance and actions being taken to resolve material model issues. The Committee considered regulatory impacts and the action being taken by the

Executive and the Board holding a strong understanding of the Group’s models, their associated risks and performance.	Group as well as benchmarking the Group’s approach to the industry. Conclusion: Whilst good progress was made in 2017, the demand for models and model related activity is expected to increase, with key drivers being the Group strategy and the need for increased automation and analytics as well as increasing regulatory demands. There will be an increased focus by the Committee in 2018 on model risk management to address these challenges.

RESPONSIBLE BUSINESS COMMITTEE REPORT

Doing business responsibly is central to our purpose to Help Britain Prosper, and supports our strategy to be a low risk, customer focused bank.

At its meetings, the RBC oversaw a wide range of responsible business activities, which included our substantial investments to provide opportunities for those starting out, whether as first time home buyers, small business start-ups, social entrepreneurs or apprentices.

We also reviewed work being done to tackle disadvantage in communities across the UK, through our four Charitable Foundations, our partnership with Mental Health UK, and our support for vulnerable customers, including those struggling with low financial skills or illness.

To respond to a rapidly changing external environment, the RBC also reviewed emerging areas such as the impact of climate change on UK businesses, individuals and communities, and ways in which we can support enhanced UK productivity through the strengthening of digital skills, particularly for individuals, small businesses and charities.

Many of these activities are described in our 2018 Helping Britain Prosper Plan, which is developed annually with the RBC to reflect the ways in which Lloyds Banking Group, both directly (as the largest corporate tax payer and a substantial UK-wide employer) and indirectly, contributes to the wider economic and social health of Britain.

I would like to thank the many thousands of colleagues who have dedicated their time and energy to supporting these activities and I very much hope you enjoy and find it interesting to read about the Committee's work.

Sara Weller

Chairman, Responsible Business Committee

How the Committee spent its time in 2017

The Chairman of the Committee reviews the forward agenda regularly to ensure that the appropriate topics are considered and adequate time is allocated for members to provide input to proposals at meetings.

During the year, the Committee considered in detail the development of the Group's responsible business approach, including a sustainability strategy. Detailed discussions took place with colleagues from relevant business areas and external advisers at which proposals were considered and challenged leading to a change of focus on some areas of the approach. The Committee contributed to the plans for strengthening the Group's ongoing commitment to supporting basic, workplace and specialist digital skills in the UK during 2018 and provided perspectives on how this could best be achieved.

The Committee also considered the following topics:

a regular progress report from the Chairman of the executive level Group Customer First Committee (see page 40) on the approach to customers, conduct and culture;
a report from Group Sourcing on working in a responsible way with the Group's suppliers;
an oversight of the processes which provide reassurance that customer rectifications are managed responsibly;
the benchmarking of trust amongst stakeholders and customers against financial services companies and acknowledged leaders in other industries;
the outputs from colleague surveys in relation to the Group's role as a responsible business; and
the draft Modern Slavery Statement, before recommending to the Board for approval.

Committee purpose

The purpose of the Committee is to oversee the Group's strategy and plans for becoming a leader in responsible business as part of the objective to help Britain prosper; the activities which have an impact on the Group's behaviour and reputation as a trusted, responsible business; and the development of the Group's

responsible business report and Helping Britain Prosper Plan, which the Committee recommends to the Board for approval.

Committee composition, attendance at meetings and effectiveness review

Alan Dickinson, Chairman of the Board Risk Committee, attended all meetings. Representatives from Group Internal Audit and the Chief Operating Office are invited to meetings as appropriate.

Representatives of the regulators attended meetings as observers in January (FCA) and July 2017 (PRA).

During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review. The Committee will consider the output from the 2017 effectiveness review and whether any changes need to be made to the way it works.

Details of the committee membership and meeting attendance can be found on page 141.

RBC Chairman's visit to Elizabeth Fry charity

In August 2017, Sara Weller visited the Elizabeth Fry Charity in Reading, which has received a grant of around £70,000 from the Lloyds Bank Foundation for England and Wales. The charity runs one of only six approved premises for women released from prison on bail, on license or as part of a community order. The charity supports residents to deal with some challenging issues, such as substance abuse or mental health problems and equips them with the skills to live (and hopefully work) more independently within 3-6 months. After the visit Sara Weller commented: "my visit reinforced the message that the Foundations actively seek out and make a difference for the most disadvantaged people in our society. Supporting them is something in which we, as a Group, take great pride."

DISCLOSURE CONTROLS AND PROCEDURES

As of 31 December 2017, Lloyds Banking Group, under the supervision and with the participation of the Group's management, including the Group Chief Executive and the Chief Financial Officer, performed an evaluation of the effectiveness of the Group's disclosure controls and procedures. Based on this evaluation, the Group Chief Executive and Chief Financial Officer concluded that the Company's disclosure controls and procedures, at 31 December 2017, were effective for gathering, analysing and disclosing with reasonable assurance the information that Lloyds Banking Group is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms. The Lloyds Banking Group's management necessarily applied its judgement in assessing the costs and benefits of such controls and procedures, which by their nature can provide only reasonable assurance regarding management's control objectives.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There have been no changes in the Lloyds Banking Group's internal control over financial reporting during the year ended 31 December 2017 that have materially affected, or are reasonably likely to materially affect, the Lloyds Banking Group's internal control over financial reporting.

MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Lloyds Banking Group plc is responsible for establishing and maintaining adequate internal control over financial reporting. Lloyds Banking Group plc's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorisations of management and directors of Lloyds Banking Group plc; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Internal control systems, no matter how well designed, have inherent limitations and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The management of Lloyds Banking Group plc assessed the effectiveness of the Company’s internal control over financial reporting at 31 December 2017 based on the criteria established in Internal Control – Integrated Framework 2013 issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). Based on this assessment, management concluded that, at 31 December 2017, the Company’s internal control over financial reporting was effective.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued an audit report on the Company’s internal control over financial reporting as of 31 December 2017. This report appears on page F-2.

GOING CONCERN

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: funding and liquidity on page 43 and pages 94 to 100 and capital position on pages 87 to 94. Additionally, the Directors have considered capital and funding projections for the Company and the Group. Accordingly, the Directors conclude that the Company and the Group have adequate resources to continue in operational existence for a period of at least 12 months from the date of approval of the financial statements and therefore it is appropriate to continue to adopt the going concern basis in preparing the accounts.

MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

MAJOR SHAREHOLDERS

All shareholders within a class of the Company's shares have the same voting rights. As at 23 February 2018 the Company had received notification under the FCA Disclosure Guidance and Transparency Rules ('DTR') of the following holdings in the Company's issued ordinary share capital.

	Interest in shares	% of issued share capital /voting rights[4]
BlackRock Inc.	3,668,756,765[1]	5.14%
Harris Associates L.P.	3,607,058,758[2,3]	5.01%

1 The notification of 13 May 2015 provided by BlackRock Inc. under Rule 5 of the DTR identifies (i) an indirect holding of 3,599,451,380 shares in the Company representing 5.04 per cent of the voting rights in the Company, and (ii) a holding of 69,305,385 in other financial instruments in respect of the Company representing 0.09 per cent of the voting rights of the Company. BlackRock Inc.'s holding most recently notified to the Company under Rule 5 of the DTR varies from the holding disclosed in BlackRock Inc.'s Schedule 13-G filing with the US Securities and Exchange Commission dated 7 February 2018, which identifies beneficial ownership of 4,843,291,732 shares in the Company representing 6.7 per cent of the issued share capital in the Company. This variance is attributable to different notification and disclosure requirements between these regulatory regimes. The notifiable holding by BlackRock Inc. in the Company has not changed since 31 December 2015. Prior to 31 December 2015, BlackRock Inc.'s holding in the Company was not required to be disclosed under the US Securities and Exchange Commission rules.

2 An indirect holding

3 Notification received on 18 September 2017.

4 Percentage correct as at the date of notification.

As at 23 February 2018, the Company had 2,444,198 registered ordinary shareholders. The majority of the Company's ordinary shareholders are registered in the United Kingdom. 2,510,635,157 ordinary shares, representing 3.48 per cent of the Company's issued share capital, were held by BNY Mellon as depositary for the ordinary share American Depositary Share Programme through which there were 183 record holders.

Additionally, the majority of the Company's preference shareholders are registered in the United Kingdom, with a further four record holders with an address in the United States registered through the Company's preference share American Depositary Share Programme.

RELATED PARTY TRANSACTIONS

The Group, as at 31 December 2017, had related party transactions with 19 key management personnel, certain of its pension funds, collective investment schemes and joint ventures and associates. See note 46 to the financial statements.

REGULATION

APPROACH OF THE FINANCIAL CONDUCT AUTHORITY ("FCA")

As per the FSMA (amended by the Financial Services Act 2012), the FCA has a strategic function to ensure that the relevant markets function well. In support of this, the FCA has three operational objectives: to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system and to promote effective competition in the interests of consumers.

The FCA Handbook sets out rules and guidance across a range of conduct issues with which financial institutions are required to comply including high level principles of business and detailed conduct of business standards and reporting standards.

REGULATORY APPROACH OF THE PRA

As per the Financial Services Act 2012, the PRA has two statutory objectives: to promote the safety and soundness of the firms which it supervises and, with respect to insurers, to contribute to the securing of an appropriate degree of protection for policyholders. The PRA's regulatory and supervisory approach incorporates three key characteristics: to take a judgement-based approach, a forward-looking approach, and a focused-approach.

The PRA has largely inherited the prudential aspects of the former FSA Handbook, including regulations and guidance relating to capital adequacy and liquidity among several other things.

OTHER BODIES IMPACTING THE REGULATORY REGIME

THE BANK OF ENGLAND AND HM TREASURY

The agreed framework for co-operation in the field of financial stability in the financial markets is detailed in the Memorandum of Understanding published jointly by HM Treasury, the FCA (formerly the FSA) and the Bank of England (now including the PRA) (together, the "Tripartite Authorities"). The Bank of England has specific responsibilities in relation to financial stability, including: (i) ensuring the stability of the monetary system; (ii) oversight of the financial system infrastructure, in particular payments systems in the UK and abroad; and (iii) maintaining a broad overview of the financial system through its monetary stability role. The Bank of England also wholly incorporates the PRA.

UK FINANCIAL OMBUDSMAN SERVICE (“**FOS**”)

The FOS provides consumers with a free and independent service designed to resolve disputes where the customer is not satisfied with the response received from the regulated firm. The FOS resolves disputes for eligible persons that cover most financial products and services provided in (or from) the UK. The jurisdiction of the FOS extends to include firms conducting activities under the Consumer Credit Act (“CCA”). Although the FOS takes account of relevant regulation and legislation, its guiding principle is to resolve cases on the basis of what is fair and reasonable; in this regard, the FOS is not bound by law or even its own precedent. The decisions made by the FOS are binding on regulated firms.

THE FINANCIAL SERVICES COMPENSATION SCHEME (“**FSCS**”)

The FSCS was established under the FSMA and is the UK’s statutory fund of last resort for customers of authorised financial services firms. Companies within the Group are responsible for contributing to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. The FSCS can pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it. The FSCS is funded by levies on firms authorised by the PRA and the FCA, including companies within the Group.

LENDING STANDARDS BOARD

The Lending Standards Board (formerly the Banking Code Standards Board) is responsible for monitoring and enforcing compliance with the Standards of Lending Practice (which replaced the voluntary Lending Code on 1 October 2016). The standards relate to certain lending (current account overdrafts, loans and credit cards) to consumers, micro-enterprises and charities with an income of less than £1 million.

UK COMPETITION AND MARKETS AUTHORITY

Since 1 April 2014 the competition functions previously exercised by the Office of Fair Trading and the Competition Commission have been transferred to the new CMA or the FCA. The CMA’s regulatory and enforcement powers impact the banking sector in a number of ways, including powers to investigate and prosecute a number of criminal offences under competition law. In addition, the CMA is now the lead enforcer under the Unfair Terms in Consumer Contracts Regulations 1999.

UK INFORMATION COMMISSIONER'S OFFICE

The UK Information Commissioner's Office is responsible for overseeing implementation of the Data Protection Act 1998. This Act regulates, among other things, the retention and use of data relating to individual customers. The Freedom of Information Act 2000 (the "**FOIA"**) sets out a scheme under which any person can obtain information held by, or on behalf of, a "public authority" without needing to justify the request. A public authority will not be required to disclose information if certain exemptions set out in the FOIA apply.

THE PAYMENTS SYSTEM REGULATOR ("PSR")

The PSR is an independent economic regulator for the £75 trillion payment systems industry, which was launched in April 2015. Payment systems form a vital part of the UK's financial system – they underpin the services that enable funds to be transferred between people and institutions. The purpose of PSR is to make payment systems work well for those that use them. The PSR is a subsidiary of the FCA, but has its own statutory objectives, Managing Director and Board. In summary their objectives are: to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them; to promote effective competition in the markets for payment systems and services - between operators, payment services providers and infrastructure providers; and to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

COMPETITION REGULATION

The CMA commenced a Phase 2 competition investigation into PCA and SME Banking in November 2014. The final CMA report was published on 9 August 2016. Findings and proposed remedies were largely as expected and consistent with the interim publication. Key remedies include: introduction of "Open Banking", publication of service quality information and customer information prompts. Recommendations were also made regarding improvements to current account switching, monthly maximum charge for PCA overdraft users, overdraft notifications and additional measures for small business to make comparison easier.

REGULATION

The FCA obtained concurrent competition powers on 1 April 2015 in relation to the provision of financial services in the UK, in addition to its already existing competition objective. The FCA has been undertaking a programme of work to assess markets across financial services to ascertain whether or not competition is working effectively in the best interests of consumers. The FCA announced on 3 November 2016 that it will take action to improve competition in the current account market, following the CMA's recommendations. The FCA actions will extend beyond the CMA remedies and will include considering whether rules are required in relation to the maximum monthly charge for overdrafts plus taking forward further work on overdrafts through its work on high cost credit. The FCA will also act as an observer on the "Open Banking" steering group and be involved in developing and testing "prompts" to encourage customers to consider their banking arrangements.

The PSR became operational in April 2015 with concurrent competition powers in respect of UK payment systems, in addition to a statutory objective to promote effective competition. The PSR has completed two market reviews into the provision of indirect access and into the ownership and competitiveness of payments infrastructure. The final report for indirect access was published in July 2016 noting some concerns with quality of access, limited choice and barriers to switching. The final report for competitiveness of payments infrastructure, also published in July 2016, noted some concerns with competition in payments infrastructure.

In addition, the PRA also has a secondary objective under the Financial Services (Banking Reform) Act to, so far as reasonably possible, act in a way which facilitates effective competition.

The UK Government has a continuing interest in competition. In November 2015, the UK Government published a document entitled "A better deal: boosting competition to bring down bills for families and firms". This document focuses on the competition aspects of the UK Government's productivity plan and aims to promote competition in various sectors, including financial services.

The new regulatory regime may lead to greater UK Government and regulatory scrutiny or intervention in the future, ranging from enforced product and service developments and payment system changes to significant structural changes. This could have a significant effect on the Group's operations, financial condition or the business of the Group.

EU REGULATION

The Liikanen Report considered whether there is a need for structural reforms of the EU banking sector and to make relevant proposals as appropriate, with the objective of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market. The high-level expert group chaired by Erkki Liikanen presented its recommendations to the EU Commissioner on 2 October 2012. They recommended a set of five measures that augment and complement the set of regulatory reforms already enacted or proposed by the EU, the Basel Committee and national governments. First, proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of the bank's business. This would ensure that trading activities beyond the threshold are carried out on a stand-alone basis and separate from the deposit bank. The other measures include: emphasising the need for banks to draw up and maintain effective and realistic recovery and resolution plans; supporting the use of designated bail out instruments; applying more robust weights in the determination of minimum capital standards; and augmenting existing corporate governance reforms such as strengthening boards and management, promoting the risk management function, rein in compensation for bank management and staff, improve risk disclosure, and strengthening sanctioning powers.

On 17 January 2014, the EU Commission published a press release confirming that it intends to make a proposal for the reform of the structure of banking in the EU, which will be based on the Liikanen Report. The objective of the reforms will be to make the financial sector as a whole more robust and resilient, to reduce the impact of potential bank failures, and ensure the financial sector is at the service of the real economy. In doing so, the reforms will aim to eliminate the concept of banks being "too big to fail". The proposed regulation included derogation from the separate requirements for banks in EU member states which had implemented equivalent legislation before 29 January 2014 (including the UK). The form of the proposed EU regulation has been subject to much debate within the European institutions, with uncertainty surrounding both the outcome and timeline for conclusion. The main disagreements concern the need for "automatic" separation of trading activities and the level of discretion given to national competent authorities.

The UK is subject to the directives introduced under the Financial Services Action Plan. However, these directives are regularly reviewed at EU level and could be subject to change. The Group will continue to monitor the progress of these initiatives, provide specialist input on their drafting and assess the likely impact on its business.

CRD IV implements the Basel III agreement in the EU, and introduces significant changes in the prudential regulatory regime applicable to banks including: increased minimum capital ratios; changes to the definition of capital and the calculation of risk-weighted assets; and the introduction of new measures relating to leverage, liquidity and funding. CRD IV also makes changes to rules on corporate governance, including remuneration, and introduces standardised EU regulatory reporting requirements which will specify the information that must be reported to supervisors in areas such as own funds, large exposures and financial information.

On 29 January 2014, the European Commission published its long-awaited proposals for structural reform of EU banks in the form of a draft regulation. The proposals apply to the largest EU banks and groups – on the basis of historical data the European Commission estimates that 29 EU banks may be subject to such proposed regulation. The European Commission's publication is only a proposal at this stage. It may well be amended, perhaps substantially, by the European Parliament and the Council before it is adopted.

U.S. REGULATION

In the United States, Lloyds Bank maintains a branch in New York, licensed by the New York State Department of Financial Services ("**NYDFS**") and subject to regulation and examination by the NYDFS and the Federal Reserve Bank of New York ("**FRBNY**").

The licensing authority of Lloyds Bank'sU.S. branch has the authority, in certain circumstances, to take possession of the business and property of Lloyds Bank located in the state of the office it licenses. Such circumstances generally include violations of law, unsafe business practices and insolvency.

The existence of a branch in the U.S. subjects the Company and its subsidiaries doing business or conducting activities in the U.S. to oversight by the Board of Governors of the Federal Reserve System **("Federal Reserve Board").**

Each of the Company, Lloyds Bank, HBOS and BoS is a foreign banking organisation treated as a bank holding company within the meaning of the U.S. Bank Holding Company Act of 1956 **("BHC Act")** in accordance with the provisions of the International Banking Act of 1978 and each has elected, with the permission of the Federal Reserve Board, to be treated as a financial holding company under the BHC Act.

REGULATION

Financial holding companies may engage in a broader range of financial and related activities than are permitted to bank holding companies that do not maintain financial holding company status, including underwriting and dealing in all types of securities. To maintain financial holding company status, the Company, Lloyds Bank, HBOS and BoS are required to meet certain capital ratios and be deemed to be “well managed” for purposes of the Federal Reserve Board’s regulations. The Group’s direct and indirect activities and investments in the United States are limited to those that are “financial in nature” or “incidental” or “complementary” to a financial activity, as determined by the Federal Reserve Board.

The Group is also required to obtain the prior approval of the Federal Reserve Board before acquiring, directly or indirectly, the ownership or control of more than 5 per cent. of any class of the voting shares of any U.S. bank or bank holding company.

The Group’s U.S. broker dealer, Lloyds Securities Inc., is subject to regulation and supervision by the Securities and Exchange Commission **(“SEC”)** and the Financial Industry Regulatory Authority with respect to its securities activities, including sales methods, trade practices, use of safekeeping of customers’ funds and securities, capital structure, recordkeeping, the financing of customers’ purchases and conduct of directors, officers and employees.

A major focus of U.S. governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with U.S. economic sanctions, with serious legal and reputational consequences for any failures arising in these areas. The Group engages, or has engaged, in a limited amount of business with counterparties in certain countries which the U.S. State Department currently designates as state sponsors of terrorism, including Iran, Syria, Sudan and North Korea. The Group intends to engage only in new business in such jurisdictions and only in very limited circumstances where the Group is satisfied concerning legal, compliance and reputational issues. At 31 December 2017, the Group does not believe that the Group’s business activities relating to countries designated as state sponsors of terrorism were material to its overall business.

The Group estimates that the value of the Group’s business in respect of such states represented less than 0.01 per cent. of the Group’s total assets and, for the year ended December 2017, the Group believes that the Group’s revenues from all activities relating to such states were less than 0.001 per cent. of its total income, net of insurance claims. This information has been compiled from various sources within the Group, including information manually collected from relevant business units, and this has necessarily involved some degree of estimate and judgement.

U.S. regulation, including changes implemented under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), addresses systemic risk oversight, bank capital standards, the resolution of failing systemically significant financial institutions in the U.S., OTC derivatives, restrictions on the ability of banking entities to engage in proprietary trading activities and make investments in and sponsor certain private equity funds and hedge funds (known as the “**Volcker Rule**”), asset securitisation activities and securities market conduct and oversight.

Among other requirements, the Dodd-Frank Act also required entities that are swap dealers and major swap participants to register with the U.S. Commodity Futures Trading Commission ("**CFTC**"). Lloyds Bank is registered as a swap dealer and as such, is subject to regulation and supervision by the CFTC and the National Futures Association with respect to its swap activities, including risk management, practices, trade documentation and reporting, business conduct and recordkeeping, among others.

DISCLOSURE PURSUANT TO SECTION 219 OF THE IRAN THREAT REDUCTION AND SYRIA HUMAN RIGHTS ACT (ITRA)

Since the introduction of an enhanced financial sanctions policy, the Group has been proactive in reducing its dealings with Iran and individuals and entities associated with Iran. There remain a small number of historic Iran-related business activities which the Group has not yet been able to terminate for legal or contractual reasons.

Pursuant to ITRA Section 219, the Group notes that during 2017, its non-US affiliates, Lloyds Bank plc and Bank of Scotland plc, received or made payments involving entities owned or controlled by the Government of Iran as defined under section 560.304 of title 31, Code of Federal Regulations, and/or designated under Executive Order 13382. In all cases, the payment was permitted under UK and EU sanctions legislation, specific authority was sought from and granted by HM Treasury, the UK's Competent Authority to provide such authorisations or the payment(s) were credited to a blocked account, held in the name of the entity, in accordance with UK and EC sanctions legislation.

Gross revenues from these activities were approximately £5,000. Net profits from these activities were approximately £5,000.

The Group's businesses, being reported below, are conducted in compliance with applicable laws in respect of Iran sanctions and, except as noted below, the Group intends to continue these historic activities until it is able to legally terminate the contractual relationships or maintain/manage in accordance with prevailing sanctions obligations. The nature of these activities is as follows:

1. Receipts in relation to repayments of a European Export Credit Agreement loan made prior to 2005 with respect to an underlying commercial contract between National Iranian Steel Company (Iran) and IRASCO srl (Italy). The loan is now fully repaid.
2. Payments made to and received from entities directly or indirectly linked to the Government of Iran. Such payments comply with UK regulation and legislation.
3. Payments received relating to operational and processing costs for a joint venture between BP Exploration Company Limited and Iranian Oil Company (UK) Limited. The Iranian Oil Company (UK) Limited is designated under

Executive Order 13599). These payments are permitted under OFAC license IA-2013-302799-6.

4. Payments made to a blocked account in the name of Commercial Bank of Syria related to historic guarantees, entered into by the Group between 1997 and 2008, the majority of which relate to Bail Bonds for vessels. The Commercial Bank of Syria is designated under Executive order 13382.

5. Sums paid out from a pension trust fund to UK nationals resident in the UK who were employees of a company indirectly owned or controlled by an entity designated under Executive Order 13382 that is also owned or controlled by the Government of Iran.

6. Lloyds continues to provide payment clearing services to a UK based and UK authorised bank, one of whose account holders is an entity designated under Executive Order 13224 (although not by the UK or EU authorities). Lloyds concludes from the nature of such payment clearing services that revenue and profit (if any) arising from indirectly providing such services to the designated entity is negligible and not material to the Group's activities and in any event does not flow directly from the designated entity. To the extent that the activities of the designated entity and its UK authorised bank continue to comply with UK regulation and legislation, Lloyds intends to keep this activity under review.

LISTING INFORMATION

The ordinary shares of Lloyds Banking Group plc are listed and traded on the London Stock Exchange under the symbol 'LLOY.L'. The prices for shares as quoted in the official list of the London Stock Exchange are in pounds sterling. The following table shows the reported high and low closing prices for the ordinary shares on the London Stock Exchange. This information has been extracted from publicly available documents from various sources, including officially prepared materials from the London Stock Exchange, and has not been prepared or independently verified by the Lloyds Banking Group.

	Price per share (in pence) High	Price per share (in pence) Low
Annual prices:		
2017	73.10	62.20
2016	73.74	47.55
2015	89.00	68.68
2014	86.30	70.94
2013	80.37	46.31
Quarterly prices:		
2017		
Fourth quarter	68.93	64.51
Third quarter	69.08	63.05
Second quarter	73.10	62.20
First quarter	69.70	64.20
2016		
Fourth quarter	64.37	52.38
Third quarter	60.95	47.55
Second quarter	73.74	51.15
First quarter	73.27	56.00
2015		
Fourth quarter	77.83	68.68
Third quarter	87.65	72.30
Second quarter	89.00	77.38
First quarter	81.43	72.87
Monthly prices:		
January 2018	72.12	67.47
December 2017	68.06	64.51
November 2017	68.63	64.83
October 2017	68.93	65.59
September 2017	67.73	63.05
August 2017	67.26	63.60

On 23 February 2018, the closing price of shares on the London Stock Exchange was 68.65 pence, equivalent to 95.97 US cents per share translated at the Noon Buying Rate of $1.3979 per £1.00 on 23 February 2018.

Lloyds Banking Group plc's American Depositary Receipts (ADRs) were traded on the over-the-counter market in the US under the symbol 'LLDTY' between March 2000 and November 2001. Since 27 November 2001 Lloyds Banking Group plc American Depositary Shares (ADSs) have been listed on the New York Stock Exchange under the symbol 'LYG'. Each ADS represents four ordinary shares.

LISTING INFORMATION

The following table shows the reported high and low closing prices for ADSs on the New York Stock Exchange.

	Price per ADS (in US dollars) High	Price per ADS (in US dollars) Low
Annual prices:		
2017	3.86	3.17
2016	4.40	2.55
2015	5.64	4.25
2014	5.76	4.62
2013	5.36	2.84
Quarterly prices:		
2017		
Fourth quarter	3.75	3.50
Third quarter	3.66	3.27
Second quarter	3.86	3.17
First quarter	3.54	3.21
2016		
Fourth quarter	3.21	2.61
Third quarter	3.31	2.55
Second quarter	4.40	2.78
First quarter	4.32	3.32
2015		
Fourth quarter	4.83	4.25
Third quarter	5.53	4.47
Second quarter	5.64	4.65
First quarter	4.96	4.38
2014		
Fourth quarter	5.02	4.62
Third quarter	5.32	4.70
Second quarter	5.53	4.83
First quarter	5.76	5.01
2013		
Fourth quarter	5.36	4.67
Third quarter	5.00	3.83
Second quarter	3.91	2.84
First quarter	3.58	2.89
Monthly prices:		
January 2018	4.19	3.73
December 2017	3.75	3.50
November 2017	3.70	3.52
October 2017	3.69	3.56
September 2017	3.66	3.27
August 2017	3.54	3.30

On 23 February 2018, the closing price of ADSs on the New York Stock Exchange was $3.94.

LISTING INFORMATION

ADR FEES

The Group's depositary, The Bank of New York Mellon, collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deductions from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

Persons depositing or withdrawing shares must pay:	For:
$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)	Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property. Cancellation of ADSs for the purpose of withdrawal, including if the deposit agreement terminates.
$.02 (or less) per ADS	Any cash distribution to ADS registered holders.
A fee equivalent to the fee that would be payable if securities distributed had been shares and the shares had been deposited for issuance of ADSs	Distribution of securities distributed to holders of deposited securities which are distributed by the depositary to ADS registered holders.
$.02 (or less) per ADSs per calendar year	Depositary services.
Registration or transfer fees	Transfer and registration of shares on the share register to or from the name of the depositary or its agent when you deposit or withdraw shares.
Expenses of the depositary	Cable, telex and facsimile transmissions (when expressly provided in the deposit agreement). Converting foreign currency to US dollars.
Taxes and other governmental charges the depositary or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes	As necessary.
Any charges incurred by the depositary or its agents for servicing the deposited securities	As necessary.

FEES RECEIVED TO DATE

In 2017, the Company received from the depositary $819,277 for continuing annual stock exchange listing fees, standard out-of-pocket maintenance costs for the ADRs (consisting of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls), any applicable performance indicators relating to the ADR facility, underwriting fees and legal fees.

FEES TO BE PAID IN THE FUTURE

The Bank of New York Mellon, as depositary, has agreed to reimburse the Company for maintenance expenses that they incur for the ADS program. The depositary has agreed to reimburse the Company for its continuing annual stock exchange listing fees. The depositary has also agreed to pay the standard out-of-pocket maintenance costs for the ADRs, which consist of the expenses of postage and envelopes for mailing annual and interim financial reports, printing and distributing dividend checks, electronic filing of US Federal tax information, mailing required tax forms, stationery, postage, facsimile, and telephone calls. It has also agreed to reimburse the Company annually for certain investor relationship programs or special investor relations promotional activities. In certain instances, the depositary has agreed to provide additional payments to the Company based on any applicable performance indicators relating to the ADR facility. There are limits on the amount of expenses for which the depositary will reimburse the Company, but the amount of reimbursement available to the Company is not necessarily tied to the amount of fees the depositary collects from investors.

DIVIDENDS

Lloyds Banking Group plc's ability to pay dividends is restricted under UK company law. Dividends may only be paid if distributable profits are available for that purpose. In the case of a public limited company, a dividend may only be paid if the amount of net assets is not less than the aggregate of the called-up share capital and undistributable reserves and if the payment of the dividend will not reduce the amount of the net assets to less than that aggregate. In addition, a company cannot pay a dividend if any of its UK insurance subsidiaries is insolvent on a regulatory valuation basis or, in the case of regulated entities, if the payment of a dividend results in regulatory capital requirements not being met. Similar restrictions exist over the ability of Lloyds Banking Group plc's subsidiary companies to pay dividends to their immediate parent companies. Furthermore, in the case of Lloyds Banking Group plc, dividends may only be paid if sufficient distributable profits are available for distributions due in the financial year on certain preferred securities. The board has the discretion to decide whether to pay a dividend and the amount of any dividend. In making this decision, the board is mindful of the level of dividend cover and, consequently, profit growth may not necessarily result in increases in the dividend. In the case of American Depositary Shares, dividends are paid through The Bank of New York Mellon which acts as paying and transfer agent.

The total ordinary dividend for 2017 of 3.05 pence per share has increased by 20 per cent from 2.55 pence per share in 2016, in line with the Group's progressive and sustainable ordinary dividend policy.

The Board continues to give due consideration at each year end to the return of any surplus capital and for 2017, the Board intends to implement a share buyback of up to £1 billion. This represents the return of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties. The share buyback programme will commence in March 2018 and is expected to be completed during the next 12 months.

In prior years, the Board has distributed surplus capital by means of a special dividend. The Board's current preference is to return surplus capital by way of a buyback programme given the amount of surplus capital (£1 billion in 2017 compared to £350 million in 2016), the normalisation of ordinary dividends, our return to full private ownership and the flexibility that a buyback programme offers.

The rate of growth of the ordinary dividend will be decided by the Board in light of circumstances at the time and, having grown very significantly in the last three years, going forward the ordinary dividend is likely to grow at a more normalised rate, whilst being supplemented by buybacks or special dividends.

The table below sets out the interim and final dividends in respect of the ordinary shares for fiscal years 2004 through 2017. The sterling amounts have been converted into US dollars at the Noon Buying Rate in effect on each payment date with the exception of the recommended final dividend for 2017, for which the sterling amount has been converted in US dollars at the Noon Buying Rate on 23 February 2018.

	Interim ordinary dividend per share (pence)	Interim ordinary dividend per share (cents)	Final ordinary dividend per share (pence)	Final ordinary dividend per share (cents)
2004	10.7	19.0	23.5	44.7
2005	10.7	18.9	23.5	43.3
2006	10.7	20.2	23.5	46.8
2007	11.2	22.8	24.7	48.2
2008	11.4	20.3	–	–
2009	–	–	–	–
2010	–	–	–	–
2011	–	–	–	–
2012	–	–	–	–
2013	–	–	–	–
2014[1]	–	–	0.75	1.16
2015[2]	0.75	1.14	1.5	2.17
2016[3]	0.85	1.10	1.70	2.20
2017	**1.00**	**1.34**	**2.05**	**2.87**

[1] The recommended dividend for 2014 was in respect of the full year.

[2] For 2015, the Board also made a capital distribution in the form of a special dividend of 0.5 pence per share (0.72 cents per share). This is not listed in the table above.

[3] For 2016, the Board also made a capital distribution in the form of a special dividend of 0.5 pence per share (0.65 cents per share). This is not listed in the table above.

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

Lloyds Banking Group plc is incorporated in Scotland under the UK Companies Act 1985 with registered number SC95000.

As resolved at the 2017 Annual General Meeting, Lloyds Banking Group plc redesignated the limited voting shares then in issue as ordinary shares in the capital of Lloyds Banking Group plc with effect from 1 July 2017 and adopted amended Articles of Association to facilitate such redesignation occurring. The amended Articles of Association were adopted and took effect from 11 May 2017.

A summary of the material provisions of Lloyds Banking Group plc's Articles of Association is set out below.

OBJECTS OF LLOYDS BANKING GROUP PLC

The objects of Lloyds Banking Group plc are unrestricted.

RIGHTS ATTACHING TO SHARES

Any share in Lloyds Banking Group plc may be issued with any preferred, deferred or other special rights (including being denominated in another currency), or subject to such restrictions (whether as regards dividend, returns of capital, voting or otherwise) as Lloyds Banking Group plc may from time to time determine by ordinary resolution or as otherwise provided in the Articles of Association.

Subject to statute, Lloyds Banking Group plc may issue any shares which are, or at Lloyds Banking Group plc's option are, liable to be redeemed. The directors may determine the terms and conditions and manner of such redemption.

VOTING RIGHTS

For the purposes of determining which persons are entitled to attend or vote at a meeting and how many votes such persons may cast, Lloyds Banking Group plc may specify in the notice of the meeting a time, not more than 48 hours before the time fixed for the meeting, by which a person must be entered on the register in order to have the right to attend or vote at the meeting.

Every holder of ordinary shares who is entitled to be and is present in person (including any corporation by its duly authorised representative) at a general meeting of Lloyds Banking Group plc and is entitled to vote will have one vote on a show of hands and, on a poll, if present in person or by proxy, will have one vote for every such share held by him, save that a member will not be entitled to exercise the right to vote carried by such shares if he or any person appearing to be interested in the shares held by him has been duly served with a notice under the Companies Act (requiring disclosure of interests in shares) and is in default in supplying Lloyds Banking Group plc with information required by such notice.

Preference shares confer such rights as may be determined by the directors on allotment, but unless the directors otherwise determine, fully paid preference shares confer identical rights as to voting, capital, dividends (save as to currency or payment thereof) and otherwise, notwithstanding that they are denominated in different currencies and shall be treated as if they are one single class of shares. There are no limitations imposed by UK law or the Articles of Association restricting the rights of non-residents of the UK or non-citizens of the UK to hold or vote shares of Lloyds Banking Group plc.

GENERAL MEETINGS

Annual general meetings of Lloyds Banking Group plc are to be held, in each period of six months beginning with the day following Lloyds Banking Group plc’s accounting reference date, in Edinburgh or such other place in Scotland as the directors shall appoint and at a date and time as may be determined by the directors. All other general meetings may be convened whenever the directors think fit and shall be requisitioned in accordance with the requirements of the Articles of Association.

Lloyds Banking Group plc must prepare a notice of meeting in respect of a general meeting in accordance with the requirements of the Articles of Association and the Companies Act. Lloyds Banking Group plc must give at least 21 clear days’ notice in writing of an annual general meeting. All other general meetings may be called by at least 14 clear days’ notice in writing.

The directors may make arrangements to enable attendance or regulate the level of attendance at any place specified in the notice of meeting for the holding of a general meeting and, in any such case, shall direct that the meeting be held at a specified place, where the chairman of the meeting shall preside, and make arrangements for simultaneous attendance and participation by members and proxies at other locations. The chairman of a general meeting has express authority to adjourn the meeting if, in his opinion, it appears impracticable to hold or continue the meeting because of crowding or unruly conduct or because an adjournment is otherwise necessary for the proper conduct of the meeting.

The processes and procedures for the conduct of a general meeting (including adjourning meetings, voting, amending resolutions and appointing proxies) is established under the Articles of Association and the Companies Act. The chairman of a general meeting shall be entitled to take any action he considers appropriate for properly and orderly conduct before and during a general meeting. The directors shall be entitled to ask persons wanting to attend to submit to searches or other security arrangements as such directors consider appropriate.

The quorum necessary for the transaction of business at a general meeting is three members present in person or by proxy and entitled to vote.

DIVIDENDS AND OTHER DISTRIBUTIONS AND RETURN OF CAPITAL

Under the Companies Act, before Lloyds Banking Group plc can lawfully make a distribution, it must ensure that it has sufficient distributable reserves (accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made). Under the Articles of Association (and subject to statute) the directors are entitled to set aside out of the profits of Lloyds Banking Group plc any sums as they think proper which, at their discretion, shall be applicable for any purpose to which the profits of Lloyds Banking Group plc may be applied.

The shareholders in general meeting may by ordinary resolution declare dividends to be paid to members of Lloyds Banking Group plc, but no dividends shall be declared in excess of the amount recommended by the directors. The directors may pay fixed dividends on any class of shares carrying a fixed dividend and may also from time to time pay dividends, interim or otherwise, on shares of any class as they think fit. Except in so far as the rights attaching to any shares otherwise provide, all dividends shall be apportioned and paid pro rata according to the amounts paid up thereon. Subject to the rights attaching to any shares, any dividend or other monies payable in respect of a share may be paid in such currency or currencies as the directors may determine using such exchange rates as the directors may select.

The opportunity to elect to receive new shares instead of any cash dividend recommended by the directors may be offered to shareholders provided that the directors shall have obtained in advance the shareholders' approval to do so as required by the Articles of Association and the procedure under the Articles of Association is followed for allotting such shares.

In addition, Lloyds Banking Group plc may by ordinary resolution direct the payment of a dividend in whole or in part by the distribution of specific assets (a distribution *in specie*).

On any distribution by way of capitalisation, the amount to be distributed will be appropriated amongst the holders of ordinary shares in proportion to their holdings of ordinary shares (pro rata to the amount paid up thereon). If the amount to be distributed is applied in paying up in full unissued ordinary shares of Lloyds Banking Group plc, a shareholder will be entitled to receive bonus shares of the same class as the shares giving rise to his entitlement to participate in the capitalisation.

Any dividend or other moneys payable to a member that has not been cashed or claimed after a period of 12 years from the date of declaration of such dividend or other moneys payable to a member will be forfeited and revert to Lloyds Banking Group plc. Lloyds Banking Group plc shall be entitled to use such unclaimed or unclaimed dividend or other moneys payable to a member for its benefit in any manner that the directors may think fit. Lloyds Banking Group plc shall not be a trustee of dividends or other moneys payable that have not been cashed or claimed and it shall not be liable to pay interest on such dividends or other moneys.

On a return of capital, whether in a winding-up or otherwise, the ordinary shares will rank equally in all respects and the preference shares will be entitled to the rights attaching to them on issue.

Lloyds Banking Group plc's ordinary shares do not confer any rights of redemption. Rights of redemption in respect of Lloyds Bank Group plc's preference shares shall be as the directors determine on allotment.

Lloyds Banking Group plc may, subject to applicable law and to the Articles of Association, issue redeemable shares and redeem the same. Lloyds Banking Group plc has issued certain preference shares which are redeemable. In general, subject to applicable law and the approval of the UK Prudential Regulation Authority, some of these shares are redeemable by Lloyds Banking Group plc on a specified date and in some cases, thereafter on relevant dividend payment dates. Others are redeemable at any time during a specified period and following the occurrence of specified regulatory events.

Under the Articles of Association and the Companies Act, the liability of shareholders is limited to the amount (if any) for the time being unpaid on the shares held by that shareholder.

CONVERSION OF LIMITED VOTING SHARES

Each limited voting share was redesignated as an ordinary share in the capital of Lloyds Banking Group plc on 1 July 2017 and therefore no limited voting shares remain in issue. The remaining provisions regarding the limited voting shares in the Articles of Association of Lloyds Banking Group plc therefore have no application.

The ordinary shares resulting from such redesignation carry the right to receive all dividends and other distributions declared, made or paid on the ordinary share capital of Lloyds Banking Group plc by reference to a record date on or after 1 July 2017 and rank equally in all other respects and form one class with the ordinary share capital of Lloyds Banking Group plc then in issue and fully paid.

VARIATION OF RIGHTS AND ALTERATION OF CAPITAL

Subject to the provisions of the Companies Act, the CREST Regulations and every other statute for the time being in force or any judgment or order of any court of competent jurisdiction concerning companies and affecting Lloyds Banking Group plc (the statutes), the rights attached to any class of shares for the time being in issue may be varied or abrogated with the consent in writing of the holders of not less than three-quarters in nominal value of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of shares of that class. At any such separate meeting, the provisions of the Articles of Association relating to general meetings will apply, but the necessary quorum at any such meeting will be two persons holding or representing by proxy at least one-third in nominal value of the issued shares of that class (except at an adjourned meeting, at which the quorum shall be any holder of shares of the class, present in person or by proxy) and any such person may demand a poll and every such holder shall on a poll have one vote for every share of the class held by such holder.

Any special rights attached to any class of shares having preferential rights will not be deemed to be varied by: (i) the creation or issue of further shares ranking in some or all respects equally to such class (but not in priority thereto); or (ii) the creation or redemption by Lloyds Banking Group plc of its own shares.

As a matter of UK law, Lloyds Banking Group plc may, by ordinary resolution, increase its share capital, consolidate and divide all or any of its shares into shares of larger amount, sub-divide all or any of its shares into shares of smaller amount and cancel any shares not taken or agreed to be taken by any person. Where a consolidation or subdivision of shares would result in fractions of a share, the directors may sell the shares representing the fractions for the best price reasonably obtainable, and distribute the net proceeds of such sale to the relevant members entitled to such proceeds. Where a member’s entitlement to a portion of the proceeds of sale amounts to less than a minimum figure (as determined by the directors), such portion may be distributed to a charitable organisation at the directors' discretion.

Subject to the provisions of the statutes, Lloyds Banking Group plc may, by special resolution, reduce its share capital, any capital redemption reserve, share premium account or other undistributable reserve in any way.

TRANSFER OF SHARES

All transfers of shares which are in certificated form may be effected by transfer in writing in any usual or common form or in any other form acceptable to the directors and must be executed by or on behalf of the transferor and, except in the case of fully paid shares, by or on behalf of the transferee. The transferor will be deemed to remain the holder of the shares transferred until the name of the transferee is entered in the register of members of Lloyds Banking Group plc in respect thereof. All transfers of shares which are in uncertificated form may be effected by means of a relevant system, unless the CREST Regulations provide otherwise.

The directors may, in the case of shares in certificated form, in their absolute discretion and without assigning any reason therefor, refuse to register any transfer of shares (not being fully paid shares) provided that, where any such shares are admitted to the Official List of the UK Financial Conduct

ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

Authority, such discretion may not be exercised in such a way as to prevent dealings in the shares of that class from taking place on an open and proper basis. The directors may also decline to register a transfer unless:

- the instrument of transfer and the lodging of such instrument complies with the requirements of the Articles of Association and the transfer is in respect of only one class of shares; or
- the transfer is in favour of not more than four persons as the transferee.

The directors shall refuse to register the transfer of any share on which Lloyds Banking Group plc has a lien.

The Articles of Association otherwise contain no restrictions on the free transferability of fully paid shares.

Subject to the statutes and the rules (as defined in the CREST Regulations), and apart from any class of wholly dematerialised security, the directors may determine that any class of shares may be held in uncertificated form and that title to such shares may be transferred by means of an electronic trading system or that shares of any class should cease to be so held and so transferred.

DISCLOSURE OF HOLDINGS EXCEEDING CERTAIN PERCENTAGES

In broad terms, the Disclosure and Transparency Rules of the UK Financial Conduct Authority require Lloyds Banking Group plc shareholders to notify Lloyds Banking Group plc if the voting rights held by such Lloyds Banking Group plc shareholders (including by way of a certain financial instrument) reaches, exceeds or falls below three per cent, four per cent, five per cent, six per cent, seven per cent, eight per cent, nine per cent, ten per cent and each one per cent threshold thereafter up to 100 per cent. Under the Disclosure and Transparency Rules, certain voting rights in Lloyds Banking Group plc may be disregarded.

Pursuant to the Companies Act, Lloyds Banking Group plc may also send a notice to any person whom Lloyds Banking Group plc knows or has reasonably cause to believe that such person is interested in Lloyds Banking Group plc's shares or at any time during the three years immediately preceding the date on which such notice is issued to have been so interested, requiring that person to confirm whether he has or had such an interest and if so provide details of that interest as required by the notice.

Under the Articles of Association and UK law, if a person fails to comply with such a notice or provides information that is false in a material particular in respect of any shares (the default shares), the Lloyds Banking Group plc directors may serve a restriction notice on such a person. Such a restriction notice will state that the default shares and, if the Lloyds Banking Group plc directors determine, any other shares held by that person, shall not confer any right to attend or vote at any general meeting of Lloyds Banking Group plc.

In respect of a person with a 0.25 per cent or more interest in the issued shares of the class in question, the Lloyds Banking Group plc directors may direct by notice to such member that, subject to certain exceptions, no transfers of shares held by such person shall be registered and/or that any dividends or other payments on the default shares shall be retained by Lloyds Banking Group plc pending receipt by Lloyds Banking Group plc of the information requested by the Lloyds Banking Group plc directors. Certain consequences of the issue of a restriction notice are outlined above.

MANDATORY TAKEOVER BIDS, SQUEEZE-OUT AND SELL-OUT RULES

Other than as provided by the Companies Act and the City Code, there are no rules or provisions relating to mandatory bids and/or squeeze-out and sell-out rules in relation to the ordinary shares.

UNTRACED MEMBERS

Lloyds Banking Group plc is entitled to sell, as the agent of a member, at the best price reasonably obtainable, any share registered in the name of a member (or any other person entitled to such shares at law) provided that: (i) such shares remaining untraced for 12 years and during that period at least three dividends in respect of such shares have become payable and no dividend in respect of those shares has been cashed or claimed by the relevant member; (ii) Lloyds Banking Group plc uses reasonable efforts to trace the relevant member and, following the expiry of the 12 year period, sends a notice to the last known physical or email address of such member stating Lloyds Banking Group plc's intention to sell the shares; and (iii) during the three months following sending such notice, Lloyds Banking Group plc does not receive any communication from such member. Lloyds Banking Group plc can also sell, at the best price reasonably obtainable, any addition shares held by the same member that were issued during such 12 year period provided that no dividend on such additional shares has been cashed or claimed by such member during such period.

The proceeds from the sale of untraced shares shall be forfeited by the relevant member and shall belong to Lloyds Banking Group plc. Lloyds Banking Group plc shall not be liable or be required to account to the member for the proceeds of such sale. Lloyds Banking Group plc is entitled to use or invest the proceeds from such sale in any manner that the directors think fit.

FORFEITURE AND LIEN

The directors may by resolution make calls upon members in respect of any moneys unpaid on their shares (but subject to the terms of allotment of such shares) in the manner required by the Articles of Association.

If a member fails to pay in full any call or instalment of a call on or before the due date for payment, then, following notice by the directors requiring payment of the unpaid amount with any accrued interest and any expenses incurred, such share may be forfeited by a resolution of the directors to that effect (including all dividends declared in respect of the forfeited share and not actually paid before such forfeiture). A member whose shares have been forfeited will cease to be a member in respect of the shares, but will, notwithstanding the forfeiture, remain liable to pay to Lloyds Banking Group plc all monies which at the date of forfeiture were presently payable together with interest. The directors may at their absolute discretion enforce payment without any allowance for the value of the shares at the time of forfeiture or for any consideration received on their disposal or waive payment in whole or part.

Lloyds Banking Group plc has a first and paramount lien on every share (not being a fully paid share) for all monies (whether presently payable or not) called or payable at a fixed time in respect of such share, and the directors may waive any lien which has arisen and may resolve that any share shall for some limited period be exempt from such a lien, either wholly or partially.

A forfeited share becomes the property of Lloyds Banking Group plc, and it may be sold, re-allotted, otherwise disposed of or cancelled as the directors see fit. Any share on which Lloyds Banking Group plc has a lien may be sold on the terms set out in the Articles of Association. The proceeds of sale shall first be applied towards payment of the amount in respect of the lien insofar as it is still payable and then on surrender of the share certificate for cancellation (in the case of shares in certificated form), to the person entitled to the shares at the time of sale.

WINDING-UP

The directors have the power, in the name and on behalf of Lloyds Banking Group plc, to present a petition to the court for Lloyds Banking Group plc to be wound up.

If Lloyds Banking Group plc is wound up, the liquidator may, with the authority of an ordinary resolution, divide amongst the members in specie or kind the whole or any part of the assets of Lloyds Banking Group plc. The liquidator may for such purpose set such value as he deems fair upon any one or more class or classes of property and may determine how such division shall be carried out as between the members or different classes of members. The liquidator may vest any part of the assets in trustees upon such trusts for the benefit of members as the liquidator thinks fit, and the liquidation may be closed and Lloyds Banking Group plc dissolved, but so that no contributory shall be compelled to accept any shares or other property in respect of which there is a liability.

DIRECTORS

Subject to any other provision of the Articles of Association, the number of directors of Lloyds Banking Group plc shall be no fewer than seven. The minimum/maximum number of directors may be varied by ordinary resolution of Lloyds Banking Group plc. The directors may elect from them a chairman and deputy chairman (or two or more deputy chairman) and determine the period for which each is to hold office.

The business and affairs of Lloyds Banking Group plc shall be managed by the directors, who may exercise all such powers of Lloyds Banking Group plc (including its borrowing powers) as are not by the statutes or by the Articles of Association required to be exercised by Lloyds Banking Group plc in general meeting, subject to the Articles of Association, to the provisions of the statutes and to such regulations as may be set by special resolution of Lloyds Banking Group plc, but no regulation so made by Lloyds Banking Group plc will invalidate any prior act of the directors which would have been valid if such regulation had not been made.

The directors may confer upon any director holding any executive office any of the powers exercisable by them on such terms and conditions, and with such restrictions, as they think fit. The directors may also delegate any of their powers to committees. Any such committee shall have power to sub-delegate to sub-committees or to any person any of the powers delegated to it. Any such committee or sub-committee shall consist of one or more directors only. The meetings and proceedings of any such committee or sub-committee consisting of two or more persons shall be governed, with such changes as are appropriate, by the provisions of the Articles of Association regulating the meetings and proceedings of the directors. The directors may also grant powers of attorney to appoint a company, firm or person (or body of persons) to be the attorneys for Lloyds Banking Group plc with such powers, authorities and discretions and for such period and subject to such conditions as the directors think fit.

The directors may meet to consider this business of Lloyds Banking Group plc as they think fit. Any director may summon a meeting on request. The quorum necessary for the transaction of business of the directors may be fixed from time to time by the directors and unless so fixed at any other number shall be four. Questions arising at any meeting of the directors shall be determined by a majority of votes. In the case of an equality of votes, the chairman of the meeting shall have a second or casting vote.

DIRECTORS' RETIREMENT

The Articles of Association provide that a director appointed by the board either to fill a casual vacancy or as an additional director shall retire at the annual general meeting next after his appointment but shall be eligible for election as a director at that meeting. The Articles of Association further provide that each director shall retire at the annual general meeting held in the third calendar year following the year in which he was elected or last re-elected and shall be eligible for re-election as a director at that meeting. No person shall be eligible for election as a director at any general meeting unless he is a director that is retiring or is recommended by the directors for election in the manner required by the Articles of Association.

REMOVAL OF A DIRECTOR AND VACATION FROM OFFICE

Subject to statute, Lloyds Banking Group plc may remove any director from office by ordinary resolution of which special notice has been given.

The officer of a director will be vacated in the following circumstances:

- the director becomes prohibited by law from acting as a director;
- the director resigns in writing to the chairman or deputy chairman or the secretary and the directors resolve to accept such offer of resignation;
- if a bankruptcy order is made against such director or such director applies to the court in connection with a voluntary arrangement under the UK Insolvency Act 1986;

- if an order is made by the court claiming jurisdiction on the ground of mentor disorder for the director's detention or for the appointment of a guardian or for the appointment of a person to exercise powers in respect of such director's property or affairs;

- if the director is absent from meetings of directors for six months without leave and the directors resolve that such director's office be vacated; or

- if a written notice is served on him (signed by no less than three-quarters of the directors) to the effect that such director's office shall be vacated.

DIRECTORS' SHARE QUALIFICATION

A director is not required to hold any shares of Lloyds Banking Group plc by way of qualification.

DIRECTORS' INDEMNITY/INSURANCE

So far as may be permitted by the statutes, any person who is or was at any time a director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) may be indemnified by Lloyds Banking Group plc against any liability incurred by him in connection with any negligence, default, breach of duty or breach of trust by him in relation to Lloyds Banking Group plc (or any associated company) or any other liability incurred in the execution of his duties, the exercise of his powers or otherwise in connection with his duties, powers or offices. The directors of Lloyds Banking Group plc may also purchase and maintain insurance in respect of such liabilities. So far as may be permitted by the statutes, Lloyds Banking Group plc may also provide defence costs in relation to any criminal, civil or regulatory proceedings to which any current or former director, officer, employee or trustee of Lloyds Banking Group plc (or any associated company) is subject and do anything to enable any such a person to avoid incurring such expenditure.

AUTHORISATION OF DIRECTORS' INTERESTS

Subject to the provisions of the statutes, the directors can authorise any matter which would or might otherwise constitute or cause a breach of the duty of a director to avoid a situation in which he has or can have a direct or indirect interest that conflicts, or possibly may conflict, with the interests of Lloyds Banking Group plc.

Such authorisation of a matter shall be effective only if the matter in question shall have been proposed in writing for consideration at a meeting of the directors in accordance with the board's normal procedures or in such other manner as the directors may determine, the quorum requirement for the meeting of directors at which the matter is considered is satisfied and the matter is (or would have been) agreed to without the interested directors voting.

Any authorisation of a matter under the Articles of Association shall be subject to such conditions or limitations as the directors may determine, whether at the time such authorisation is given or subsequently, and may be terminated by the directors at any time. A director shall comply with any obligations imposed on him pursuant to any such authorisation.

A director shall not, save as otherwise agreed by him, be accountable to Lloyds Banking Group plc for any benefit which he (or a person connected with him) derives from any matter authorised by the directors and any contract, transaction or arrangement relating thereto shall not be liable to be avoided on the grounds of any such benefit.

Where a director has an interest which can reasonably be regarded as likely to give rise to a conflict of interest, the director may, and shall if so requested by the directors, take such additional steps as may be necessary or desirable for the purpose of managing such conflict of interest, including compliance with any procedures laid down from time to time by the directors.

Lloyds Banking Group plc may by ordinary resolution ratify any contract, transaction or arrangement, or other proposal, not properly authorised under the Articles of Association.

MATERIAL INTERESTS

In general, the Companies Act requires that a director disclose to Lloyds Banking Group plc any personal interest that he may have and all related material information and documents known to him, in connection with any existing or proposed transaction by Lloyds Banking Group plc. The disclosure is required to be made promptly and in any event, no later than at the board of directors meeting in which the transaction is first discussed.

Subject to the provisions of the statutes, the director (or a person connected with him), provided that the director has declared the nature and extent of any interest as required under the Articles of Association:

- may be a director or other officer of, or be employed by, or otherwise interested (including by the holding of shares) in Lloyds Banking Group plc, a subsidiary undertaking of Lloyds Banking Group plc, any holding company of Lloyds Banking Group plc, a subsidiary undertaking of any such holding company, or any body corporate promoted by Lloyds Banking Group plc or in which Lloyds Banking Group plc is otherwise interested (a relevant company);
- may be a party to, or otherwise interested in, any contract, transaction or arrangement with a relevant company (or in which the company is otherwise interested);
- may (and any firm of which he is a partner, employee or member may) act in a professional capacity for any relevant company (other than as auditor) and be remunerated therefor;
- may have an interest which cannot reasonably be regarded as likely to give rise to a conflict of interest;
- may have an interest, or a transaction or arrangement giving rise to such an interest, of which the director is not aware; and
- may have any other interest authorised under the Articles of Association or by shareholder resolution.

Subject to the provisions of the Companies Act, a director is entitled to vote and be counted in the quorum in respect of any resolution concerning any contract, transaction or arrangement or any other proposal:

- in which he has an interest of which he is not aware;
- in which he has an interest which cannot reasonably be regarded as likely to give rise to a conflict of interest;
- in which he has an interest only by virtue of interests in shares, debentures or other securities of the company, or by reason of any other interest in or through Lloyds Banking Group plc;
- which involves the giving of any security, guarantee or indemnity to the director or any other person in respect of (i) money lent or obligations incurred by him or by any other person at the request of or for the benefit of the company

or any of its subsidiary undertakings; or (ii) a debt or other obligation of the company or any of its subsidiary undertakings for which he himself has assumed responsibility in whole or in part under a guarantee or indemnity or by the giving of security;

– concerning an offer of shares or debentures or other securities of or by the company or any of its subsidiary undertakings (i) in which offer he is or may be entitled to participate as a holder of securities; or (ii) in the underwriting or subunderwriting of which he is to participate;

– concerning any other body corporate in which he is interested, directly or indirectly and whether as an officer, shareholder, creditor, employee or otherwise, provided that he (together with persons connected with him) is not the holder of, or beneficially interested in, one per cent or more of the issued equity share capital of any class of such body corporate or of the voting rights available to members of the relevant body corporate;

– relating to an arrangement for the benefit of the employees or former employees of the company or any of its subsidiary undertakings which does not award him any privilege or benefit not generally awarded to the employees or former employees to whom such arrangement relates;

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ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

- concerning the purchase or maintenance by the company of insurance for any liability for the benefit of directors or for the benefit of persons who include directors;
- concerning the giving of indemnities in favour of directors;
- concerning the funding of expenditure by any director or directors on (i) defending criminal, civil or regulatory proceedings or actions against him or them, (ii) in connection with an application to the court for relief, or (iii) defending him or them in any regulatory investigations (and doing anything to enable any director or directors to avoid incurring such expenditure); and
- in respect of which his interest, or the interest of directors generally, has been authorised by ordinary resolution.

Except as set out above and subject to the Companies Act, a director shall not be entitled to vote on any resolution in respect of any contract, transaction or arrangement, or any other proposal, in which he (or a person connected with him) is interested. Any vote of a director in respect of a matter where he is not entitled to vote shall be disregarded. A director shall not be counted in the quorum for a meeting of the directors in relation to any resolution on which he is not entitled to vote.

If a question arises at any time as to whether any interest of a director prevents him from voting, or being counted in the quorum, and such question is not resolved by his voluntarily agreeing to abstain from voting, such question shall be referred to the chairman of the meeting and his ruling in relation to any director other than himself shall be final and conclusive, provided that the nature or extent of the interest of such director has been fairly disclosed. If any such question shall arise in respect of the chairman of the meeting, the question shall be decided by resolution of the directors and the resolution shall be conclusive provided that the nature or extent of the interest of the chairman of the meeting has been fairly disclosed to the directors.

CONFIDENTIAL INFORMATION

If a director, otherwise than by virtue of his position as director, receives information in respect of which he owes a duty of confidentiality to a person other than Lloyds Banking Group plc, he shall not be required to disclose such information to Lloyds Banking Group plc or otherwise use or apply such confidential information for the purpose of or in connection with the performance of his duties as a director, provided that such an actual or potential conflict of interest arises from a permitted or authorised interest under the Articles of Association. This is without prejudice to any equitable principle or rule of law which may excuse or release the director from disclosing information, in circumstances where disclosure may otherwise be required under the Articles of Association.

REMUNERATION

Lloyds Banking Group plc must obtain a binding vote of shareholders on remuneration policy at least once every three years and an advisory vote on an implementation report on how the remuneration policy was implemented in the relevant financial year.

The ordinary remuneration of the directors is determined by the directors except that such ordinary remuneration shall not exceed £1,000,000 per annum in aggregate or such higher amount as may from time to time be determined by ordinary resolution of Lloyds Banking Group plc. Such ordinary remuneration is (unless otherwise provided by ordinary resolution of Lloyds Banking Group plc) divisible among the directors as they may agree, or, failing agreement, equally. However, any director who holds office for only part of the period in respect of which remuneration is payable shall be entitled only to rank in such division for a proportion of the remuneration relating to the period during which he has held office.

Any director who holds an executive office, or who serves on any committee of the directors, or who otherwise performs services which in the opinion of the directors are outside the scope of the ordinary duties of a director, may be paid extra remuneration by way of salary, commission or otherwise or may receive such other benefits as the directors may determine in their discretion. Such extra remuneration or other benefits are in addition to, or in substitution for, any or all of a director’s entitlement to ordinary remuneration.

Where proposals are under consideration concerning the appointment (including fixing or varying the terms of appointment) of two or more directors to offices or employments with Lloyds Banking Group plc (or any body corporate in which Lloyds Banking Group plc is interested), the proposals may be divided and considered in relation to each director separately. In such case, each of the directors concerned shall be entitled to vote, and be counted in the quorum, in respect of each resolution except that concerning his own appointment or the fixing or variation of the terms thereof.

The directors may repay to any director all such reasonable expenses as he may incur in attending and returning from meetings of the directors or of any committee of the directors or general meetings or otherwise in connection with the business of Lloyds Banking Group plc. The directors have the power to pay and agree to pay gratuities, pensions or other retirement, superannuation, death or disability benefits to, or to any person in respect of, any director or ex-director.

ELECTRONIC COMMUNICATIONS

Subject to and in accordance with statute, Lloyds Banking Group plc has the right to offer shareholders the opportunity to have documents and information made available to them through Lloyds Banking Group plc’s website and in electronic form.

EXCHANGE CONTROLS

There are no UK laws, decrees or regulations that restrict Lloyds Banking Group plc's export or import of capital, including the availability of cash and cash equivalents for use by Lloyds Banking Group, or that affect the remittance of dividends or other shareholders' payments to non-UK holders of Lloyds Banking Group plc shares, except as set out in *Taxation*.

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TAXATION

The following discussion is intended only as a general guide to current UK and US federal income tax considerations relevant to US holders (as defined below in the section on US federal income tax considerations) of Lloyds Banking Group ordinary shares or ADSs. It is based on current law and tax authority practice and the terms of the current UK/US income tax treaty (the Treaty), all of which are subject to change at any time, possibly with retroactive effect.

The Treaty for the avoidance of double taxation with respect to taxes on income entered into force following the exchange of instruments of ratification by the UK Parliament and the US Senate on 31 March 2003.

This summary does not consider your personal circumstances, and it is not a substitute for tax advice. Any person who is in any doubt as to his tax position should consult his own professional adviser.

UK TAXATION OF CHARGEABLE GAINS

Subject to the provisions set out in the next paragraph in relation to temporary non-residents, US holders generally will not be liable for UK tax on chargeable gains unless they carry on a trade, profession or vocation in the UK through a branch or agency and the ordinary shares or ADSs are or have been used or held by or for the purposes of the branch or agency, in which case such US holder might, depending on individual circumstances, be liable to UK tax on chargeable gains on any disposition of ordinary shares or ADSs.

An individual US holder who is only temporarily not resident in the UK may, under anti-avoidance legislation, still be liable for UK tax on chargeable gains realised, subject to any available exemption, relief and/or foreign tax credit.

A US holder who is an individual and who has, on or after 17 March 1998, ceased to be resident or ordinarily resident for tax purposes in the UK for a period of five or fewer years of assessment and who disposes of ordinary shares or ADSs during that period may be liable, on return to the UK, to UK taxation on chargeable gains arising during the period of absence, subject to any available exemption, relief and/or foreign tax credit.

UK TAXATION OF DIVIDENDS

Lloyds Banking Group plc will not be required to withhold tax at source when paying a dividend on the ordinary shares or ADSs to a US holder.

STAMP DUTY AND STAMP DUTY RESERVE TAX

Any conveyance or transfer on sale of ordinary shares (whether effected using the CREST settlement system or not) will be subject to UK stamp duty or stamp duty reserve tax (SDRT). The transfer on sale of ordinary shares will be liable to ad valorem UK stamp duty or SDRT, generally at the rate of 0.5 per cent of the consideration paid (rounded up to the next multiple of £5 in the case of stamp duty). Stamp duty is usually the liability of the purchaser or transferee of the ordinary shares. An unconditional agreement to transfer such ordinary shares will be liable to SDRT, generally at the rate of 0.5 per cent of the consideration paid, but such liability will be cancelled, or, if already paid, refunded, if the agreement is completed by a duly stamped transfer within six years of the agreement having become unconditional. SDRT is normally the liability of the purchaser or transferee of the ordinary shares.

UK tax law requires that when Lloyds Banking Group plc issues ordinary shares or a holder of ordinary shares transfers such shares to the custodian or nominee for the depositary to facilitate the issue of ADSs to a person representing the ordinary shares or to a person providing clearance services (or their nominee or agent), a liability to UK stamp duty or SDRT at the rate of 1.5 per cent (rounded up to the next multiple of £5 in the case of the stamp duty) of either the issue price or, in the case of transfer, the listed price of the ordinary shares, calculated in sterling, will arise. However, following litigation, HMRC now accepts that the charge to SDRT at 1.5 per cent on the issue of shares into clearance services or depository receipt schemes is not compatible with EU law, and will not apply the charge. Where a holder of ordinary shares transfers such shares to the custodian or nominee for the depositary or clearance services this charge will apply, and generally be payable by the person receiving the ADSs or transferring the ordinary shares into the clearance service.

No liability to stamp duty or SDRT will arise as a result of the cancellation of any ADSs with the ordinary shares that they represent being transferred to the ADS holder.

No liability to UK stamp duty or SDRT will arise on a transfer of ADSs provided that any document that gives effect to such transfer is not executed in the UK and remains at all subsequent times outside the UK. An agreement to transfer ADSs will not give rise to a liability to SDRT.

US FEDERAL INCOME TAX CONSIDERATIONS

The following summary describes material US federal income tax consequences of the ownership and disposition of ADSs or ordinary shares to the US holders described below, but it does not purport to be a comprehensive description of all of the tax considerations that may be relevant to a decision to own such securities. The summary applies only to US holders that hold ADSs or ordinary shares as capital assets for US federal income tax purposes.

This discussion does not address any alternative minimum or Medicare Contribution tax consequences, nor does it address US federal tax consequences to US holders that are subject to special rules, such as:

- certain financial institutions;
- dealers or traders in securities that use a mark-to-market method of tax accounting;
- persons holding ADSs or ordinary shares as part of a hedge, straddle, wash sale, conversion or other integrated transaction or holders entering into a constructive sale with respect to ADSs or ordinary shares;
- persons whose functional currency for US federal income tax purposes is not the US dollar;
- persons who acquired ADSs or ordinary shares pursuant to the exercise of any employee stock option or otherwise as compensation;
- tax-exempt entities, ‘individual retirement accounts’ or ‘Roth IRAs’;
- persons holding ADSs or ordinary shares in connection with a trade or business conducted outside of the United States;
- partnerships or other entities classified as partnerships for US federal income tax purposes; or

TAXATION

– persons that own or are deemed to own 10 per cent or more (by vote or value) of the shares of Lloyds Banking Group plc.

If an entity that is classified as a partnership for US federal income tax purposes holds ADSs or ordinary shares, the US federal income tax treatment of a partner will generally depend on the status of the partner and the activities of the partnership. Partnerships holding ADSs or ordinary shares and partners in such partnerships should consult their tax advisers as to the particular US federal income tax consequences of holding and disposing of the ADSs or ordinary shares.

This summary is based on the US Internal Revenue Code of 1986, as amended (the Code), administrative pronouncements, judicial decisions and final, temporary and proposed Treasury Regulations, as well as the Treaty, all as of the date hereof, changes to any of which may affect the tax consequences described herein, possibly with retroactive effect. It is also based in part on representations of the depositary and assumes that each obligation provided for in or otherwise contemplated by the Deposit Agreement or any other related document will be performed in accordance with its terms.

As used herein, a ‘US holder’ is a beneficial owner of ADSs or ordinary shares that is, for US federal income tax purposes:

– a citizen or individual resident of the United States;

– a corporation, or other entity taxable as a corporation, created or organised in or under the laws of the United States, any state therein or the District of Columbia; or

– an estate or trust the income of which is subject to US federal income taxation regardless of its source.

In general, a US holder who owns ADSs should be treated as the owner of the underlying shares represented by those ADSs for US federal income tax purposes. Accordingly, no gain or loss should be recognised if a US holder exchanges ADSs for the underlying shares represented by those ADSs.

The US Treasury has expressed concerns that parties to whom American depositary shares are released before shares are delivered to the depositary (‘pre-release’), or intermediaries in the chain of ownership between holders and the issuer of the security underlying the American depositary shares, may be taking actions that are inconsistent with the claiming of foreign tax credits by US holders of American depositary shares. Such actions would also be inconsistent with the claiming of the reduced rate of tax applicable to dividends received by certain non-corporate US holders. Accordingly, the availability of the preferential tax rate for dividends received by certain non-corporate US holders, described below, could be affected by actions taken by such parties or intermediaries.

Owners of ADSs or ordinary shares should consult their tax advisers as to the US, UK or other tax consequences of the ownership and disposition of such securities in their particular circumstances, including the effect of any US state or local tax laws.

TAXATION OF DISTRIBUTIONS

Distributions paid on ADSs or ordinary shares, other than certain pro rata distributions of ordinary shares, will generally be treated as dividends to the extent paid out of Lloyds Banking Group plc’s current or accumulated earnings and profits (as determined in accordance with US federal income tax principles). Because Lloyds Banking Group plc does not maintain calculations of its earnings and profits under US federal income tax principles, it is expected that distributions generally will be reported to US holders as dividends. The dividends will generally be foreign-source income to US holders and will not be eligible for the dividends-received deduction generally allowed to US corporations under the Code.

Subject to applicable limitations and the discussion above regarding concerns expressed by the US Treasury, dividends paid to certain non-corporate US holders may be taxable at favourable rates. Non-corporate US holders should consult their tax advisers to determine whether the favourable rates will apply to dividends they receive and whether they are subject to any special rules that limit their ability to be taxed at these favourable rates.

Dividends will be included in a US Holder’s income on the date of the US Holder’s or, in the case of ADSs, the depositary’s receipt of the dividend. The amount of a dividend will equal the US dollar value of the pounds sterling received, calculated by reference to the exchange rate in effect on the date of receipt regardless of whether the payment is converted into US dollars on the date of receipt. If the pounds sterling received as a dividend are not converted into US dollars on the date of receipt, then the US holder’s tax basis in the pounds sterling received will equal such US dollar value and the US holder may realise a foreign exchange gain or loss on the subsequent conversion into US dollars. Generally, any gains or losses resulting from the conversion of pounds sterling into US dollars will be treated as US-source ordinary income or loss.

TAXATION OF CAPITAL GAINS

Gain or loss realised by a US holder on a sale or other disposition of ADSs or ordinary shares will generally be subject to US federal income tax as capital gain or loss in an amount equal to the difference between the US holder’s tax basis in the ADSs or ordinary shares disposed of and the amount realised on the disposition, in each case as determined in US dollars. Gains or losses, if any, will generally be US-source and will be long-term if the US Holder held the ADSs or ordinary shares for more than one year. The deductibility of losses is subject to limitations.

INFORMATION REPORTING AND BACKUP WITHHOLDING

Dividends paid on, and the sale proceeds from, ADSs or ordinary shares that are made within the US or through certain US-related financial intermediaries may be subject to information reporting and backup withholding requirements unless the US holder:

- is a corporation or other exempt recipient, or
- in the case of backup withholding, the US holder provides a correct taxpayer identification number and certifies that it is not subject to backup withholding.

The amount of any backup withholding from a payment to a US holder will be allowed as a credit against the US holder's US federal income tax liability and may entitle it to a refund, provided that the required information is timely furnished to the Internal Revenue Service.

WHERE YOU CAN FIND MORE INFORMATION

The documents concerning the Lloyds Banking Group which are referred to herein may be inspected at the Securities and Exchange Commission (SEC). You may read and copy any document filed or furnished by the Group at the SEC's public reference room in Washington D.C., at 100 F Street, N.E., Washington D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the reference rooms. The SEC also maintains a website at www.sec.gov which contains, in electronic form, each of the reports and other information that the Group has filed electronically with the SEC.

ENFORCEABILITY OF CIVIL LIABILITIES

Lloyds Banking Group plc is a public limited company incorporated under the laws of Scotland. Most of Lloyds Banking Group plc's directors and executive officers and certain of the experts named herein are residents of the UK. A substantial portion of the assets of Lloyds Banking Group plc, its subsidiaries and such persons, are located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon all such persons or to enforce against them in US courts judgments obtained in such courts, including those predicated upon the civil liability provisions of the federal securities laws of the United States. Furthermore, Lloyds Banking Group plc has been advised by its solicitors that there is doubt as to the enforceability in the UK, in original actions or in actions for enforcement of judgments of US courts, of certain civil liabilities, including those predicated solely upon the federal securities laws of the United States.

RISK FACTORS

Set out below is a summary of certain risk factors which could affect Lloyds Banking Group's future results and cause them to differ from expected results in material respects. The factors discussed below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties that Lloyds Banking Group's businesses face. For information on Lloyds Banking Group's risk management policies and procedures, see "Lloyds Banking Group—Operating and financial review and prospects—Risk Management".

RISK FACTORS RELATING TO THE COMPANY AND THE GROUP

CREDIT RELATED RISKS

The Group's businesses are subject to inherent risks concerning borrower and counterparty credit quality which have affected and may adversely impact the recoverability and value of assets on the Group's balance sheet.

The Group has exposures (including, but not limited to, lending, undrawn commitments, derivative, equity, contingent, bonds, securities and/or settlement risks) to many different products, counterparties, obligors and other contractual relationships and the credit quality of its exposures can have a significant impact on the Group's earnings. Credit risk exposures are categorised as either "retail", arising primarily in the Retail and parts of the Run-Off and Insurance and Wealth divisions, and small and medium-sized enterprises ("**SME**"), or "corporate" (including medium and large corporates, banks, financial institutions and sovereigns), arising primarily in the Commercial Banking, Run-Off and Insurance and Wealth divisions. This reflects the risks inherent in the Group's lending and lending-related activities and in the insurance business primarily in respect of investment holdings (including loan assets and bonds) and exposures to reinsurers. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties or collateral held in support of exposures, or in their behaviour or businesses, may 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 outside the Group's control, which include but are not limited to an adverse economic environment (in the UK and/or in countries where the Group and/or its customers/ counterparties do and do not operate, such as any adverse economic effects that could occur in connection with the UK's exit from the EU following the referendum decision), reduced UK consumer and/or government spending (in light of the Group's concentration in the UK), cuts to benefits, a slower pace of global economic growth leading to constraints on liquidity (given the possibility of adverse global economic developments and potential market volatility), changes in the credit rating of individual counterparties (including sovereigns), the debt levels of individual contractual counterparties and the economic environment in which they operate, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, adverse sector concerns, falling stock and bond/other financial markets, reduced corporate profits, over-indebtedness (including sovereigns), changes (and the timing, quantum and pace of these changes) in interest rates (including the potential increase in the use of negative interest rates), and any subsequent impact on pension liabilities (particularly given changing longevity rates), volatility of oil and commodity prices, changes in foreign exchange rates, higher tenant defaults, counterparty challenges to the interpretation or validity of contractual arrangements, an increase in credit spreads, changes to insolvency regimes making it harder to enforce against counterparties, the impact of technological disruption or cyber crime, changes in consumer demands and requirements and any external factors of a political, legislative, environmental or regulatory nature, including for example, rising "living wage" requirements, changes in accounting rules and changes to tax legislation and rates.

The EU referendum decision has heightened the probability of some or all of these events happening and adds further uncertainty to counterparty credit risk and the Group's financial condition. Key related risks which may impact the Group's business and/or the Group's clients' businesses include, but are not limited to: reduced consumer spending, dampened consumer confidence, weaker sterling, volatility in financial markets, a downgrade of the UK credit rating, inflation risk, prolonged low or rising interest rates, impact on European sovereigns and counterparties, loss and/or postponement of foreign direct investment and domestic direct investment, political uncertainty, potential wider European political instability, uncertainty around trade negotiations and/or the UK's ability to retain access to the single market, financial services passporting and free movement and cost of labour, relocation of companies and institutions away from the UK, and the withdrawal and/or reduction of EU funding. For more detail on the EU referendum decision see "*—Business and Economic Risks— Political, legal, regulatory, constitutional and economic uncertainty arising from the outcome of the referendum on the UK's membership of the EU could adversely impact the Group's business, results of operations, financial condition and prospects*" below. For further information on general macro-economic risks affecting the Group in the UK and the EU see "*— Business and Economic Risks— The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the U.S., the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems*".

There are many other factors that could impact credit risk including fraud, sustainability of client business models, industrial and strike action, war and acts of terrorism, climate change, natural disasters and flooding.

The Group has credit exposure both in the UK and internationally, including Europe, the U.S. and Asia. The Group's credit exposure includes residential mortgage lending (in the UK and to a lesser extent, Ireland, and the Netherlands) and commercial real estate lending, including commercial real estate lending secured against secondary and tertiary non-prime assets in the UK. The Group's retail customer portfolios (including those in the Retail and parts of the Run-Off and Insurance and Wealth divisions) will remain strongly linked to the UK economic environment, with house price deterioration, unemployment increases, inflationary pressures, consumer over-indebtedness and prolonged low or rising interest rates among the factors that may impact secured and unsecured retail credit exposures. Deterioration in used vehicle prices, including as a result of changing consumer demand, could result in increased provisions and/or accelerated depreciation changes. The Group also has significant credit exposure to certain individual counterparties in higher risk and cyclical asset classes and sectors (such as commercial real estate, leveraged lending, oil and gas and related sectors, commodities trading, automotive and related sectors, manufacturing, construction, retail, care homes, housebuilders and outsourcing services) and weakened geographic markets and to counterparties whose businesses may be impacted by material unforeseen events. In addition, the Group has concentrated country exposure in the UK and within certain industry sectors, namely real estate and real estate-related sectors and financial intermediation including providing facilities to funds, mainly against high quality (investment grade equivalent) investors. Certain industry sectors have been adversely impacted by recent global economic events; for example, the oil and gas and related sectors, manufacturing (including auto manufacturers) and commodities trading and such adverse developments in these sectors increases the risk of default by the Group's customers in these sectors.

In recent years, a number of factors, such as Eurozone instability (including the risk of economic stagnation/deflation in the Eurozone or of one or more members leaving the Eurozone), the deterioration of capital market conditions, a slower pace of global economic growth (given slowdown in economic growth across China and emerging markets and other macro-economic issues) and measures adopted by the governments of individual countries, have reduced and could further reduce households' disposable income and businesses' profitability. In the UK, the sterling's depreciation is squeezing households' real incomes by pushing up inflation. If such volatile conditions were to continue or increase, this could also have a negative impact on customers' ability to honour their obligations, which in turn would result in deterioration of the Group's credit quality. If political conditions or uncertainty over the Eurozone, or the UK Government and Eurozone austerity measures and public spending cuts, result in a prolonged period of economic stagnation for the UK or Eurozone, or a slowdown in the rate of economic recovery, or there is a broader economic slowdown, it may lead to further weakening of counterparty credit quality and subsequent higher impairment charges or fair value reductions in the Group's lending and contingent equity and derivative portfolios. This could have a material adverse effect on the Group's results of operations, financial condition or prospects.

The possibility of prolonged economic stagnation in the EU or the risk of one or more members leaving the EU (including the UK's exit from the EU following the referendum decision), or the risk of a Eurozone member leaving the Eurozone, could impact the UK's own economic recovery, given the extensive trade and financial links between the UK and the Eurozone/EU and in turn, this could impact upon the Group's performance. The Group has credit exposure to SMEs and corporates, financial institutions and securities which may have material direct and indirect exposures in the Eurozone countries. Any default on the sovereign debt of these countries and the resulting impact on other Eurozone countries, including the potential that some countries could leave the Eurozone, could have a material adverse effect on the Group's business.

At present, default rates are partly cushioned by low rates of interest which have helped customer affordability, but the risk remains of increased default rates as interest rates rise. The timing, quantum and pace of any change in interest rates is a key risk factor for the Group's default rates with expectations on the timing and quantum of any changes set by the Bank of England and also by the relevant central bank when lending in a foreign currency.

All lending decisions, and decisions related to other exposures (including, but not limited to, undrawn commitments, derivative, equity, contingent and/ or settlement risks), are dependent on the Group's assessment of each customer's ability to repay and the value of any underlying security. There is an inherent risk that the Group has incorrectly assessed the credit quality and/or the ability or willingness of borrowers to repay, possibly as a result of incomplete or inaccurate disclosure by those borrowers or as a result of the inherent uncertainty that is involved in the exercise of constructing and using models to estimate the risk of lending to counterparties. The Group estimates and establishes reserves for credit risks and potential credit losses inherent in its credit exposure. This process, which is critical to the Group's results and financial condition, requires difficult, subjective and complex judgments, including forecasts of how macro-economic conditions might impair the ability of borrowers to repay their loans. As is the case with any such assessments, there is always a risk that the Group will fail to adequately identify the relevant factors or that it will fail to estimate accurately the impact of these identified factors. The introduction of the impairment requirements of IFRS 9 – Financial Instruments on 1 January 2018 is expected to result in higher impairment loss allowances that are recognised earlier, on a more forward looking basis and on a broader scope of financial instruments than is the case under IAS 39. Measurement will involve increased complexity and judgement and impairment charges will tend to be more volatile and could adversely impact the Group's results of operations, financial condition or prospects. See "*—Other Risks—The Group's financial statements are based, in part, on assumptions and estimates*".

Concentration of credit and market risk could increase the Group's potential for significant losses including in an adverse market/environment.

The Group has exposure to concentration risk where its business activities focus particularly on a single obligor or a similar type of customer (borrower, sovereign, financial institution or central counterparty), product, industrial sector or geographic location, including the UK.

The Group has significant exposure to UK residential mortgages and consumer lending. As detailed in "*Credit Related Risks - The Group's businesses are subject to inherent risks concerning borrower and counterparty credit quality which have affected and may adversely impact the recoverability and value of assets on the Group's balance sheet*", the Group's UK mortgage and consumer lending portfolios remain strongly linked to the UK economy with any deterioration in the UK's economic environment having the potential to adversely affect the credit quality of such portfolios. Any decreases in property values may reduce the collateral values against the mortgage portfolios, which could hinder recovery values in default situations, leading to higher impairment charges.

Additionally, the Group has significant sector concentrations (primarily in gilts, real estate and real estate-related lending, financial intermediation including providing facilities to financial sponsors and funds, mainly against high quality (investment grade equivalent) investors, and automotive and related sectors and to a lesser extent, oil and gas and related sectors, manufacturing , agriculture and leveraged lending), as well as significant global credit exposure.

The Group has significant real estate and real estate-related exposure, including secondary and tertiary non-prime assets, meaning that decreases in residential or commercial property values and/or increases in tenant defaults are likely to lead to higher impairment charges, which could materially affect the Group's results of operations, financial condition or prospects.

The Group's corporate lending portfolio also contains substantial exposure to large and mid-sized, public and private companies. Exposures to sectors that have experienced cyclical weakness in recent years, coupled with a historic strategy of taking large single name concentrations to non-listed companies and entrepreneurs, and taking exposure at various levels of the capital structure, may give rise to (albeit reducing) single name and risk capital exposure. Whilst expectation of default for these exposures is appropriately provided for within the Group's base case assumptions, they remain vulnerable to downside risks. As in the UK, the Group's lending business overseas is also exposed to a small number of long-term customer relationships and these single name concentrations place the Group at risk of loss should default occur.

The Group's efforts to continue to divest, diversify or manage its credit portfolio against concentration risks may not be successful and any concentration of credit risk could increase the potential for significant losses in its credit portfolio. In addition, any disruption in the liquidity or transparency of the financial markets may result in the Group's inability to sell or syndicate securities, loans or other instruments or positions held (including underwrites), thereby leading to increased concentrations of such positions. These concentrations could expose the Group to losses if the mark-to-market value of the securities, loans or other instruments or positions declines causing the Group to take write-downs. Moreover, the inability to reduce the Group's positions not only increases the market and credit risks associated with such positions, but also increases the level of risk-weighted assets on the Group's balance sheet, thereby increasing its capital requirements and funding costs, all of which could materially adversely affect the Group's operating results, financial condition or prospects.

The Group's corporate portfolios are also susceptible to "fallen angel" risk, that is, the probability of default increases significantly following material unexpected events, resulting in the potential for large losses. These types of events can occur from time to time, and may include for example, major fraud, cyber crime, poor corporate governance, high profile incidents and collapse in specific sectors or products, all of which are very difficult to forecast, and could adversely impact the Group's results of operations, financial condition or prospects.

The Group may be required to record credit value adjustments, funding value adjustments and debit value adjustments on its derivative portfolio, which could have a material adverse effect on the Group's results of operations, financial condition or prospects.

The Group continually seeks to limit and manage counterparty credit risk exposure to market counterparties. Credit value adjustment ("CVA") and funding value adjustment ("**FVA**") reserves are held against uncollateralised derivative exposures and a risk management framework is in place to mitigate reserve value changes. CVA is an expected loss calculation that incorporates current market factors including counterparty credit spreads. FVA reserves are held to capitalise the cost of funding uncollateralised derivative exposures. The Group also calculates a debit value adjustment to reflect

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RISK FACTORS

own credit spread risk as part of the fair value of derivative liabilities. The Group uses several credit risk mitigation techniques to limit counterparty credit risk exposure including netting agreements, collateral agreements, credit default swaps and other forms of credit enhancement where possible. However, deterioration in the creditworthiness of financial counterparties, or large adverse financial market movements, could impact the size of CVA and FVA reserves and result in a material charge to the Group's profit and loss account.

CONDUCT RISKS

The Group is exposed to various forms of conduct risk in its operations, including the risk of mis-selling financial products, mishandling of complaints, business planning and strategy not being based upon customer need and not supporting fair customer outcomes, not promoting effective competition in the interest of customers and engaging in conduct which could undermine the integrity of a market in which it is active, any of which could have a material adverse effect on the Group's results or its relations with its customers and regulators.

The Group is exposed to various forms of conduct risk in its operations. Such risks are inherent in banking services. These include business and strategic planning that does not sufficiently consider customer need (leading to products being offered beyond target markets and mis-selling of financial products), ineffective management and monitoring of products and their distribution (which could result in customers receiving unfair outcomes), a culture that is not sufficiently customer-centric (potentially driving improper decision making and unfair outcomes for customers), outsourcing of customer service and product delivery via third parties that do not have the same level of control, oversight and culture as the Group (which could result in potentially unfair or inconsistent customer outcomes), the possibility of alleged mis-selling of financial products or the mishandling of complaints related to the sale of such products (which could require amendments to sales processes, withdrawal of products or the provision of restitution to affected customers, all of which may require additional provisions in the Group's financial accounts), ineffective processes or procedures to support customers in vulnerable circumstances (which could result in customers receiving unfair outcomes or treatments which do not support their individual needs) and poor governance of colleagues' incentives and rewards and approval of schemes which drive unfair customer outcomes. These can lead to remediation, reputational damage and regulatory intervention/enforcement (including fines). Ineffective management and oversight of legacy conduct issues can result in customers who are undergoing remediation being unfairly treated and therefore further rectification being required. The Group is also exposed to the risk of engaging in conduct which could undermine the integrity of a market in which it is active or distort competition.

While the Group has implemented a number of policies in order to help mitigate against these risks, no assurance can be given that the conduct framework will be effective and that the risks set out above will not have an adverse effect on the Group's results of operations, financial condition or prospects.

REGULATORY AND LEGAL RISKS

The Group and its businesses are subject to substantial regulation and oversight. Adverse legal or regulatory developments could have a significant material adverse effect on the Group's business, results of operations, financial condition or prospects.

The Group and its businesses are subject to legislation, regulation, court proceedings, policies and voluntary codes of practice including the effects of any changes in these or the interpretation of them in the UK, the EU and the other markets in which the Group operates. The Group is therefore subject to associated legal and regulatory risks, including risk in connection with legal and regulatory actions and market reviews. Depending on the specific nature of the requirements and how they are enforced, they could have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations.

These laws and regulations include (i) increased regulatory oversight, particularly in respect of conduct issues; (ii) prudential regulatory developments, including ring-fencing; (iii) increased legislative requirements, including the Competition and Market Authority Open Banking programme which launched on 13 January 2018, the General Data Protection Regulation ("**GDPR**"), which will enter into force in May 2018 and the Second Payment Services Directive ("**PSD2**"), which entered into force in January 2016 and applied in the UK from January 2018; and (iv) other industry-wide initiatives.

Unfavourable developments across any of these areas could materially affect the Group's ability to maintain appropriate liquidity, increase its funding costs, constrain the operation of its business and/or have a material adverse effect on the Group's business, results of operations and financial condition. Areas where these changes could have an adverse effect on the Group include, but are not limited to:

(i) general changes in government, central bank or regulatory policy, or changes in regulatory regimes that may influence investor decisions in particular markets in which the Group operates, any of which may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;

(ii) external bodies applying or interpreting standards, laws, regulations or contracts differently to the Group;

(iii) an uncertain and rapidly evolving prudential regulatory environment which could materially adversely affect the Group's ability to maintain liquidity and increase its funding costs;

(iv) changes in competitive and pricing environments, including markets investigations, or one or more of the Group's regulators intervening to mandate the pricing of the Group's products, as a consumer protection measure;

(v) one or more of the Group's regulators intervening to prevent or delay the launch of a product or service, or prohibiting an existing product or service;

(vi) further requirements relating to financial reporting, corporate governance, corporate structure and conduct of business and employee compensation;

(vii) expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership;

(viii) changes to regulation and legislation relating to economic and trading sanctions, money laundering and terrorist financing; and

(ix) regulatory changes which influence business strategy, particularly the rate of growth of the business, or which impose conditions on the sales and servicing of products, which have the effect of making such products unprofitable or unattractive to sell.

For more detail on the changing prudential regulatory environment see "*—Regulatory and legal risks—The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment*" below.

RISK FACTORS

The Group faces risks associated with an uncertain and rapidly evolving international prudential, legal and regulatory environment.

The Group's borrowing costs and access to capital markets, as well as its ability to lend or carry out certain aspects of its business, could be affected by prudential regulatory developments, including (i) amendments to FSMA introduced by the Financial Services (Banking Reform) Act 2013 (the "**Banking Reform Act**") along with secondary legislation and PRA/FCA rules made under the Banking Reform Act; (ii) amendments to the EU legislation comprising the Capital Requirements Directive and the Capital Requirements Regulation (together, "**CRD IV**"), or implementation of CRD IV or BRRD (as defined below) in the UK; (iii) evolving European and global prudential and regulatory changes; (iv) regulatory changes in the U.S and (v) the evolving regulatory and legal impacts of EU exit.

BANKING REFORM ACT

The Banking Reform Act's measures contain provisions with respect to, amongst other things (i) ring-fencing domestic retail banking services of UK banks; (ii) the implementation of the Senior Managers and Certification Regime (the "**SMCR**").

RING-FENCING

The Banking Reform Act, secondary legislation and PRA/FCA rules made under the FSMA have enacted amendments to the FSMA and the UK regulatory regime that require UK banking groups (such as the Group) with more than £25 billion (on a group-wide basis) of core deposits (defined as "**ring-fenced bodies" or "RFBs**") to separate the retail banking activities of their UK banks – particularly deposit-taking and associated services – from certain prohibited forms of activity, including: (i) dealing in investments; (ii) incurring exposures to relevant financial institutions (which include, amongst others, credit institutions (other than RFBs), investment firms and alternative investment funds (subject to certain limited exceptions)); (iii) participating in an inter-bank payment system other than as a direct member (subject to certain limited exceptions); and (iv) having non-EEA branches or subsidiaries. RFBs are also subject to regulations governing how pension arrangements can be managed, following the implementation of ring-fencing.

The PRA and FCA are required by the Banking Reform Act to implement ring-fencing rules (the "**Ring-fencing Rules**") by 1 January 2019, with the deadline for implementing changes to the Group's pension scheme being 1 January 2026. In July 2016, following consultation periods, the PRA published its final policy statement, supervisory statement and rules covering: (i) the legal structure of an RFB and its wider group; (ii) the governance arrangements for an RFB; (iii) the continuity of services and facilities; (iv) prudential requirements applicable to the RFB sub-group; (v) intra-group arrangements; and (vi) the use of financial market infrastructure by RFBs. RFBs are able to apply for waivers of the Ring-fencing Rules in accordance with the statutory procedure for waivers set out in FSMA. The consultation process for reporting requirements regarding compliance with the ring-fencing regime, including an RFB's reliance on any exemptions to the excluded activities and prohibitions under secondary legislation, has now closed. RFBs are able to apply for waivers of the Ring-fencing Rules in accordance with the statutory procedure for waivers set out in FSMA. The PRA and FCA have also been granted powers under the FSMA to impose certain restructuring requirements on RFBs, their parent undertakings and certain other regulated entities within an RFB's group if, in broad terms, the financial stability of the RFB is deemed to be at risk as a result of the implementation of the Ring-Fencing Rules within the relevant banking group.

The implementation of the Ring-fencing Rules will have an impact on the Group's structure, governance arrangements, business and reporting models, operations, costs and financing arrangements. The Group is making good progress with the implementation of its ring-fencing programme, including the establishment of the non ring-fenced bank, Lloyds Bank Corporate Markets plc (LBCM), and remains on track to meet the legal and regulatory requirements by 1 January 2019. As a predominantly UK retail and commercial bank, the impact on the Group is relatively limited, with minimal impact for the majority of the Group's retail and commercial customers.

Over the course of 2018, in order to comply with the ring-fencing legislation, certain businesses will be transferred out of Lloyds Bank plc and its subsidiaries to other parts of the Group, by means of statutory or contractual transfers. This will include the transfer of certain wholesale and international businesses to Lloyds Bank Corporate Markets and the transfer of Scottish Widows Group and other insurance subsidiaries to Lloyds Banking Group plc.

Due to the Group's UK retail and commercial focus, the vast majority of the Group's business will continue to be held by Lloyds Bank plc and its subsidiaries (together the ring-fenced bank) and as a result these transfers will not have a material impact on the financial strength of Lloyds Bank plc.

The Group is actively engaged with Her Majesty's Treasury ("HM Treasury"), the PRA and FCA to ensure that it is able to fully implement the restructuring required to implement ring-fencing by the January 2019 deadline. In addition, the Group will become subject to the expanded oversight powers granted to HM Treasury, the PRA and the FCA under the Banking Reform Act from 1 January 2019.

SENIOR MANAGERS AND CERTIFICATION REGIME

The SMCR came into force on 7 March 2016 and replaces the approved persons regime for deposit takers and other PRA designated firms. The SMCR comprises a number of elements, including the senior managers' regime, the certification regime and the conduct rules, which are due to be expanded to apply to insurance firms in late 2018 and to solo-regulated firms in mid-to-late 2019 (subject to confirmation by HM Treasury) by changes proposed by the Bank of England and the Financial Services Act 2016. The Group could be exposed to additional risk or loss if it is unable to comply with the requirements arising from the SMCR or if doing so imposes significant demands on the attention of management.

CAPITAL REQUIREMENTS REGULATION AND CAPITAL REQUIREMENTS DIRECTIVE

In 2012, the Basel Committee on Banking Supervision (the "**Basel Committee**") approved significant changes to the regulatory framework applicable to the Group, including new capital and liquidity requirements intended to reinforce capital standards and to establish minimum liquidity standards for credit institutions (such changes being commonly referred to as "**Basel III**"). The Basel III changes refer to, among other things, (i) new requirements for a bank's capital base; (ii) measures to strengthen capital requirements for counterparty credit exposures arising from certain transactions; (iii) the introduction of a leverage ratio; and (iv) short-term and longer-term standards for funding and liquidity.

The Basel III reform package has been implemented in Europe through CRD IV. Full implementation began from 1 January 2014, with particular elements being phased in over a period of time, to be fully effective by 2024.

As a European regulation, the Capital Requirements Regulation is directly applicable in the UK and the Group is subject to its requirements. In December 2013, the PRA published its principal statement of policy, setting out the PRA rules in order to implement the Capital Requirements Directive in the UK.

CRD IV introduced a number of new capital buffers to provide further capital cushions for additional risks that financial institutions may be subject to. These buffers will be fully phased in by 1 January 2019 and comprise: (i) a capital conservation buffer ("CCB"); (ii) a time-varying countercyclical capital buffer ("**CCyB**"); (iii) buffers applicable to global systemically important banks ("G-SIBs"); (iv) buffers applicable to other systematically important banks; and (v) a systemic risk buffer ("**SRB**").

Under Article 141 of the Capital Requirements Directive, institutions that fail to meet their "combined buffer requirements" (consisting of buffers (i), (ii) above, and the higher of (iii), (iv) and (v) above) will be subject to restrictions on the making of certain discretionary payments (including dividends on ordinary shares, coupons on Additional Tier 1 securities and certain items of variable remuneration). These restrictions are scaled according to the extent of the breach and result in a maximum distributable amount which may be expended on such discretionary payments in each relevant period.

In December 2015, the Financial Policy Committee ("**FPC**") released a supplement to its Financial Stability Report on the framework of capital requirements for UK banks, which outlined how these buffers are to be applied and how the framework of capital requirements is expected to transition from its current state to its end point in 2019 for UK banks. The supplement outlined the FPC's final views on the overall calibration of the UK capital framework, as well as ongoing work to refine requirements during that transition period including the rectification of risk-weight measurement

shortcomings, partly addressed through the finalisation of the Basel III capital framework. The FPC intends to prioritise a review of the requirements underlying the overall calibration of the risk-weighted capital framework for UK banks and this is likely to take place in 2019.

In line with CRD IV, the CCB will increase to 2.5 per cent. of risk-weighted assets over the period from January 2016 to January 2019. During 2017, it was 1.250 per cent., increasing to 1.875 per cent. in 2018. The FPC set out its strategy for the time-varying UK CCyB, which will be applied to a bank's UK exposures, expecting this to be set at 1.0 per cent. in a 'standard risk environment' where 'risks are judged to be neither subdued nor elevated'. The CCyB rate for UK exposures is currently set at zero per cent. but it is scheduled to increase to 0.5 per cent. of risk-weighted assets from 27 June 2018 and to 1.0 per cent. from 28 November 2018. The Bank of England has stated that this is not expected to require UK banks to strengthen their capital positions for these increases, but rather to incorporate excess capital into their buffers. The FPC has indicated that it will reconsider the adequacy of a 1.0 per cent. UK CCyB rate during the first half of 2018 in light of the evolution of the overall risk environment. There remains a risk that any future changes to the CCyB rate in the UK could lead to an increase in capital requirements applicable to the Group where these changes are deemed not to be already captured by Pillar 2 supervisory capital buffers.

The Group is not currently categorised as a G-SIB for which the Financial Stability Board ("**FSB**") has set buffer rates. The FPC published the final framework for the UK SRB in May 2016 and the PRA published their statement of policy on their approach for implementing the SRB in December 2016. The PRA will communicate the SRB level to the Group in early 2019, which will be applicable to the RFB sub-group based on its total assets.

The FPC supplement also sets out how the PRA intends to set a PRA buffer for individual banks which is the minimum level of capital buffer required by the PRA. The PRA buffer is confidential between the Group and the PRA and can be set at a level in excess of the combined buffer requirements and any further sectoral capital measures that the PRA has imposed. As a result, investors may not be able to predict accurately the risk of dividends on ordinary shares or distributions on other securities being restricted as a result of the PRA buffer.

As outlined above, the Group's capital buffer requirements are still being finalised and investors may not be able to predict accurately the risk of dividends on ordinary shares or distributions on other securities being prohibited or restricted as a result of Article 141 of the Capital Requirements Directive.

In addition to the risk-based capital framework, the Group is also subject to minimum requirements under the UK leverage framework. As at 31 December 2017, the minimum leverage ratio requirement under the UK leverage ratio framework was 3.25 per cent., revised following a PRA Policy Statement in October 2017. At least 75 per cent. of the minimum 3.25 per cent. requirement, and the entirety of any buffers that may apply, must be met by Common Equity Tier 1 capital. The calculation of the leverage ratio under the UK leverage ratio framework differs from CRD IV requirements in that the UK version excludes qualifying central bank claims from the leverage exposure measure. The

Group is required to continue to calculate and disclose a leverage ratio on a CRD IV basis, alongside the UK leverage ratio framework. Currently, the UK leverage ratio framework does not give rise to higher capital requirements for the Group than the risk-based capital framework but there is a risk that it could do so as a result of a change in the Group's financial position or a strengthening of the regulatory requirements.

EVOLVING EUROPEAN AND GLOBAL PRUDENTIAL AND REGULATORY CHANGES

The CRD IV regime is expected to continue to evolve as a result of further changes agreed by EU legislators, binding regulatory technical standards and guidelines to be developed by the European Banking Authority ("**EBA**") and changes to the way in which the PRA interprets and applies these requirements to UK financial institutions. In particular, on 23 November 2016, the European Commission first put forward significant draft proposals to amend, among other things, both the Capital Requirements Regulation and the Capital Requirements Directive (such amended Capital Requirements Regulation to be known as "**CRR 2**" and the Capital Requirements Directive as "**CRD V**"), including to propose a binding leverage ratio, a binding net stable funding ratio and more risk-sensitive capital requirements. These reforms remain under discussion and are not expected to enter into force until 2019 at the earliest, with the majority of requirements applying two years thereafter.

More generally, the Basel Committee published a package of further revisions to Basel III in December 2017, including changes to: standardised approach for credit risk; internal ratings based approaches for credit risk; the credit valuation adjustment risk framework; the operational risk framework; the leverage ratio framework; and a revised output floor. The Basel Committee expects these changes to be implemented from January 2022, with transitional arrangements for the output floor up to January 2027, although these timelines remain unclear until such rules are translated into draft European and UK legislation. It therefore remains premature at this stage to estimate the full impact or timelines.

The Minimum Requirement for Own Funds and Eligible Liabilities ("**MREL**"), which is being implemented in the EU and the UK, will apply to EU financial institutions and will comprise capital and debt instruments that are capable of being written-down or converted to equity. In November 2016, the Bank of England published a statement of policy outlining its approach to setting MREL. The Bank of England has set an interim MREL compliance date of 1 January 2020 and a final MREL conformance date of 1 January 2022.

The Group will continue to monitor the ongoing changes to the global, EU and UK prudential framework which may affect the Group's financial position or require the strengthening of regulatory requirements.

European Regulation 648/2012, known as the European Market Infrastructure Regulation ("**EMIR**"), introduces new requirements to improve transparency and reduce the risks associated with the derivatives market. EMIR came into force on 16 August 2012 and when it fully comes into effect, EMIR will require entities that enter into any form of derivative contract, including interest rate, foreign exchange, equity, credit and commodity derivatives, to: (i) report every derivative contract entered into to a trade repository; (ii) implement new risk management standards (including operational processes and margining) for all bilateral over the counter ("**OTC**") derivative trades that are not cleared by a central counterparty; and (iii) clear, through a central counterparty, OTC derivatives that are subject to a mandatory clearing obligation. Certain of the requirements under EMIR (such as some clearing requirements) have yet to fully come into effect. The first clearing obligations for certain interest rate derivatives have applied from June 2016. Variation margin requirements for uncleared trades came into effect on 4 February 2017 for market participants with a sufficiently large derivative trading volume and on 1 March 2017 for all other counterparties, including the Group. Certain products are exempt from variation margin requirements at this time and implementation for these products is due to be phased in. The Group does not expect initial margin requirements to apply to it until September 2018. It is expected that there will be additional costs and limitations on the Group's business resulting from these requirements.

It is difficult to predict how and in what final form many of the regulatory changes described herein will be implemented and what financial obligations may be imposed in relation thereto. While the Group continues to work closely with regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes, the Group could be exposed to additional risk of loss if it is unable to comply with the requirements arising from these regulations or if doing so imposes significant demands on the attention of management. Depending on the specific nature of the requirements and how they are enforced, such changes could have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements including changes to how the Group and its businesses are capitalised and funded, distribution of capital, reducing weighted assets, modifying legal entity structure and changing the Group's business mix to strengthen the Group's capital position.

The Group and its UK subsidiaries may become subject to the provisions of the Banking Act 2009, as amended, which could have an adverse impact on the Group's business.

Under the Banking Act 2009, as amended, (the "**Banking Act**"), substantial powers have been granted to HM Treasury, the Bank of England and the PRA and FCA (together, the "**Authorities**") as part of the special resolution regime (the "**SRR**"). These powers enable the Authorities to deal with and stabilise UK-incorporated institutions with permission to accept deposits pursuant to Part 4A of the FSMA if they are failing or are likely to fail to satisfy certain threshold conditions (within the meaning of Section 55B of the FSMA). The SRR consists of five stabilisation options: (i) transfer of all or part of the business of the relevant entity or the shares of the relevant entity to a private sector purchaser; (ii) transfer of all or part of the business of the relevant entity to a "bridge bank" established and wholly owned by the Bank of England; (iii) transfer all or part of the relevant entity or "bridge bank" to an asset management vehicle; (iv) making of one or more resolution instruments by the Bank of England; and (v) temporary public ownership of the relevant entity. HM Treasury may also take a parent company of a relevant entity into temporary public ownership where certain conditions are met. The SRR also provides for two new insolvency and administration procedures for relevant entities. Certain ancillary powers include the power to modify certain contractual arrangements in certain circumstances.

In addition, the Group's costs of doing business may increase by amendments made to the Banking Act in relation to deposits covered by the UK Financial Services Compensation Scheme (the "**FSCS**"). The Group contributes to compensation schemes such as the FSCS in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. Further provisions in respect of these costs are likely to be necessary in the future. The ultimate cost to the industry, which will also include the cost of any compensation payments made by the FSCS and, if necessary, the cost of meeting any shortfall after recoveries on the borrowings entered into by the FSCS, remains uncertain but may be significant and may have a material effect on the Group's business, results of operations or financial condition.

The final text of the EU Directive 2014/59/EU establishing an EU-wide framework for the recovery and resolution of credit institutions and investment firms (the "**BRRD**"), entered into force on 2 July 2014 and in the UK, the Banking Reform Act made provision for certain aspects of the "bail-in" power. Under the "bail-in" power, prior to insolvency proceedings, regulators have the power to impose losses on holders of regulatory capital securities, senior bondholders and/or other creditors while potentially leaving untouched certain other classes of excluded creditors; generally losses are to be taken in accordance with the priority of claims under normal insolvency proceedings. Bail-in is expected to apply to all of the Group's unsecured senior and subordinated debt instruments with a remaining maturity of greater than seven days. The stated aim of the BRRD is to provide authorities designated by EU member states to apply the resolution tools and exercise the resolution powers set forth in the BRRD (the "resolution authorities") with common tools and powers to address banking crises pre-emptively in order to safeguard financial stability and minimise taxpayers' exposure to losses. The powers granted to resolution authorities under the BRRD include, but are not limited to: (i) a "write-down and conversion power" relating to Tier 1 and Tier 2 capital instruments and (ii) a "bail-in" power relating to eligible liabilities (including the capital instruments and senior debt securities issued by the Group). Such powers give resolution authorities the ability to write-down or write-off all or a portion of the claims of certain unsecured creditors of a failing institution or group and/or to convert certain debt claims into another security, including ordinary shares of the surviving group entity, if any. Such resulting ordinary shares may be subject to severe dilution, transfer for no consideration, write-down or write-off. Such powers were implemented in the UK with effect from 1 January 2015. Certain amendments to the BRRD may be made as a result of proposals published by the European Commission on 23 November 2016, including extending the "write down and conversion power" to cover non-own funds MREL-eligible liabilities of entities in a banking group other than the resolution entity.

The conditions for use of the "bail-in" power are, in summary, that (i) the regulator determines that the bank is failing or likely to fail; (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank to avoid the failure of the bank; (iii) the relevant UK resolution authority determines that it is necessary having regard to the public interest to exercise the "bail-in" power in the advancement of one of the statutory objectives of resolution; and (iv) one or more of those objectives would not be met to the same extent by the winding up of the bank. The Banking Act and secondary legislation made thereunder provides certain other limited safeguards for creditors in specific circumstances. The "no creditor worse off" safeguard contained in the Banking Act may not apply in relation to an application of the write-down and conversion power in circumstances where a stabilisation power is not also used; holders of debt instruments which are subject to the power may, however, have ordinary shares transferred to or issued to them by way of compensation. The exercise of mandatory write-down and conversion power under the Banking Act or any suggestion of such exercise could, therefore, materially adversely affect the rights of the holders of equity and debt securities and the price or value of their investment and/or the ability of the Group to satisfy its obligations under such debt securities.

In addition to the provisions described above, it is possible that the exercise of other powers under the Banking Act to resolve failing banks in the UK and give the authorities powers to amend the terms of contracts (for example, varying the maturity of a debt instrument) and to override events of default or termination rights that might be invoked as a result of the exercise of the resolution powers could have a material adverse effect on the rights of holders of the equity and debt securities issued by the Group, including through a material adverse effect on the price of such securities. The Banking Act also gives the Bank of England the power to override, vary or impose contractual obligations between a UK bank, its holding company and its group undertakings for reasonable consideration, in order to enable any transferee or successor bank to operate effectively. There is also power for HM Treasury to amend the law (excluding provisions made by or under the Banking Act) for the purpose of enabling it to use the regime powers effectively, potentially with retrospective effect.

The determination that securities and other obligations issued by the Group will be subject to write-down, conversion or "bail-in" is likely to be inherently unpredictable and may depend on a number of factors which may be outside of the Group's control. This determination will also be made by the relevant UK resolution authority and there may be many factors, including factors not directly related to the Company or the Group, which could result in such a determination. Because of this inherent uncertainty and given that both BRRD and the relevant provisions of the Banking Act remain untested in practice, it will be difficult to predict when, if at all, the exercise of a "bail-in" power may occur which would result in a principal write-off or conversion to other securities, including the ordinary shares of the Company. Moreover, as the criteria that the relevant UK resolution authority will be obliged to consider in exercising any "bail-in" power provide it with considerable discretion, holders of the securities issued by the Group may not be able to refer to publicly available criteria in order to anticipate a potential exercise of any such power and consequently its potential effect on the Group and the securities issued by the Group.

Potential investors in the securities issued by the Group should consider the risk that a holder may lose some or all of its investment, including the principal amount plus any accrued interest, if such statutory loss absorption measures are acted upon. The BRRD and applicable state aid rules provide that, other than in certain limited circumstances set out in the BRRD, extraordinary governmental financial support will only be available to the Group as a last resort once the write down and conversion powers and resolution tools referred to above have been exploited to the maximum extent possible.

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Holders of the Group's securities may have limited rights or no rights to challenge any decision of the relevant UK resolution authority to exercise the UK "bail-in" power or to have that decision reviewed by a judicial or administrative process or otherwise. Accordingly, trading behaviour in respect of such securities is not necessarily expected to follow the trading behaviour associated with other types of securities that are not subject to such recovery and resolution powers. Potential investors in securities issued by the Group should consider the risk that a holder of such securities may lose all of its investment, including (in the case of debt securities) the principal amount plus any accrued and unpaid interest, if such statutory loss absorption measures are acted upon or if that senior debt instrument may be converted into Lloyds Banking Group plc ordinary shares. Further, the introduction or amendment of such recovery and resolution powers, and/or any implication or anticipation that they may be used, may have a significant adverse effect on the market price of such securities, even if such powers are not used.

The Group faces risks associated with its compliance with a wide range of laws and regulations.

The Group is exposed to various forms of legal and regulatory risk, including:

(i) certain aspects of the Group's activities and business may be determined by the relevant authorities, the Financial Ombudsman Service (the "FOS") or the courts not to have been conducted in accordance with applicable laws or regulations, or, in the case of the FOS, with what is fair and reasonable in the Ombudsman's opinion;

(ii) the possibility of alleged mis-selling of financial products or the mishandling of complaints related to the sale of such products by or attributed to a member of the Group, resulting in disciplinary action or requirements to amend sales processes, withdraw products, or provide restitution to affected customers, all of which may require additional provisions;

(iii) risks relating to compliance with, or enforcement actions in respect of, existing and/or new regulatory or reporting requirements, including as a result of a change in focus of regulation or a transfer of responsibility for regulating certain aspects of the Group's activities and business to other regulatory bodies;

(iv) contractual and other obligations may either not be enforceable as intended or may be enforced against the Group in an adverse way;

(v) the intellectual property of the Group (such as trade names) may not be adequately protected;

(vi) the Group may be liable for damages to third parties harmed by the conduct of its business;

(vii) the risk of regulatory proceedings, enforcement actions and/or private litigation, arising out of regulatory investigations or otherwise (brought by individuals or groups of plaintiffs) in the UK and other jurisdictions; and

(viii) risks related to court or UK Government activity leading to a requirement to equalise pension benefits for the effect of Guaranteed Minimum Pensions. It is possible that any such requirement could increase liabilities in the Group's defined benefit pension schemes.

Regulatory and legal actions pose a number of risks to the Group, including substantial monetary damages or fines, the amounts of which are difficult to predict and may exceed the amount of provisions set aside to cover such risks. In addition, the Group may be subject, including as a result of regulatory actions, to other penalties and injunctive relief, civil or private litigation arising out of a regulatory investigation or otherwise, the potential for criminal prosecution in certain circumstances and regulatory restrictions on the Group's business, all of which can have a negative effect on the Group's reputation. Any of these risks could have an adverse impact on the Group's operations, financial condition, results of operations or prospects and the confidence of customers in the Group, as well as taking a significant amount of management time and resources away from the implementation of the Group's strategy.

The Group's operations also expose it to various forms of reputational impacts. Negative public opinion can result from the actual or perceived manner in which the Group conducts its business activities, from the Group's financial performance, the level of direct and indirect government support, actual or perceived practices in the banking and financial industry, or allegations of misconduct. Negative public opinion may adversely affect the Group's ability to keep and attract customers, which may result in a material adverse effect on the Group's financial condition, results of operations or prospects. Negative public opinion referenced in the media as "lack of trust" in banking can be impacted by actions of competitors across the industry as well as actions by the Group. Regaining the trust of customers and the public is a key objective of the Group.

The Group may settle litigation or regulatory proceedings prior to a final judgment or determination of liability to avoid the cost, management efforts or negative business, regulatory or reputational consequences of continuing to contest liability, even when the Group believes that it has no liability or when the potential consequences of failing to prevail would be disproportionate to the costs of settlement. Furthermore, the Group may, for similar reasons, reimburse counterparties for their losses even in situations where the Group does not believe that it is legally compelled to do so. Failure to manage these risks adequately could materially affect the Group, both financially and reputationally.

The Group faces risks associated with the high level of scrutiny of the treatment of customers by financial institutions from regulatory bodies, the media and politicians.

The Group's operations, in particular related to its treatment of customers, are subject to supervision by the FCA and other regulatory authorities. In recent periods, the UK banking industry has been subject to heightened attention from these regulatory authorities, as well as the press and the UK Government.

The Group is subject to the Markets in Financial Instruments Directive ("**MiFID**") and its various implementing measures, which together regulate the provision of "investment services and activities" in relation to a range of customer-related areas, including customer classification, conflicts of interest, client order handling, investment research and financial analysis, suitability and appropriateness, transparency obligations and transaction reporting. MiFID has been replaced by a revised directive ("**MiFID II**") and a new regulation (Markets in Financial Instruments Regulation or "**MiFIR**"), which entered into force on 2 July 2014. The changes to MiFID include expanded supervisory powers that include the ability to ban specific products, services or practices. The Group has implemented MiFID II across the divisions. If the Group incurs substantial expenses associated with ongoing compliance, ongoing compliance imposes significant demands on the attention of management that result in other areas of the Group's business not receiving sufficient management attention, or if particular products, services or practices are banned, the

Group's results of operations could be materially adversely affected.

The Group is also subject to European regulation on customer deposits. On 12 June 2014, the Deposit Guarantee Schemes Directive 2014/49/EU (the "**recast DGSD**") was published in the Official Journal of the EU, which replaced Directive 94/19/EC on Deposit Guarantee Schemes. As required by the recast DGSD, the UK introduced a compliant deposit guarantee scheme ("DGS") that:

- gives a preference in liquidation or resolution to deposits made by retail customers and SMEs over other senior creditors;

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- sets out the rights of eligible depositors (typically retail customers) to compensation, and repayment circumstances and procedures by the DGS, covering the unavailability of any deposit, up to aggregate deposits of €100,000;
- places obligations on credit institutions, in particular, requirements to provide specified information to depositors (and potential depositors) on their rights to compensation under the DGS; and
- sets out provisions on the financing of DGSs, including target funding levels and contribution amounts by credit institutions.

In addition, the GDPR requires the Group to afford greater transparency and control to customers over how their personal data is used, stored and shared which may limit the extent to which customer data can be used to support the Group using its strategic objectives. Failure to comply may erode customer trust and result in regulatory fines.

The financial impact of legal proceedings and regulatory risks might be material but is difficult to quantify. Amounts eventually paid may materially exceed the amount of provisions set aside to cover such risks, or existing provisions may need to be materially increased in response to changing circumstances, as has been the case in respect of payment protection insurance ("PPI") redress payments.

Where provisions have already been taken in published financial statements of the Group or results announcements for ongoing legal or regulatory matters, these have been recognised, in accordance with IAS 37 ("Provisions, Contingent Liabilities and Contingent Assets"), as the best estimate of the expenditure required to settle the obligation as at the reporting date. Such estimates are inherently uncertain and it is possible that the eventual outcomes may differ materially from current estimates, resulting in future increases or decreases to the required provisions, or actual losses that exceed or fall short of the provisions taken.

The Group increased provisions for expected PPI costs by a further £1.3 billion in 2017, of which £0.6 billion was in the fourth quarter. This brings the total amount provided for at the end of 2017 to £18.7 billion, of which £2.4 billion remains unutilised relating to complaints and administration costs. Provisions have not been taken where no obligation (as defined in IAS 37 ("Provisions, Contingent Liabilities and Contingent Assets")) has been established, whether associated with a known or potential future litigation or regulatory matter. Accordingly, an adverse decision in any such matters could result in significant losses to the Group which have not been provided for. Such losses would have an adverse impact on the Group's financial condition and operations.

In November 2014, the UK Supreme Court ruled in Plevin v Paragon Personal Finance Limited [2014] UKSC 61 ("**Plevin**") that failure to disclose to a customer a "high" commission payment on a single premium PPI policy sold with a consumer credit agreement created an unfair relationship between the lender and the borrower under s140 of the Consumer Credit Act 1974. It did not define a tipping point above which commission was deemed "high". The disclosure of commission was not a requirement of the FSA's (now FCA's) Insurance: Conduct of Business sourcebook rules for the sale of general insurance (including PPI). Permission to appeal the redress outcome in the Plevin case was refused by the Court of Appeal in July 2015 and by the President of the Family Division in November 2015.

In November 2015 and August 2016, the FCA consulted on the introduction of a two year industry deadline by which consumers would need to make their PPI complaints or lose their right to have them assessed, and proposed rules and guidance about how firms should handle PPI complaints fairly in light of the Plevin judgment discussed above. On 2 March 2017, the FCA confirmed the deadline would be 29 August 2019. The FCA's new rules to address Plevin commenced on 29 August 2017. The industry deadline applies to the handling of these complaints. It is anticipated that the introduction of an industry deadline could encourage eligible consumers to bring their claims earlier than would have otherwise been expected during such period in the absence of an industry deadline for having complaints assessed. The new rules could have a material adverse effect on the Group's reputation, business, financial condition, results of operations and prospects.

BUSINESS AND ECONOMIC RISKS

The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the U.S., the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems.

The Group's businesses are subject to inherent and indirect risks arising from general and sector-specific economic conditions in the markets in which it operates, particularly the UK, where the Group's earnings are predominantly generated and the Group's operations are increasingly concentrated following the strategic reduction of its international presence. The Group may have credit exposure in countries outside the UK even if it does not have direct exposure or a presence in such countries. Any significant macro-economic deterioration in the UK and/or other economies could have a material adverse effect on the results of operations, financial condition or prospects of the Group, as could continued or increasing political uncertainty within the UK and the EU. The profitability of the Group's businesses could be affected by market factors such as the deterioration of UK economic growth significantly below long-term average levels, rising unemployment, reduced corporate profitability, reduced personal income levels (in real terms), inflationary pressures, including those arising from the sterling's depreciation, reduced UK Government and/or consumer expenditure, changes in interest rates (and the timing, quantum and pace of those changes as well as the possibility of further reductions in interest rates, including negative interest rates or of unexpected increases in interest rates which may have a detrimental effect on the Group's customers and their ability to service interest), increased personal, corporate or SME insolvency rates, borrowers' reduced ability to repay loans and increased tenant defaults which could cause prices of residential or commercial real estate or other asset prices to fall, thereby reducing the collateral value on many of the Group's assets, fluctuations in commodity prices, changes in foreign exchange rates; or a marked deterioration in global economic growth reflecting the high levels of debt that have built up in some emerging economies, most notably China. These, in turn, could cause increased impairments and/or fair value adjustments.

In addition to the possibility of macro-economic deterioration, any increase of financial market instability including any increase in credit spreads, increase or reduction in interest rates, including negative interest rates, and general illiquidity within the markets that the Group uses for hedging or bond issuances may represent further risk to the Group's business. The outlook for global growth remains uncertain due to issues such as geopolitical tensions (e.g. Middle Eastern instability and rising tensions in the Korean Peninsula), the impact of economic policies of foreign governments, continued divergence in economic performance between countries within the Eurozone, and the slow-down of economic growth rates in emerging markets generally and China in particular. The Group has significant exposures, particularly by way of loans, in a number of overseas jurisdictions and is therefore subject to various risks relating to the stability of these financial markets. The global financial system has suffered considerable turbulence and uncertainty in recent years and, despite recent growth in the Eurozone and other advanced economies, the outlook for the global economy over the near to medium term remains uncertain. See also "*—Business and Economic Risks— Political, legal, regulatory, constitutional and economic uncertainty arising from the outcome of the referendum on the UK's membership of the EU could adversely impact the Group's business, results of operations, financial condition and prospects*" below.

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In the Eurozone, while the pace of economic recovery has lagged behind that of other advanced countries following the global recession, the region is now experiencing a solid recovery. Nevertheless, high levels of private and public debt, outstanding weaknesses in the financial sector and reform fatigue remain a concern and the timing and pace of the European Central Bank's withdrawal of monetary stimulus could cause market volatility. In addition, increased political uncertainty in the Eurozone, and fragmentation risk in the EU and UK, could create financial instability and have a negative impact on the Eurozone and global economies. Any of these risks could weaken the UK's economic prospects, given the extensive economic and financial linkages between the UK and the Eurozone.

The uncertainty around the economic policies of foreign governments could create additional uncertainty for the global economic outlook. For example, in the U.S., whilst it is possible that the current administration's economic policies might have an adverse effect on U.S. and global growth as well as global trade prospects, it is also possible that expansionary policies could boost growth temporarily at a time of limited spare capacity resulting in higher U.S. inflation and interest rates which could in turn significantly impact global investor risk appetite, sparking elevated financial market volatility and a tightening of financial conditions.

In addition, developing macro-economic uncertainty in emerging markets, in particular the high and growing level of debt in China and the risk of a sharp slowdown in Chinese economic growth, which may be exacerbated by attempts to de-risk its highly leveraged economy, or a devaluation of the Renminbi could pose threats to global economic recovery. External debt levels are higher now in emerging markets than before the global financial crisis, which could lead to higher levels of defaults and non-performing loans, in particular in an environment of rising interest rates. Financial markets may experience renewed periods of volatility, especially given the recent instability in oil and other commodity prices impacting corporates and emerging markets dependent on the oil and gas sector, creating the potential for a return of contagion between countries and banking systems which may place new strains on funding markets.

The Group has credit exposure to SMEs and corporates, financial institutions, sovereigns and securities which may have material direct and indirect exposures in Eurozone countries, the U.S. and other countries.

Any default on the sovereign debt of a Eurozone country and the resulting impact on other Eurozone countries, including the potential that some countries could leave the Eurozone, could have a material adverse effect on the Group's business. The exit of any member state from the European Monetary Union (the "EMU") could result in deterioration in the economic and financial environment in the UK and the Eurozone that would materially affect the capital and the funding position of participants in the banking industry, including the Group. This could also give rise to operational disruptions to the Group's business.

Examples of indirect risks to the Group associated with the Eurozone which have been identified are adverse developments relating to: European banking groups with lending and other exposures to certain Eurozone countries, corporate customers with operations or significant trade in certain European jurisdictions, major travel operators and airlines known to operate in certain Eurozone countries, and international banks with custodian operations based in certain European locations. Adverse developments relating to these sectors, or banking groups could increase the risk of defaults and negatively impact the Group's business, results of operations or financial condition.

The effects on the UK, European and global economies of the exit of one or more EU member states from the EMU, or the redenomination of financial instruments from the Euro to a different currency, are extremely uncertain and very difficult to predict and protect fully against in view of: (i) the potential for economic and financial instability in the Eurozone and possibly in the UK; (ii) the lasting impact on governments' financial positions of the global financial crisis; (iii) the uncertain legal position; and (iv) the fact that many of the risks related to the business are totally, or in part, outside the control of the Group. However, if any such events were to occur, they may result in: (a) significant market dislocation; (b) heightened counterparty risk; (c) an adverse effect on the management of market risk and, in particular, asset and liability management due, in part, to redenomination of financial assets and liabilities; (d) an indirect risk of counterparty failure; or (e) further political uncertainty in the UK, any of which could have a material adverse effect on the results of operations, financial condition or prospects of the Group. Any adverse changes affecting the economies of the countries in which the Group has significant direct and indirect credit exposures, including those discussed above and any further deterioration in global macro-economic conditions, could have a material adverse effect on the Group's results of operations, financial condition or prospects.

Political, legal, regulatory, constitutional and economic uncertainty arising from the outcome of the referendum on the UK's membership of the European Union could adversely impact the Group's business, results of operations, financial condition and prospects.

On 23 June 2016, the UK held a referendum on the UK's continued membership of the EU. A majority of voters voted for the UK to leave the EU. The announcement of the referendum result caused significant volatility in global stock markets and currency exchange rate fluctuations immediately following the EU referendum result that resulted in a significant weakening of the sterling against the U.S. dollar, the euro and other major currencies. The share prices of major UK banks and bank holding companies, including the Company, suffered significant declines in market prices immediately following the result of the referendum and major credit rating agencies downgraded the UK's sovereign credit rating.

A process of negotiation is on-going to determine the terms of the UK's exit from the EU, and to set the framework for future discussions on the terms of the UK's relationship with the EU. The uncertainty regarding the timing of, and the process for, the UK's exit from the EU before, during and after the period of negotiation could have a negative economic impact and result in further volatility in the markets which could in turn adversely impact the Group's business, results of operations, financial condition and prospects.

The effects on the UK, European and global economies of the uncertainties arising from the results of the referendum and the process of the UK's exit from the EU are difficult to predict but may include economic and financial instability in the UK, Europe and the global economy and the other types of risks described in "*—The Group's businesses are subject to inherent and indirect risks arising from general macro-economic conditions in the UK, the U.S., the Eurozone, Asia and globally, and any resulting instability of financial markets or banking systems*" above.

Under Article 50 of the Treaty on European Union ("**Article 50**") once the exit process is triggered by the withdrawing member state, a two-year period of negotiation begins to determine the terms of the withdrawing member's exit from the EU with reference to the planned post-exit relationship, after which period its EU membership ceases unless the European Council, together with the withdrawing member, unanimously decides to extend this period.

Following the UK Government's decision to invoke Article 50 on 29 March 2017, it is expected that the UK will leave the EU in March 2019, although this deadline could be extended or a transitional arrangement put in place, subject to agreement by all EU member states. Negotiations relating to the terms of the UK's relationship with the EU are likely to extend beyond the two-year period set forth therein which could create additional volatility in the markets and have an adverse impact on the Group's profitability. The timing of, and process for, such negotiations and the resulting terms of the UK's future economic, trading and legal relationships are uncertain, and will be impacted by the stance the current UK government and the other EU Member

States adopt, which may be fluid. In addition, an unfavourable outcome of negotiations relating to the UK's exit from the EU is likely to create further volatility in the markets which could in turn adversely impact the Group's business, results of operations, financial condition and prospects.

The UK general election held on 8 June 2017 resulted in a minority government. The UK political environment remains fragile, heightened by the EU exit negotiations.

Furthermore, any uncertainty in the UK arising from the UK leaving the EU could be exacerbated by the re-emergence of the possibility of a further Scottish independence referendum. This could cause further uncertainty and risks to the Group.

The longer term effects of the UK's expected exit from the EU are difficult to predict but could include further financial instability and slower economic growth, in the UK in particular, but also in Europe and the global economy. In the event of any substantial weakening in economic growth, the possible policy of decreases in interest rates by the Bank of England or sustained low or negative interest rates would put further pressure on the Group's interest margins and adversely affect the Group's profitability and prospects. Furthermore, such market conditions may also result in an increase in the Group's pension deficit.

A challenging macroeconomic environment, reduced profitability and greater market uncertainty could negatively impact the Group's performance and potentially lead to credit ratings downgrades which could adversely impact the Group's ability to access funding and the cost of such funding. The Group's ability to access capital markets on acceptable terms and hence its ability to raise the amount of capital and funding required to meet its regulatory requirements and targets, including those relating to loss-absorbing instruments to be issued by the Group, could be affected.

The Group is subject to substantial EU-derived laws, regulation and oversight. There is now significant uncertainty as to the respective legal and regulatory environments in which the Group and its subsidiaries will operate when the UK is no longer a member of the EU. In particular, the Group and its counterparties may no longer be able to rely on the European passporting framework for financial services, which could result in the loss of customers and/or the requirement for the Group to apply for authorisation in multiple EU jurisdictions, the costs, timing and viability of which are uncertain. This uncertainty, and any actions taken as a result of this uncertainty (such as corporate clients of the Group preferring to transact with European competitors or to relocate from the UK to the EU to avoid a loss of passporting rights), as well as new or amended legislation and regulation, may have a significant impact on the Group's operations, profitability and business model. For further information on the Group's regulatory and legal risks see "*—Regulatory and legal risks*".

Any tightening of monetary policy in jurisdictions in which the Group operates could affect the financial condition of its customers, clients and counterparties, including governments and other financial institutions, which could in turn adversely affect the Group's results of operations.

Quantitative easing measures implemented by major central banks, adopted alongside record low interest rates to support recovery from the global financial crisis, have arguably helped loosen financial conditions and reduce borrowing costs. These measures may have led to the emergence of high liquidity and valuations for asset classes that are both vulnerable to rapid price corrections as financial conditions tighten, potentially causing losses to investors and increasing the risk of default on the Group's exposure to these sectors.

The U.S. Federal Reserve has been gradually increasing its policy interest rates since December 2015 and these are expected to remain on a tightening trajectory. The Bank of England raised UK interest rates from 0.25 per cent to 0.5 per cent in November 2017 and has signalled that UK interest rates may rise at a faster pace than previously anticipated. Some other major central banks, such as the Bank of Canada, are also on a tightening cycle, but the withdrawal of accommodative policies in the Eurozone and in Japan is expected to be somewhat slower.

Although uncertainty remains about the timing of any increases by central banks, it is possible that any increase in interest rates may lead to increasing levels of defaults by the Group's customers. Monetary policy has been highly accommodative in recent years, further supported by the Bank of England and HM Treasury "Funding for Lending" scheme, the "Help to Buy" scheme, the "Term Funding Scheme" and the purchase of corporate bonds in the UK, which have helped to support demand at a time of very pronounced fiscal tightening and balance sheet repair. Such a long period of stimulus has increased uncertainty over the impact of its reduction, including the possibility of a withdrawal of such programmes which could lead to a risk of higher borrowing costs in wholesale markets, generally weaker than expected growth, or even contracting gross domestic product ("**GDP**"), reduced business and consumer confidence, higher levels of unemployment or underemployment, adverse changes to levels of inflation and falling property prices in the markets in which the Group operates, and consequently to an increase in delinquency rates and default rates among its customers. Similar risks result from the low level of inflation in developed economies, which in Europe particularly could deteriorate into sustained deflation if policy measures prove ineffective and economic growth weakens. Reduced monetary stimulus and the actions and commercial soundness of other financial institutions have the potential to impact market liquidity. The adverse impact on the credit quality of the Group's customers and counterparties, coupled with a decline in collateral values, could lead to a reduction in recoverability and value of the Group's assets and higher levels of impairment allowances, which could have an adverse effect on the Group's operations, financial condition or prospects.

Accommodative credit conditions in some areas of the world since the global financial crisis have led to a further build-up of debt, with private sector corporate debt in emerging markets growing particularly quickly. Emerging market currency depreciation and rising U.S. interest rates could result in increasing difficulties in servicing this increased debt, especially debt that is denominated in U.S. dollars, possibly leading to debt defaults, which may negatively affect economic growth in emerging markets or globally.

The Group's businesses are inherently subject to the risk of market fluctuations, which could have a material adverse effect on the results of operations, financial condition or prospects of the Group.

The Group's businesses are inherently subject to risks in financial markets and in the wider economy, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that its customers act in a manner which is inconsistent with the Group's business, pricing and hedging assumptions. Movements in these markets will continue to have a significant impact on the Group in a number of key areas.

For example, adverse market movements have had and would have an adverse effect, which could be material, upon the financial condition of the defined benefit pension schemes of the Group. The schemes' main exposures are to real rate risk and credit spread risk. These risks arise from two main sources: the "AA" corporate bond liability discount rate and asset holdings.

Banking and trading activities that are undertaken by the Group are also subject to market movements, including interest rate risk, foreign exchange risk, inflation risk and credit spread risk. For example, changes in interest rate levels, interbank margins over official rates, yield curves and spreads affect the interest rate margin realised between lending and borrowing costs. The potential for future volatility and margin changes remains. Competitive pressures on fixed rates or product terms in existing loans and deposits may restrict the Group in its ability to change interest rates applying to customers in response to changes in official and wholesale market rates. The Group will continue to face interest rate margin compression in the prolonged low (or negative) interest rate environment and the yield on its structural hedge will reduce as reinvestment is undertaken at lower rates.

The insurance business of the Group is exposed indirectly to equity and credit markets through the value of future management charges on policyholder funds. Credit spread risk within insurance primarily arises from bonds and loans used to back annuities. The performance of the investment markets will thus have a direct impact upon the profit from investment contracts and on the insurance value in force ("**VIF**") and the Group's operating results, financial condition or prospects.

Changes in foreign exchange rates, including with respect to the U.S. dollar and the Euro, affect the Group's financial position and/or forecasted earnings. Foreign exchange risk is actively managed by the Group within a low risk appetite, minimising the Group's exposure to exchange rate fluctuations.

Market conditions have resulted, and are expected to result in the future, in material changes to the estimated fair values of financial assets of the Group. Negative fair value adjustments have had, and may continue to have in the future, an adverse effect on the Group's results of operations, financial condition or prospects.

The Group has exposures to securities, derivatives and other investments, including asset-backed securities, structured investments and private equity investments that are recorded by the Group at fair value. These have been and may be subject to further negative fair value adjustments, particularly in view of the volatile global markets and challenging economic environment. Although credit value adjustments, debit value adjustments and funding value adjustments are actively managed within the Group, in stressed market conditions adverse movements in these could result in a material charge to the Group's profit and loss account.

In volatile markets, hedging and other risk management strategies (including collateralisation and the purchase of credit default swaps) may not be as effective as they are in normal market conditions, due in part to the decreasing credit quality of hedge counterparties, and general illiquidity in the markets within which transactions are executed. Asset valuations in future periods, reflecting prevailing market conditions, may result in further negative changes in the fair values of the Group's financial assets and these may also translate into increased impairment charges.

In circumstances where fair values are determined using financial valuation models, the Group's valuation methodologies may require it to make assumptions, judgments and estimates in order to establish fair value. These valuation models are complex and the assumptions used are difficult to make and are inherently uncertain. This is particularly relevant in light of uncertainty as to the strength of the global economic recovery and continuing downside risks and may be amplified during periods of market volatility and illiquidity. Any consequential impairments, write-downs or adjustments could have a material adverse effect on the Group's operating results, capital ratios, financial condition or prospects.

The value ultimately realised by the Group for its securities and other investments may be lower than their current fair value. Any of these factors could require the Group to record further negative fair value adjustments, which may have a material adverse effect on its operating results, financial condition or prospects. Material losses from the fair value of financial assets will also have an adverse impact on the Group's capital ratios.

The Group's businesses are conducted in competitive environments, with increased competition scrutiny, and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures.

The markets for UK financial services, and the other markets within which the Group operates, are competitive, and management expects such competition to continue or intensify. This expectation is due to competitor behaviour, new entrants to the market (including a number of new retail banks as well as non-traditional financial services providers), consumer demand, technological changes such as the growth of digital banking, and the impact of regulatory actions and other factors. The Group's financial performance and its ability to maintain existing or capture additional market share depends significantly upon the competitive environment and management's response thereto.

Notwithstanding this increase in competition described above, intervention by the UK Government competition authorities and/or European regulatory bodies and/or governments of other countries in which the Group operates, including in response to any perceived lack of competition within these markets by such regulatory authorities, may significantly impact the competitive position of the Group relative to its international competitors, which may be subject to different forms of government intervention, thus potentially putting the Group at a competitive disadvantage.

The Competition and Markets Authority (the "**CMA**") launched a full market investigation into competition in the SME banking and personal current account ("**PCA**") markets in November 2014 published its final report on 9 August 2016, and published the Retail Banking Market Investigation Order 2017 on 2 February 2017. The key final remedies include: the introduction of "Open Banking", the publication of service quality information and customer information prompts. Recommendations were also made regarding improvements to current account switching, monthly maximum charges for PCA overdraft users, overdraft notifications and additional measures to assist small business in comparing the different products available.

The FCA launched its Strategic Review of Retail Banking Business Models in May 2017 to evaluate matters relating to competition and conduct and issued a Purpose and Scope Paper in October 2017. This review is intended to ensure that the FCA's regulatory approach remains fit for purpose. The outcomes of the review may have a significant impact on the Group's current business model depending on the findings and recommendations made.

Recent political debate on the reform of the UK banking markets, other current or potential competition reviews, the payment systems regulator and the FCA statutory objective to promote competition, along with concurrent competition powers, may lead to proposals or initiatives to reduce regulators' competition concerns, and for greater UK Government and regulatory scrutiny in the future that may impact the Group further. Additionally, the Group may be affected by changes in regulatory oversight following the pension review recommended by the Department for Work and Pensions. For more information on the Group's regulatory environment, see "— *Regulation—Other Bodies Impacting the Regulatory Regime*".

The internet and mobile technologies are changing customer behaviour and the competitive environment. There has been a steep rise in customer use of mobile banking over the last four years. The Group faces competition from established providers of financial services as well as from banking business developed by non-financial companies, including technology companies with strong brand recognition.

As a result of any restructuring or evolution in the market, there may emerge one or more new viable competitors in the UK banking market or a material strengthening of one or more of the Group's existing competitors in that market. Any of these factors or a combination thereof could result in a significant reduction in the profit of the Group.

OPERATIONAL RISKS

The Group could fail to attract or retain senior management or other key employees.

The Group’s success depends on its ability to attract, retain and develop high calibre talent. The Group’s achievement of this aim may be impacted by the introduction of the SMCR. The SMCR includes a criminal offence of reckless misconduct, a statutory “duty of responsibility” to take reasonable steps to prevent regulatory breaches occurring or continuing in the area of the firm for which they have responsibility and increasing use of senior management attestations. In addition, the limits on variable pay and “clawback” requirements which were introduced pursuant to CRD IV in the UK may put the Group at a competitive disadvantage compared to companies who are not subject to such restrictions. In addition, macro-economic conditions and negative media attention on the financial services industry may adversely impact employee retention, colleague sentiment and engagement.

In addition, the uncertainty resulting from the UK’s exit from the EU, following the referendum decision, on foreign nationals’ long-term residency permissions in the UK may make it challenging for the Group to retain and recruit adequate staff.

Failure to attract and retain senior management and key employees could have a material adverse effect on the Group’s results of operations, financial condition or prospects.

Operational risks such as weaknesses or failures in the Group’s processes, systems and security and risks due to reliance on third party services and products could materially adversely affect the Group’s operations, results of operations, financial condition or prospects, and could result in the reputational damage of the Group.

Operational risks, through inadequate or failed processes, systems (including financial reporting and risk monitoring processes) or security, or from people-related or external events, including the risk of fraud and other criminal acts carried out against the Group, are present in the Group’s businesses. The Group’s businesses are dependent on processing and reporting accurately and efficiently a high volume of complex transactions across numerous and diverse products and services, in different currencies and subject to a number of different legal and regulatory regimes. Any weakness or errors in these processes, systems or security could have an adverse effect on the Group’s results, reporting of such results, and on the ability to deliver appropriate customer outcomes during the affected period which may lead to an increase in complaints and damage to the reputation of the Group.

Specifically, failure to develop, deliver or maintain effective IT solutions in line with the Group’s operating environment could have a material adverse impact on customer service and business operations. Any prolonged loss of service availability could damage the Group’s ability to service its customers, could result in compensation costs and could cause long-term damage to the Group’s business and brand. Furthermore, failure to protect the Group’s operations from increasingly sophisticated cyber-attacks could result in the loss and/or corruption of customer data or other sensitive information. This could be exacerbated by the increase in data protection requirements as a result of GDPR. The resilience of the Group's IT infrastructure is of critical importance to the Group; accordingly, significant investment has been, and will continue to be, made in IT infrastructure and supporting capabilities to ensure its resilience and subsequently the delivery of services to customers. The Group continues to invest in IT, cyber and information security control environments, including activity on user access management and network security controls to address evolving threats. The Group maintains contingency plans for a range of Group specific and industry wide IT failure and cyber-attack scenarios.

The Group adopts a risk based approach to mitigate the internal and external fraud risks it faces, reflecting the current and emerging fraud risks within the market. This approach drives a continual programme of prioritised enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Group-wide policies and operational control frameworks are maintained and designed to provide customer confidence, protect the Group's commercial interests and reputation, comply with legal requirements and meet regulatory expectations. The Group also plays an active role with other financial institutions, industry bodies and enforcement agencies in identifying and combatting fraud. The Group's fraud awareness programme remains a key component of its fraud control environment. Although the Group devotes significant resources to maintain and regularly update the processes and systems that are designed to protect the security of the Group's systems, software, networks and other technology assets, there is no assurance that all of the Group's security measures will provide absolute security. Any damage to the Group's reputation (including to customer confidence) arising from actual or perceived inadequacies, weaknesses or failures in Group systems, processes or security could have a material adverse effect on the Group's results of operations, financial condition or prospects.

Third parties upon which the Group relies for important products and services could also be sources of operational risk, specifically with regard to security breaches affecting such parties. Many of the operational risks described above also apply when the Group relies on outside suppliers or vendors to provide key components of its business infrastructure. The Group may be required to take steps to protect the integrity of its operational systems, thereby increasing its operational costs. Additionally, any problems caused by these third parties, including as a result of their not providing the Group their services for any reason, their performing their services poorly, or employee misconduct, could adversely affect the Group's ability to deliver products and services to customers and otherwise to conduct business. Replacing these third party vendors or moving critical services from one provider to another could also entail significant delays and expense.

Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Company or any relevant company within the Group will be unable to comply with its obligations as a company with securities admitted to the Official List or as a supervised firm regulated by the FCA and/or the PRA.

The Group's business is subject to risks related to cybercrime.

The Group relies on the effectiveness of its Group Information and Cyber Security Policy and associated procedures, infrastructure and capabilities to protect the confidentiality and integrity of information held on its IT infrastructure and the infrastructure of third parties on whom the Group relies. The Group also takes protective measures against attacks designed to impact the availability of critical business processes to its customers. In certain international locations, there are additional regulatory requirements that must be followed for business conducted in that jurisdiction. In the U.S., for example, the Company was required from February 2018 to formally attest that it complies with specific cyber-security requirements put forth by the New York State Department of Financial Services in Part 500 of Title 23 of the Official Compilation of Codes, Rules and Regulations of the State of New York.

Despite preventative measures, the Group's IT infrastructure, and that of third parties on whom the Group relies, may be vulnerable to cyber-attacks, malware, denial of services, unauthorised access and other events that have a security impact. Such an event may impact the confidentiality or integrity of the Group's or its clients', employees' or counterparties' information or the availability of services to customers. As a result of such an event or a failure in the Group's cyber security policies, the Group could experience material financial loss, loss of competitive position, regulatory actions, breach of client contracts, reputational harm or legal liability, which, in turn, could have a material adverse effect on the Group's results of operations, financial condition or prospects. The Group may be required to spend additional resources to modify its protective measures or to investigate and remediate vulnerabilities

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or other exposures, and it may be subject to litigation and financial losses that are either not insured against fully or not fully covered through any insurance that it maintains. The Group is committed to continued participation in industry-wide activity relating to cyber risk. This includes working with relevant regulatory and government departments to evaluate the approach the Group is taking to mitigate this risk and sharing relevant information across the financial services sector.

Terrorist acts, other acts of war, geopolitical events, pandemics or other such events could have a material adverse effect on the Group's results of operations, financial condition or prospects.

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

The Group must comply with anti-money laundering, counter terrorist financing, anti-bribery and sanctions regulations, and a failure to prevent or detect any illegal or improper activities fully or on a timely basis could negatively impact customers and expose the Group to liability.

The Group is required to comply with applicable anti-money laundering, anti-terrorism, sanctions, anti-bribery and other laws and regulations in the jurisdictions in which it operates. These laws and regulations require the Group, amongst other things, to adopt and enforce "know-your-customer" policies and procedures and to report suspicions of money laundering and terrorist financing, and in some countries specific transactions to the applicable regulatory authorities. These laws and regulations have become increasingly complex and detailed, require improved systems and sophisticated monitoring and compliance personnel, and have become the subject of enhanced government and regulatory supervision.

The Group has adopted policies and enhanced its procedures aimed at detecting and preventing the use of its banking network and services for money laundering, financing terrorism, tax evasion, human trafficking, modern day slavery and related activities, applying systems and controls on a risk-based approach throughout its businesses and operations, including through its Financial Intelligence Unit and its interactions with external agencies and other financial institutions. These controls, however, may not completely eliminate instances where third parties seek to use the Group's products and services to engage in illegal or improper activities. In addition, while the Group reviews its relevant counterparties' internal policies and procedures with respect to such matters, the Group, to a large degree, relies upon its relevant counterparties to maintain and properly apply their own appropriate anti-money laundering procedures. Such measures, procedures and compliance may not be completely effective in preventing third parties from using the Group (and its relevant counterparties) as a conduit for money laundering and terrorist financing (including illegal cash operations) without the Group's (and its relevant counterparties') knowledge. If the Group is associated with, or even accused of being associated with, or becomes a party to, money laundering or terrorist financing, the Group's reputation could suffer and/or it could become subject to fines, sanctions and/or legal enforcement (including being added to any "black lists" that would prohibit certain parties from engaging in transactions with the Group), any one of which could have a material adverse effect on the Group's operating results, financial condition and prospects.

To the extent that the Group fails to comply fully with applicable laws and regulations, the relevant government and regulatory agencies to which it reports have the power and authority to impose fines and other penalties on the Group, including the revocation of licences. In addition, the Group's business and reputation could suffer if customers use its banking network for money laundering, financing terrorism, or other illegal or improper purposes.

The Group may fail to execute its ongoing strategic change initiatives, and the expected benefits of such initiatives may not be achieved at the time or to the extent expected, or at all.

In order to maintain and enhance the Group's strategic position, it continues to invest in new initiatives and programmes. The Group acknowledges the challenges faced with delivering these initiatives and programmes alongside the extensive agenda of regulatory and legal changes whilst enhancing systems and controls. In the development of the Group's strategy, the Group considers these demands against its capacity to ensure successful delivery for both customers and shareholders. The Group's new strategic plan provides flexibility through a broad range of initiatives with priorities frequently reviewed to adapt to the external environment, where necessary.

As the Group continues to deliver this strategy there is considerable focus on digitisation and ensuring the Group meets customer demands through digital and mobile platforms. This approach will support the Group in achieving its cost targets.

The successful completion of these programmes and the Group's other strategic initiatives requires ongoing subjective and complex judgments, including forecasts of economic conditions in various parts of the world, and can be subject to significant execution risks. For example, the Group's ability to execute its strategic initiatives successfully may be adversely impacted by a significant global macroeconomic downturn, legacy issues, limitations in the Group's management or operational capacity or significant and unexpected regulatory change in countries in which the Group operates.

Failure to execute the Group's strategic initiatives successfully could have an adverse effect on the Group's ability to achieve the stated targets and other expected benefits of these initiatives, and there is also a risk that the costs associated with implementing such initiatives may be higher than the financial benefits expected to be achieved, which could materially adversely impact the Group's results of operations, financial condition or prospects.

The Group may be unable to fully capture the expected value from acquisitions, which could materially and adversely affect the Group's results of operations, financial conditions or prospects.

The Group may from time to time undertake acquisitions as part of its growth strategy, which could subject the Group to a number of risks, such as: (i) the rationale and assumptions underlying the business plans supporting the valuation of a target business may prove inaccurate, in particular with respect to synergies and expected commercial demand;

(ii) the Group may fail to successfully integrate any acquired business, including its technologies, products and personnel; (iii) the Group may fail to retain key employees, customers and suppliers of any acquired business; (iv) the Group may be required or wish to terminate pre-existing contractual relationships, which could prove costly and/or be executed at unfavourable terms and conditions; (v) the Group may fail to discover certain contingent or undisclosed liabilities in businesses that it acquires, or its due diligence to discover any such liabilities may be inadequate; and (vi) it may be necessary to obtain regulatory and other approvals in connection with certain acquisitions and there can be no assurance that such approvals will be obtained and even if granted, that there will be no burdensome conditions attached to such approvals, all of which could materially and adversely affect the Group's results of operations, financial conditions or prospects.

The Group could be exposed to industrial action and increased labour costs resulting from a lack of agreement with trade unions.

Within the Group, there are currently two recognised unions for the purposes of collective bargaining. Combined, these collective bargaining arrangements apply to around 95 per cent. of the Group's total workforce.

Where the Group or its employees or their unions seek to change any of their contractual terms, a consultation and negotiation process is undertaken. Such a process could potentially lead to increased labour costs or, in the event that any such negotiations were to be unsuccessful and result in formal industrial action, the Group could experience a work stoppage that could materially adversely impact its business, financial condition and results of operations.

FINANCIAL SOUNDNESS RELATED RISKS

The Group's businesses are subject to inherent risks concerning liquidity and funding, particularly if the availability of traditional sources of funding such as retail deposits or the access to wholesale funding markets becomes more limited.

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 be unable to continue to source sustainable funding, its ability to fund its financial obligations could be impacted.

The Group's profitability or solvency could be adversely affected if access to liquidity and funding is constrained or made more expensive for a prolonged period of time. Under extreme and unforeseen circumstances, such as the closure of financial markets and uncertainty as to the ability of a significant number of firms to ensure they can meet their liabilities as they fall due, the Group's ability to meet its financial obligations as they fall due or to fulfil its commitments to lend could be impacted through limited access to liquidity (including government and central bank facilities). In such extreme circumstances, the Group may not be in a position to continue to operate without additional funding support, which it may be unable to access. These factors may have a material adverse effect on the Group's solvency, including its ability to meet its regulatory minimum liquidity requirements. These risks can be exacerbated by operational factors such as an over-reliance on a particular source of funding or changes in credit ratings, as well as market-wide phenomena such as market dislocation, regulatory change or major disasters.

In addition, corporate and institutional counterparties may seek to reduce aggregate credit exposures to the Group (or to all banks) which could increase the Group's cost of funding and limit its access to liquidity. The funding structure employed by the Group may also prove to be inefficient, thus giving rise to a level of funding cost where the cumulative costs are not sustainable over the longer term. The funding needs of the Group may increase and such increases may be material to the Group's operating results, financial condition or prospects. The Group relies on customer savings and transmission balances, as well as ongoing access to the global wholesale funding markets to meet its funding needs. The ability of the Group to gain access to wholesale and retail funding sources on satisfactory economic terms is subject to a number of factors outside its control, such as liquidity constraints, general market conditions, regulatory requirements, the encouraged or mandated repatriation of deposits by foreign wholesale or central bank depositors and the level of confidence in the UK banking system, any of which could have a material adverse effect on the Group's profitability or, in the longer term and under extreme circumstances, its ability to meet its financial obligations as they fall due.

Medium-term growth in the Group’s lending activities will rely, in part, on the availability of retail deposit funding on appropriate terms, for which there is increasing competition. For more information, see “*—Business and economic risks — The Group’s businesses are conducted in competitive environments, with increased competition scrutiny, and the Group’s financial performance depends upon management’s ability to respond effectively to competitive pressures*” above. The ongoing availability of retail deposit funding on appropriate terms is dependent on a variety of factors outside the Group’s control, such as general macro-economic conditions and market volatility, the confidence of retail depositors in the economy, the financial services industry and the Group, as well as the availability and extent of deposit guarantees. Increases in the cost of retail deposit funding will impact on the Group’s margins and affect profit, and a lack of availability of retail deposit funding could have a material adverse effect on the Group’s future growth.

Any loss in consumer confidence in the Group could significantly increase the amount of retail deposit withdrawals in a short period of time. Should the Group experience an unusually high and unforeseen level of withdrawals, in such extreme circumstances the Group may not be in a position to continue to operate without additional funding support, which it may be unable to access, which could have a material adverse effect on the Group’s solvency.

In recent years, the Group has also made use of central bank funding schemes such as the Bank of England’s Term Funding Scheme and Funding for Lending Scheme. Following the closures of these Schemes, the Group will have to replace matured central bank scheme funding, which could cause an increased dependence on term funding issuances. If the wholesale funding markets were to suffer stress or central bank provision of liquidity to the financial markets is abruptly curtailed, or the Group’s credit ratings are downgraded, it is likely that wholesale funding will prove more difficult to obtain. Such increased refinancing risk, in isolation or in concert with the related liquidity risks noted above, could have a material adverse effect on the Group’s profitability and, in the longer term under extreme and unforeseen circumstances, its ability to meet its financial obligations as they fall due.

The Group’s borrowing costs and access to the capital markets are dependent on a number of factors, including any reduction in the Group’s longer-term credit rating, and increased costs or reduction in access could materially adversely affect the Group’s results of operations, financial condition or prospects.

A 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, during 2017, 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 averaged 33 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.

Rating agencies regularly evaluate the Group and the Company, and their ratings of longer-term debt are based on a number of factors, including the Group’s financial strength as well as factors not entirely within the Group’s control, including conditions affecting the financial services industry generally. In light of the difficulties in the financial services industry and the financial markets, there can be no assurance that the Group or the Company will maintain their current ratings. Downgrades of the Group’s longer-term credit rating could lead to additional collateral posting and cash outflow. The effects of a potential downgrade from all three rating agencies are included in the Group liquidity stress testing. As at 31 December 2017, a hypothetical instantaneous two notch downgrade of the Group's current long-term credit rating and accompanying short-term downgrade implemented simultaneously by all major rating agencies could result in a contractual outflow of £1.1 billion of cash over a period of up to one year, £2.0 billion of collateral posting related to customer financial contracts and £5.9 billion of collateral posting associated with secured funding, calculated on an unaudited basis.

The regulatory environment in which the Group operates continues to change. Whilst uncertain at present, the Group's borrowing costs and access to capital markets could be affected by the outcome of certain regulatory developments. For further detail on the potential impact of these regulatory developments on the Group's business, see "*—Regulatory and legal risks — The Group faces risks associated with an uncertain and rapidly evolving international prudential legal and regulatory environment*".

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The Group is subject to the risk of having insufficient capital resources.

If the Group has or is perceived to have a shortage of capital then it may be subject to regulatory interventions and sanctions and may suffer a loss of confidence in the market with the result that access to liquidity and funding may become constrained or more expensive. Depending on the extent of any actions to improve the capital position there could be a material adverse effect on the Group's business, including its operating results, financial condition and prospects. This, in turn, may affect the Group's capacity to continue its business operations, pay future dividends and make other distributions or pursue acquisitions or other strategic opportunities, impacting future growth potential. If, in response to such shortage, the Group raises additional capital through the issuance of share capital, existing shareholders may experience a dilution of their holdings. If a capital or debt instrument is converted to share capital as a result of a trigger within the contractual terms of the instrument or through the exercise of statutory powers then, depending upon the terms of the conversion, existing shareholders may experience a dilution of their holdings. Separately, the Group may address a shortage of capital by taking action to reduce leverage and/or risk-weighted assets or by business disposals. Such actions may impact the profitability of the Group.

A shortage of capital could arise from:

- a depletion of the Group's capital resources through increased costs or liabilities and reduced asset values which could arise as a result of the crystallisation of credit-related risks, regulatory and legal risks, business and economic risks, operational risks, financial soundness-related risks and other risks; and/or
- an increase in the amount of capital that is needed to be held. This might be driven by a change to the actual level of risk faced by the Group or to changes in the minimum levels required by legislation or by the regulatory authorities.

Risks associated with the regulatory framework are described below:

Within the prevailing UK regulatory capital framework, the Group is subject to extensive regulatory supervision in relation to the levels of capital in its business. New or revised minimum and buffer capital requirements (including systemic and/or countercyclical capital requirements) could be applied and/or the manner in which existing regulatory requirements are applied to the Group could be changed by the regulatory authorities. For example:

- Some of the Group's risk-weighted assets are calculated from the Group's approved models. These are subject to regular review on a rolling basis to ensure that they remain appropriate in prevailing economic and business conditions. In addition, ongoing proposals from the Basel Committee, the EBA and the PRA may result in changes to the Group's approved models, specifically in relation to changes in how firms model probability of default and Loss Given Default within capital models. These reviews and model implementation may lead to increased levels of risk-weighted assets and/or expected loss, which would lower reported capital ratios.

- The minimum capital requirements derived from risk-weighted assets are supplemented by the PRA, under Pillar 2 of the regulatory capital framework, through bank specific additional minimum requirements (informed by the Group's Internal Capital Adequacy Assessment Process (ICAAP) and with effect from 1 January 2018 set through the PRA's Total Capital Requirement (formerly the Individual Capital Guidance)) and through buffer requirements (informed by the outcome of PRA stress testing and which may include an additional buffer to cover the risk posed by any weaknesses in risk management and governance). There is a risk that through these Pillar 2 processes the PRA may require the Group to hold more capital than is currently planned.

- Regulatory capital requirements are applied to individually regulated firms in the Group, and from 1 January 2019 will also be applied to the RFB sub-group. There is a risk that the amount of capital needed to meet the regulatory capital requirements and buffers of the constituent parts of the Group is more than the amount needed to meet the regulatory capital requirements and buffers applied to the Group as a whole, and so the Group may be required to hold more capital than is currently planned.

In addition, the regulatory framework continues to evolve, which may impact the Group's capital position, for further detail see "*—Regulatory and legal risks - The Group faces risks associated with an uncertain and rapidly evolving international prudential legal and regulatory environment*" above.

The Group has been and could continue to be negatively affected by the soundness and/or the perceived soundness of other financial institutions, which could result in significant systemic liquidity problems, losses or defaults by other financial institutions and counterparties, and which could materially adversely affect the Group's results of operations, financial condition or prospects.

The Group is subject to the risk of deterioration of the commercial soundness and/or perceived soundness of other financial services institutions within and outside the UK. Financial services institutions that deal with each other are interrelated as a result of trading, investment, clearing, counterparty and other relationships. This presents systemic risk and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with which the Group interacts on a daily basis, all of which could have a material adverse effect on the Group's ability to raise new funding.

The Group routinely executes a high volume of transactions with counterparties in the financial services industry, resulting in a significant credit concentration. A default by, or even concerns about the financial resilience of, one or more financial services institutions could lead to further significant systemic liquidity problems, or losses or defaults by other financial institutions, which could have a material adverse effect on the Group's results of operations, financial condition or prospects.

The Group's insurance business and defined benefit pension schemes are subject to insurance risks which could adversely affect the Group's results of operations, financial condition or prospects.

The insurance business of the Group is exposed to short-term and longer-term variability arising from uncertain longevity due to annuity portfolios. The Group's defined benefit pension schemes are also exposed to longevity risk. Increases in life expectancy (longevity) beyond current allowances will increase the cost of annuities and pension scheme benefits and may adversely affect the Group's financial condition and results of operations.

Customer behaviour in the insurance business may result in increased cancellations or ceasing of contributions at a rate in excess of business assumptions. Consequent reduction in policy persistency and fee income would have an adverse impact upon the profitability of the insurance business of the Group.

The insurance business of the Group is also exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims and higher levels of theft can increase claims on home insurance. These claims rates may differ from business assumptions and negative developments may adversely affect the Group’s financial condition and results of operations.

To a lesser extent the insurance business is exposed to mortality, morbidity and expense risk. Adverse developments in any of these factors may adversely affect the Group's financial condition and results of operations.

UK banks can recognise an insurance asset in their balance sheets representing the VIF of the business in respect of long-term life assurance contracts, being insurance contracts and investment contracts with discretionary participation features. This asset represents the present value of future profits expected to arise from the portfolio of in-force life assurance contracts. Adoption of this accounting treatment results in the earlier recognition of profit on new business, but subsequently a lower contribution from existing business, when compared to the recognition of profits on investment contracts under IAS 39 (Financial Instruments: "Recognition and Measurement"). Differences between actual and expected experience may have a significant impact on the value of the VIF asset, as changes in experience can result in significant changes to modelled future cash flows. The VIF asset is calculated based on best-estimate assumptions made by management, including mortality experience and persistency. If these assumptions prove incorrect, the VIF asset could be materially reduced, which in turn could have a material adverse effect on the Group's results of operations, financial condition or prospects.

OTHER RISKS

The Group's financial statements are based, in part, on assumptions and estimates.

The preparation of the Group's financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgments and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgments and estimates, which include impairment losses on loans and receivables, valuation of financial instruments, pensions, insurance and taxation as set out in the Company's 2017 Annual Report in "*Note 3 to the consolidated financial statements—Critical accounting estimates and judgments*".

The consolidated financial statements are prepared using judgments, estimates and assumptions based on information available at the reporting date. If one or more of these judgments, estimates and assumptions is subsequently revised as a result of new factors or circumstances emerging, there could be a material adverse effect on the Group's results of operations, financial condition or prospects and a corresponding impact on its funding requirements and capital ratios.

In July 2014, the International Accounting Standards Board (the "**IASB**") published a new accounting standard for financial instruments (IFRS 9) that will introduce a new model for recognising and measuring impairment based on expected credit losses, rather than an incurred loss model currently applied under IAS 39 (Financial Instruments: "Recognition and Measurement"), resulting in earlier recognition of credit losses. The changes will result in the recognition of an increase in the Group's balance sheet provisions for credit losses by approximately £1.3 billion on 1 January 2018 and will therefore negatively impact the Group's regulatory capital position. The European Commission has implemented transitional arrangements to mitigate the full impact of IFRS 9 expected credit losses on regulatory capital over a five year transition period, commencing 1 January 2018.

The Company is dependent on the receipt of dividends from its subsidiaries to meet its obligations, including its payment obligations with respect to its debt securities.

The Company is a non-operating holding company. The principal sources of the Company's income are, and are expected to continue to be, distributions from operating subsidiaries which also hold the principal assets of the Group. As a separate legal entity, the Company relies on such distributions in order to be able to meet its obligations (including its payment obligations with respect to its debt securities), and to create distributable reserves for payment of dividends to ordinary shareholders.

The ability of the Company's subsidiaries (including subsidiaries incorporated outside the UK) to pay dividends and the Company's ability to receive distributions from its investments in other entities will also be subject not only to their financial performance but also to applicable local laws and other restrictions. These restrictions could include, among others, any regulatory requirements, leverage requirements, any statutory reserve requirements and any applicable tax laws. There may also be restrictions as a result of current or forthcoming local ring-fencing requirements, including those relating to the payment of dividends and the maintenance of sufficient regulatory capital on a sub-consolidated basis at the level of the RFB, see "—The Group is subject to the risk of having insufficient capital resources". These laws and restrictions could limit the payment of dividends and distributions to the Company by its subsidiaries and any other entities in which it holds an investment from time to time, which could restrict the Company's ability to meet its obligations and/or to pay dividends.

The Company may not pay a dividend on its ordinary shares in any given financial/calendar year.

The determination of the Board of Directors of the Company (the "**Board**") in any given year of whether the Company can or should pay a dividend on its ordinary shares, or the amount of such dividend, is subject to a number of factors. These include, among other things, the amount of capital the Group has generated over the year, the amount of regulatory capital it is required to retain by the PRA and other regulatory authorities, and the level of investment the Board determines is in the best interests of the Group to responsibly foster the growth of the business.

The Company's ability to pay dividends may be adversely affected by the performance of the Group's business in general, factors affecting its financial position (including capital, funding, liquidity and leverage), the economic environment in which the Group operates, the contractual terms of certain of the Group's regulatory capital securities and other factors outside of the Group's control, which could arise as a result of the crystallisation of credit-related risks, regulatory and legal risks, business and economic risks, operational risks, financial soundness-related risks and other risks described herein, many of which may impact the amount of capital that is generated over the course of the year.

As the parent company of a banking group, the Company's ability to pay dividends in the future is also dependent on the maintenance of an adequate level of regulatory capital. The Company's ability to pay dividends may be affected by minimum regulatory requirements applied to the Group, imposed by the PRA under the CRD IV requirements as implemented in the UK. The Group is also required by the PRA to maintain a number of regulatory capital buffers which may adversely impact the Company's ability to distribute its reserves. The level at which these buffers may be set is determined by the CRD IV rules and the requirements of the PRA buffer. Often, the PRA notifies the Company of minimum regulatory capital requirements applicable to the Group for the coming year only a short time ahead of the Company's dividend declaration for the prior year. This means that neither the Board nor the Company's investors may be able to accurately predict the Company's ability to pay dividends. For further detail on the potential impact of these requirements on the Company's ability to pay dividends on its ordinary shares, see "*—Regulatory and Legal Risks—The Group faces risks associated*

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with an uncertain and rapidly evolving international prudential, legal and regulatory environment" and "—Financial soundness-related Risks—The Group is subject to the risk of having insufficient capital resources".

In addition, the Board must determine in any given year the optimum level of investment to responsibly foster growth and to fund investment initiatives in the business, including organic growth or growth through acquisitions as part of its growth strategy, as well as the appropriate level of retained earnings for the Company as a prudential matter to meet evolving regulatory requirements and to cover uncertainties. These determinations will change year on year based on factors such as the economic cycle and macro-economic outlook, uncertainty in the regulatory and prudential environment, and relevant opportunities available to the Group at any given point in time. The Board's decisions in relation to these matters will have an impact on the ability of the Company to pay a dividend on its ordinary shares in any given year.

Volatility in the price of the Company's ordinary shares may affect the value of any investment in the Company.

The market price of the Company's ordinary shares could be volatile and subject to significant fluctuations due to various factors, some of which may be unrelated to the Group's operating performance or prospects. These include economic or political disruption in the main jurisdictions in which the Group operates, any regulatory changes affecting the Group's operations, developments in the industry or its competitors, the operating and share price performance of other companies in the industries and markets in which the Group operates, the potential placing of large volumes of the Company's ordinary shares in the market, or speculation about the Group's business in the press, media or investment communities. Furthermore, the Group's operating results and prospects from time to time may vary from the expectations of rating agencies, market analysts or investors. Any of these events could result in volatility in the market prices of the Company's ordinary shares. In general, prospective investors should be aware that the value of an investment in the Company's ordinary shares may go down as well as up.

Failure to manage the risks associated with changes in taxation rates or applicable tax laws, or misinterpretation of such tax laws, could materially adversely affect the Group's results of operations, financial condition or prospects.

Tax risk is the risk associated with changes in taxation rates, applicable tax laws, misinterpretation of such tax laws, disputes with relevant tax authorities in relation to historic transactions, or conducting a challenge to a relevant tax authority. Failure to manage this risk adequately could cause the Group to suffer losses due to additional tax charges and other financial costs including penalties. Such failure could lead to adverse publicity, reputational damage and potentially costs materially exceeding current provisions, in each case to an extent which could have an adverse effect on the Group's results of operations, financial condition or prospects.

FORWARD LOOKING STATEMENTS

This document contains certain forward looking statements within the meaning of Section 21E of the US Securities Exchange Act of 1934, as amended, and section 27A of the US Securities Act of 1933, as amended, with respect to the business, strategy, plans and / or results of Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'like 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of Lloyds Banking Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; Lloyds Banking Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of Lloyds Banking Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from forward looking statements made by Lloyds Banking Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates, inflation, exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to Lloyds Banking Group's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, instability as a result of the exit by the UK from the European Union (EU) and the potential for other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to the security of IT and operational infrastructure, systems, data and information resulting from increased threat of cyber and other attacks; natural, pandemic and other disasters, adverse weather and similar contingencies outside Lloyds Banking Group's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside Lloyds Banking Group's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the United States or elsewhere including the implementation and interpretation of key legislation and regulation together with any resulting impact on the future structure of Lloyds Banking Group; the ability to attract and retain senior management and other employees and meet its diversity objectives; actions or omissions by

Lloyds Banking Group's directors, management or employees including industrial action; changes to Lloyds Banking Group's post-retirement defined benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by Lloyds Banking Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this document are made as of the date hereof, and Lloyds Banking Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this document to reflect any change in Lloyds Banking Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

The information, statements and opinions contained in this document do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

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LLOYDS BANKING GROUP STRUCTURE

The following is a list of the significant subsidiaries of Lloyds Banking Group plc at 31 December 2017.

Name of subsidiary undertaking	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business	Registered office
Lloyds Bank plc	England	100%	Banking and financial services	25 Gresham Street London EC2V 7HN
Scottish Widows Limited	Scotland	100%*	Life assurance	25 Gresham Street London EC2V 7HN
HBOS plc	Scotland	100%*	Holding company	The Mound Edinburgh EH1 1YZ
Bank of Scotland plc	Scotland	100%*	Banking and financial services	The Mound Edinburgh EH1 1YZ

* Indirect interest

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the board of directors and shareholders of Lloyds Banking Group plc

OPINIONS ON THE FINANCIAL STATEMENTS AND INTERNAL CONTROL OVER FINANCIAL REPORTING

We have audited the accompanying consolidated balance sheets of Lloyds Banking Group plc and its subsidiaries as of 31 December 2017 and 31 December 2016, and the related consolidated income statements, consolidated statements of comprehensive income, consolidated statements of changes in equity and consolidated cash flow statements for each of the three years in the period ended 31 December 2017, including the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of 31 December 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of 31 December 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended 31 December 2017 in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of 31 December 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

BASIS FOR OPINIONS

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management Report on Internal Control over Financial Reporting appearing on page 164 of the 2017 Annual Report on Form 20-F. Our responsibility is to express opinions on the Company’s consolidated financial statements and on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

DEFINITION AND LIMITATIONS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

London, United Kingdom

9 March 2018

We have served as the Company’s auditor since 1995.

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December

	Note	2017 £ million	2016 £ million	2015 £ million
Interest and similar income		16,006	16,620	17,615
Interest and similar expense		(5,094)	(7,346)	(6,297)
Net interest income	5	10,912	9,274	11,318
Fee and commission income		2,965	3,045	3,252
Fee and commission expense		(1,382)	(1,356)	(1,442)
Net fee and commission income	6	1,583	1,689	1,810
Net trading income	7	11,817	18,545	3,714
Insurance premium income	8	7,930	8,068	4,792
Other operating income	9	1,995	2,035	1,516
Other income		23,325	30,337	11,832
Total income		34,237	39,611	23,150
Insurance claims	10	(15,578)	(22,344)	(5,729)
Total income, net of insurance claims		18,659	17,267	17,421
Regulatory provisions		(2,165)	(2,374)	(4,837)
Other operating expenses		(10,181)	(10,253)	(10,550)
Total operating expenses	11	(12,346)	(12,627)	(15,387)
Trading surplus		6,313	4,640	2,034
Impairment	12	(688)	(752)	(390)
Profit before tax		5,625	3,888	1,644
Tax expense	13	(1,728)	(1,724)	(688)
Profit for the year		3,897	2,164	956
Profit attributable to ordinary shareholders		3,392	1,651	466
Profit attributable to other equity holders[1]		415	412	394
Profit attributable to equity holders		3,807	2,063	860
Profit attributable to non-controlling interests		90	101	96
Profit for the year		3,897	2,164	956
Basic earnings per share	14	4.9p	2.4p	0.8p
Diluted earnings per share	14	4.8p	2.4p	0.8p

1 The profit after tax attributable to other equity holders of £415 million (2016: £412 million; 2015: £394 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £102 million (2016: £91 million; 2015: £80 million).

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December

	2017 £ million	2016 £ million	2015 £ million
Profit for the year	3,897	2,164	956
Other comprehensive income			
Items that will not subsequently be reclassified to profit or loss:			
Post-retirement defined benefit scheme remeasurements:			
Remeasurements before tax	628	(1,348)	(274)
Tax	(146)	320	59
	482	(1,028)	(215)
Gains and losses attributable to own credit risk:			
Gains (losses) before tax	(55)	–	–
Tax	15	–	–
	(40)	–	–
Items that may subsequently be reclassified to profit or loss:			
Movements in revaluation reserve in respect of available-for-sale financial assets:			
Adjustment on transfer from held-to-maturity portfolio	–	1,544	–
Change in fair value	303	356	(318)
Income statement transfers in respect of disposals	(446)	(575)	(51)
Income statement transfers in respect of impairment	6	173	4
Tax	63	(301)	(6)
	(74)	1,197	(371)
Movement in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income	(363)	2,432	537
Net income statement transfers	(651)	(557)	(956)
Tax	283	(466)	7
	(731)	1,409	(412)
Currency translation differences (tax: nil)	(32)	(4)	(42)
Other comprehensive income for the year, net of tax	(395)	1,574	(1,040)
Total comprehensive income for the year	3,502	3,738	(84)
Total comprehensive income attributable to ordinary shareholders	2,997	3,225	(574)
Total comprehensive income attributable to other equity holders	415	412	394
Total comprehensive income attributable to equity holders	3,412	3,637	(180)
Total comprehensive income attributable to non-controlling interests	90	101	96
Total comprehensive income for the year	3,502	3,738	(84)

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

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CONSOLIDATED BALANCE SHEET

at 31 December

	Note	2017 £ million	2016 £ million
Assets			
Cash and balances at central banks		58,521	47,452
Items in the course of collection from banks		755	706
Trading and other financial assets at fair value through profit or loss	15	162,878	151,174
Derivative financial instruments	16	25,834	36,138
Loans and receivables:			
Loans and advances to banks		6,611	26,902
Loans and advances to customers	17	472,498	457,958
Debt securities		3,643	3,397
		482,752	488,257
Available-for-sale financial assets	21	42,098	56,524
Goodwill	23	2,310	2,016
Value of in-force business	24	4,839	5,042
Other intangible assets	25	2,835	1,681
Property, plant and equipment	26	12,727	12,972
Current tax recoverable		16	28
Deferred tax assets	36	2,284	2,706
Retirement benefit assets	35	723	342
Other assets	27	13,537	12,755
Total assets		812,109	817,793

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

CONSOLIDATED BALANCE SHEET

at 31 December

Equity and liabilities	Note	2017 £ million	2016 £ million
Liabilities			
Deposits from banks		29,804	16,384
Customer deposits	28	418,124	415,460
Items in course of transmission to banks		584	548
Trading and other financial liabilities at fair value through profit or loss	29	50,877	54,504
Derivative financial instruments	16	26,124	34,924
Notes in circulation		1,313	1,402
Debt securities in issue	30	72,450	76,314
Liabilities arising from insurance contracts and participating investment contracts	31	103,413	94,390
Liabilities arising from non-participating investment contracts	33	15,447	20,112
Other liabilities	34	20,730	29,193
Retirement benefit obligations	35	358	822
Current tax liabilities		274	226
Deferred tax liabilities	36	–	–
Other provisions	37	5,546	5,218
Subordinated liabilities	38	17,922	19,831
Total liabilities		762,966	769,328
Equity			
Share capital	39	7,197	7,146
Share premium account	40	17,634	17,622
Other reserves	41	13,815	14,652
Retained profits	42	4,905	3,250
Shareholders' equity		43,551	42,670
Other equity instruments	43	5,355	5,355
Total equity excluding non-controlling interests		48,906	48,025
Non-controlling interests		237	440
Total equity		49,143	48,465
Total equity and liabilities		812,109	817,793

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

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December

	Attributable to equity shareholders						
	Share capital and premium	Other reserves	Retained profits	Total	Other equity instruments	Non-controlling interests	Total
	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Balance at 1 January 2017	24,768	14,652	3,250	42,670	5,355	440	48,465
Comprehensive income							
Profit for the year	–	–	3,807	3,807	–	90	3,897
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	482	482	–	–	482
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(74)	–	(74)	–	–	(74)
Gains and losses attributable to own credit risk, net of tax	–	–	(40)	(40)	–	–	(40)
Movements in cash flow hedging reserve, net of tax	–	(731)	–	(731)	–	–	(731)
Currency translation differences (tax: £nil)	–	(32)	–	(32)	–	–	(32)
Total other comprehensive income	–	(837)	442	(395)	–	–	(395)
Total comprehensive income	–	(837)	4,249	3,412	–	90	3,502
Transactions with owners							
Dividends	–	–	(2,284)	(2,284)	–	(51)	(2,335)
Distributions on other equity instruments, net of tax	–	–	(313)	(313)	–	–	(313)
Issue of ordinary shares	63	–	–	63	–	–	63
Movement in treasury shares	–	–	(411)	(411)	–	–	(411)
Value of employee services:							
Share option schemes	–	–	82	82	–	–	82
Other employee award schemes	–	–	332	332	–	–	332
Changes in non-controlling interests	–	–	–	–	–	(242)	(242)
Total transactions with owners	63	–	(2,594)	(2,531)	–	(293)	(2,824)
At 31 December 2017	24,831	13,815	4,905	43,551	5,355	237	49,143

Further details of movements in the Group's share capital, reserves and other equity instruments are provided in notes 39, 40, 41, 42 and 43.

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

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Consolidated statement of changes in equity

for the year ended 31 December

	Attributable to equity shareholders						
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2015	24,427	13,216	5,692	43,335	5,355	1,213	49,903
Comprehensive income							
Profit for the year	–	–	860	860	–	96	956
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(215)	(215)	–	–	(215)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(371)	–	(371)	–	–	(371)
Movements in cash flow hedging reserve, net of tax	–	(412)	–	(412)	–	–	(412)
Currency translation differences (tax: £nil)	–	(42)	–	(42)	–	–	(42)
Total other comprehensive income	–	(825)	(215)	(1,040)	–	–	(1,040)
Total comprehensive income	–	(825)	645	(180)	–	96	(84)
Transactions with owners							
Dividends	–	–	(1,070)	(1,070)	–	(52)	(1,122)
Distributions on other equity instruments, net of tax	–	–	(314)	(314)	–	–	(314)
Redemption of preference shares	131	(131)	–	–	–	–	–
Movement in treasury shares	–	–	(816)	(816)	–	–	(816)
Value of employee services:							
Share option schemes	–	–	107	107	–	–	107
	–	–	172	172	–	–	172

Other employee award schemes							
Adjustment on sale of interest in TSB Banking Group plc	–	–	–	–	–	(825)	(825)
Other changes in non-controlling interests	–	–	–	–	–	(41)	(41)
Total transactions with owners	131	(131)	(1,921)	(1,921)	–	(918)	(2,839)
Balance at 31 December 2015	24,558	12,260	4,416	41,234	5,355	391	46,980
Comprehensive income							
Profit for the year	–	–	2,063	2,063	–	101	2,164
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(1,028)	(1,028)	–	–	(1,028)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,197	–	1,197	–	–	1,197
Movements in cash flow hedging reserve, net of tax	–	1,409	–	1,409	–	–	1,409
Currency translation differences (tax: £nil)	–	(4)	–	(4)	–	–	(4)
Total other comprehensive income	–	2,602	(1,028)	1,574	–	–	1,574
Total comprehensive income	–	2,602	1,035	3,637	–	101	3,738
Transactions with owners							
Dividends	–	–	(2,014)	(2,014)	–	(29)	(2,043)
Distributions on other equity instruments, net of tax	–	–	(321)	(321)	–	–	(321)
Redemption of preference shares	210	(210)	–	–	–	–	–
Movement in treasury shares	–	–	(175)	(175)	–	–	(175)
Value of employee services:							
Share option schemes	–	–	141	141	–	–	141
Other employee award schemes	–	–	168	168	–	–	168
Changes in non-controlling interests	–	–	–	–	–	(23)	(23)

Total transactions with owners	210	(210)	(2,201)	(2,201)	–	(52)	(2,253)
Balance at 31 December 2016	24,768	14,652	3,250	42,670	5,355	440	48,465

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

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Consolidated cash flow statement

for the year ended 31 December

	Note	**2017 £ million**	2016 £ million	2015 £ million
Profit before tax		**5,625**	3,888	1,644
Adjustments for:				
Change in operating assets	52(A)	**(15,492)**	(12,218)	34,700
Change in operating liabilities	52(B)	**(4,282)**	(2,659)	(11,985)
Non-cash and other items	52(C)	**11,982**	13,885	(7,808)
Tax paid		**(1,028)**	(822)	(179)
Net cash (used in) provided by operating activities		**(3,195)**	2,074	16,372
Cash flows from investing activities				
Purchase of financial assets		**(7,862)**	(4,930)	(19,354)
Proceeds from sale and maturity of financial assets		**18,675**	6,335	22,000
Purchase of fixed assets		**(3,655)**	(3,760)	(3,417)
Proceeds from sale of fixed assets		**1,444**	1,684	1,537
Acquisition of businesses, net of cash acquired	52(E)	**(1,923)**	(20)	(5)
Disposal of businesses, net of cash disposed	52(F)	**129**	5	(4,071)
Net cash provided by (used in) investing activities		**6,808**	(686)	(3,310)
Cash flows from financing activities				
Dividends paid to ordinary shareholders		**(2,284)**	(2,014)	(1,070)
Distributions on other equity instruments		**(415)**	(412)	(394)
Dividends paid to non-controlling interests		**(51)**	(29)	(52)
Interest paid on subordinated liabilities		**(1,275)**	(1,687)	(1,840)
Proceeds from issue of subordinated liabilities		**–**	1,061	338
Proceeds from issue of ordinary shares		**14**	–	–
Repayment of subordinated liabilities		**(1,008)**	(7,885)	(3,199)
Changes in non-controlling interests		**–**	(8)	(41)
Net cash used in financing activities		**(5,019)**	(10,974)	(6,258)
Effects of exchange rate changes on cash and cash equivalents		**–**	21	2
Change in cash and cash equivalents		**(1,406)**	(9,565)	6,806
Cash and cash equivalents at beginning of year		**62,388**	71,953	65,147
Cash and cash equivalents at end of year	52(D)	**60,982**	62,388	71,953

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

Notes to the consolidated financial statements

NOTE 1: BASIS OF PREPARATION

The consolidated financial statements of Lloyds Banking Group plc have been prepared in accordance with International Financial Reporting Standards (IFRS). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) and its predecessor body.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. The directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

To improve transparency and ease of reference, certain disclosures required under IFRS have been included within the risk and renumeration disclosures on pages 36 to 108 and 117 to 137. These disclosures are covered by the Audit opinion (inclued on page F-2) where referenced as audited.

With effect from 1 January 2017 the Group has elected to early adopt the provision in IFRS 9 for gains and losses attributable to changes in own credit risk on financial liabilities designated at fair value through profit or loss to be presented in other comprehensive income. The impact has been to increase profit after tax and reduce other comprehensive income by £40 million in the year ended 31 December 2017; there is no impact on total liabilities or shareholders' equity. Comparatives have not been restated.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2017 and which have not been applied inpreparing these financial statements are given in note 54.

NOTE 2: ACCOUNTING POLICIES

The Group's accounting policies are set out below. These accounting policies have been applied consistently.

(A) Consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures.

(1) SUBSIDIARIES

Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases.

The Group consolidates collective investment vehicles if its beneficial ownership interests give it substantive rights to remove the external fund manager over the investment activities of the fund. Where a subsidiary of the Group is the fund manager of a collective investment vehicle, the Group considers a number of factors in determining whether it acts as principal, and therefore controls the collective investment vehicle, including: an assessment of the scope of the Group’s decision making authority over the investment vehicle; the rights held by other parties including substantive removal rights without cause over the Group acting as fund manager; the remuneration to which the Group is entitled in its capacity as decision maker; and the Group’s exposure to variable returns from the beneficial interest it holds in the investment vehicle. Consolidation may be appropriate in circumstances where the Group has less than a majority beneficial interest. Where a collective investment vehicle is consolidated the interests of parties other than the Group are reported in other liabilities and the movement in these interests in interest expense.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Changes in the parent’s ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the Group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see (E)(5) below) or share capital (see (P) below). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

(2) JOINT VENTURES AND ASSOCIATES

Joint ventures are joint arrangements over which the Group has joint control with other parties and has rights to the net assets of the arrangements. Associates are entities over which the Group has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of the entity, but is not control or joint control of those policies, and is generally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting.

Notes to the consolidated financial statements

Note 2: Accounting policies continued

(B) Goodwill

Goodwill arises on business combinations and represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

(C) Other intangible assets

Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows: up to 7 years for capitalised software; 10 to 15 years for brands and other intangibles.

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

(D) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability, including early redemption fees, and related penalties; and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account.

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility.

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

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see (M) below); those relating to leases are set out in (J)(2) below.

(E) Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. The Group initially recognises loans and receivables, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (i.e. when the obligation is discharged), cancelled or expire.

(1) FINANCIAL INSTRUMENTS AT FAIR VALUE THROUGH PROFIT OR LOSS

Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see (F) below).

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

Classified at fair value through profit and loss: Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur, except that gains and losses attributable to changes in own credit risk on financial liabilities held at fair value through profit or loss are taken directly to other comprehensive income (see note 1). Financial assets and liabilities are designated at fair value through profit or loss on acquisition in the following circumstances:

– it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.

– the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis.

– where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

Note 2: Accounting policies continued

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. Refer to note 48(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

(2) AVAILABLE-FOR-SALE FINANCIAL ASSETS

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Such assets are intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would otherwise have met the definition of loans and receivables at the time of reclassification and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity. Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

(3) LOANS AND RECEIVABLES

Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see (D) above) less provision for impairment (see (H) below).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) BORROWINGS

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

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss.

(5) SALE AND REPURCHASE AGREEMENTS (INCLUDING SECURITIES LENDING AND BORROWING)

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and receivable or customer deposit.

(F) Derivative financial instruments and hedge accounting

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. All derivatives are recognised at their fair value. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 48(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

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

Note 2: Accounting policies continued

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of such instruments. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item, the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

(1) FAIR VALUE HEDGES

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

(2) CASH FLOW HEDGES

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

(3) NET INVESTMENT HEDGES

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instrument used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

(G) Offset

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. Cash collateral on exchange traded derivative transactions is presented gross unless the collateral cash flows are always settled net with the derivative cash flows. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

(H) Impairment of financial assets

(1) ASSETS ACCOUNTED FOR AT AMORTISED COST

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

Where such an event, including the identification of fraud, has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

Impairment allowances are assessed individually for financial assets that are individually significant. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For commercial lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

Notes to the consolidated financial statements

Note 2: Accounting policies continued

(2) AVAILABLE-FOR-SALE FINANCIAL ASSETS

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer, assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(I) Property, plant and equipment

Property, plant and equipment (other than investment property) is included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

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

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

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital accretion or both, primarily within the life insurance funds. In accordance with the guidance published by the Royal Institution of Chartered Surveyors, investment property is carried at fair value based on current prices for similar properties, adjusted for the specific characteristics of the property (such as location or condition). If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets. These valuations are reviewed at least annually by independent professionally qualified valuers. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be valued at fair value.

(J) Leases

(1) AS LESSEE

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

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

(2) AS LESSOR

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

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

(K) Employee benefits

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

(1) PENSION SCHEMES

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. The Group’s income statement charge includes the current service cost of providing pension benefits, past service costs, net interest expense (income), and plan administration costs that are not deducted from the return on plan assets. Past service costs, which represents the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment, are recognised when the plan amendment or curtailment occurs. Net interest expense (income) is calculated by applying the discount rate at the beginning of the period to the net defined benefit liability or asset.

Note 2: Accounting policies continued

Remeasurements, comprising actuarial gains and losses, the return on plan assets (excluding amounts included in net interest expense (income) and net of the cost of managing the plan assets), and the effect of changes to the asset ceiling (if applicable) are reflected immediately in the balance sheet with a charge or credit recognised in other comprehensive income in the period in which they occur. Remeasurements recognised in other comprehensive income are reflected immediately in retained profits and will not subsequently be reclassified to profit or loss.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes. In assessing whether a surplus is recoverable, the Group considers its current right to obtain a refund or a reduction in future contributions and does not anticipate any future acts by other parties that could change the amount of the surplus that may ultimately be recovered.

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

(2) SHARE-BASED COMPENSATION

The Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments, with a corresponding increase in equity. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model or a Monte Carlo simulation. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement.

(L) Taxation

Tax expense comprises current and deferred tax. Current and deferred tax are charged or credited in the income statement except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside the income statement (either in other comprehensive income, directly in equity, or through a business combination), in which case the tax appears in the same statement as the transaction that gave rise to it.

Current tax is the amount of corporate income taxes expected to be payable or recoverable based on the profit for the period as adjusted for items that are not taxable or not deductible, and is calculated using tax rates and laws that were enacted or substantively enacted at the balance sheet date.

Current tax includes amounts provided in respect of uncertain tax positions when management expects that, upon examination of the uncertainty by Her Majesty's Revenue and Customs (HMRC) or other relevant tax authority, it is more likely than not that an economic outflow will occur. Provisions reflect management's best estimate of the ultimate liability based on their interpretation of tax law, precedent and guidance, informed by external tax advice as necessary. Changes in facts and circumstances underlying these provisions are reassessed at each balance sheet date, and the provisions are re-measured as required to reflect current information.

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

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the balance sheet. Deferred tax is calculated using tax rates and laws that have been enacted or substantively enacted at the balance sheet date, and which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax liabilities are generally recognised for all taxable temporary differences but not recognised for taxable temporary differences arising on investments in subsidiaries where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future. Deferred tax liabilities are not recognised on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets are recognised to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilised, and are reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognised in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination. Deferred tax is not discounted.

(M) Insurance

The Group undertakes both life insurance and general insurance business. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts*, which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP and UK established practice.

Products sold by the life insurance business are classified into three categories:

- Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.

- Investment contracts containing a discretionary participation feature (participating investment contracts) – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group, within the constraints of the terms and conditions of the instrument and based upon the performance of specified assets.

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

The general insurance business issues only insurance contracts.

Note 2: Accounting policies continued

(1) LIFE INSURANCE BUSINESS

(I) ACCOUNTING FOR INSURANCE AND PARTICIPATING INVESTMENT CONTRACTS

PREMIUMS AND CLAIMS

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due except for unit-linked contracts on which premiums are recognised as revenue when received. Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified.

LIABILITIES

Changes in the value of liabilities are recognised in the income statement through insurance claims.

– Insurance and participating investment contracts in the Group's with-profit funds

Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Prudential Regulation Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below).

– Insurance and participating investment contracts which are not unit-linked or in the Group's with-profit funds

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

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

– Insurance and participating investment contracts which are unit-linked

Liabilities for unit-linked insurance contracts and participating investment contracts are stated at the bid value of units plus an additional allowance where appropriate (such as for any excess of future expenses over charges). The liability is increased or reduced by the change in the unit prices and is reduced by policy administration fees, mortality and surrender charges and any withdrawals. Benefit claims in excess of the account balances incurred in the period are also charged through insurance claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges.

UNALLOCATED SURPLUS

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

(II) ACCOUNTING FOR NON-PARTICIPATING INVESTMENT CONTRACTS

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment returns (including movements in fair value and investment income) allocated to those contracts are recognised in the income statement through insurance claims.

Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

The Group receives investment management fees in the form of an initial adjustment or charge to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them over the estimated lives of the contracts, in line with the provision of investment management services.

Costs which are directly attributable and incremental to securing new non-participating investment contracts are deferred. This asset is subsequently amortised over the period of the provision of investment management services and its recoverability is reviewed in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through fee and commission expense in the income statement. All other costs are recognised as expenses when incurred.

(III) VALUE OF IN-FORCE BUSINESS

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

The Group's contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the date of acquisition. The resulting asset is amortised over the estimated lives of the contracts. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying value of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement.

(2) GENERAL INSURANCE BUSINESS

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included in insurance premium income, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred in the balance sheet within liabilities arising from insurance contracts and participating investment contracts on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of the contract and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

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Note 2: Accounting policies continued

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

(3) LIABILITY ADEQUACY TEST

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

(4) REINSURANCE

Contracts entered into by the Group with reinsurers under which the Group is compensated for benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

ASSETS ARISING FROM REINSURANCE CONTRACTS HELD – CLASSIFIED AS INSURANCE CONTRACTS

Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

ASSETS ARISING FROM REINSURANCE CONTRACTS HELD – CLASSIFIED AS NON-PARTICIPATING INVESTMENT CONTRACTS

These contracts are accounted for as financial assets whose value is contractually linked to the fair values of financial assets within the reinsurers' investment funds. Investment returns (including movements in fair value and investment income) allocated to these contracts are recognised in insurance claims. Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the assets arising from reinsurance contracts held.

(N) Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see (F)(3) above). On disposal or liquidation of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal or liquidation.

(O) Provisions and contingent liabilities

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

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

Provision is made for irrevocable undrawn loan commitments if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

(P) Share capital

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds. Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

Where the Company or any member of the Group purchases the Company's share capital, the consideration paid is deducted from shareholders' equity as treasury shares until they are cancelled; if these shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

(Q) Cash and cash equivalents

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

NOTE 3: CRITICAL ACCOUNTING ESTIMATES

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows:

– Allowance for impairment losses on loans and receivables (note 20);

– Valuation of assets and liabilities arising from insurance business (notes 24 and 31);

– Defined benefit pension scheme obligations (note 35);

– Recoverability of deferred tax assets (note 36);

– Payment protection insurance and other regulatory provisions (note 37); and

– Fair value of financial instruments (note 48).

NOTE 4: SEGMENTAL ANALYSIS

Lloyds Banking Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

The Group Executive Committee has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. The Group Executive Committee reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. GEC considers interest income and expense on a net basis and consequently the total interest income and expense for all reportable segments is presented net. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities.

The segmental results and comparatives are presented on an underlying basis, the basis reviewed by the chief operating decision maker. The effects of the following are excluded in arriving at underlying profit:

- losses on redemption of the Enhanced Capital Notes and the volatility in the value of the embedded equity conversion feature;
- market volatility and asset sales, which includes the effects of certain asset sales, the volatility relating to the Group's own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up;
- the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets;
- restructuring costs, comprising costs relating to the Simplification programme and the costs of implementing regulatory reform and ring-fencing, the rationalisation of the non-branch property portfolio and the integration of MBNA;
- TSB build and dual running costs and the loss relating to the TSB sale in 2015; and
- payment protection insurance and other conduct provisions.

For the purposes of the underlying income statement, operating lease depreciation (net of gains on disposal of operating lease assets) is shown as an adjustment to total income.

As part of a Group restructuring during 2017:

- the Consumer Finance division has now become part of Retail;
- the Group's UK wealth business, previously part of Retail, has been transferred to the Insurance division, now renamed Insurance and Wealth;
- the Group's International wealth business, previously part of Retail, has been transferred to the Commercial Banking division; and
- the Group's venture capital business, previously part of Commercial Banking, has been transferred to Other.

Comparatives have been restated accordingly. Following this restructuring, the Group's activities are now organised into three financial reporting segments: Retail; Commercial Banking; and Insurance and Wealth.

Retail offers a broad range of financial service products, including current accounts, savings, mortgages, motor finance and unsecured consumer lending to personal and small business customers.

Commercial Banking provides a range of products and services such as lending, transactional banking, working capital management, risk management and debt capital markets services to SMEs, corporates and financial institutions.

Insurance and Wealth offers insurance, investment and wealth management products and services.

Other includes certain assets previously reported as outside of the Group’s risk appetite and income and expenditure not attributed to divisions, including the costs of certain central and head office functions and the Group’s private equity business, Lloyds Development Capital.

Inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

Notes to the consolidated financial statements

Note 4: Segmental analysis continued

For the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the movement in the fair value of the derivative to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the derivative and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and leads to accounting volatility, which is managed centrally and reported within Other.

	Retail £m	Commercial Banking £m	Insurance and Wealth £m	Other £m	Underlying basis total £m
Year ended 31 December 2017					
Net interest income	**8,706**	**3,086**	**133**	**395**	**12,320**
Other income, net of insurance claims	**2,217**	**1,761**	**1,846**	**381**	**6,205**
Total underlying income, net of insurance claims	**10,923**	**4,847**	**1,979**	**776**	**18,525**
Operating lease depreciation[1]	**(946)**	**(44)**	**–**	**(63)**	**(1,053)**
Net income	**9,977**	**4,803**	**1,979**	**713**	**17,472**
Operating costs	**(4,857)**	**(2,199)**	**(1,040)**	**(88)**	**(8,184)**
Impairment (charge) credit	**(717)**	**(115)**	**–**	**37**	**(795)**
Underlying profit	**4,403**	**2,489**	**939**	**662**	**8,493**
External income	**12,651**	**3,093**	**1,883**	**898**	**18,525**
Inter-segment income	**(1,728)**	**1,754**	**96**	**(122)**	**–**
Segment underlying income, net of insurance claims	**10,923**	**4,847**	**1,979**	**776**	**18,525**
Segment external assets	**349,116**	**174,081**	**151,986**	**136,926**	**812,109**
Segment customer deposits	**253,127**	**147,588**	**13,770**	**3,639**	**418,124**
Segment external liabilities	**258,423**	**223,543**	**157,824**	**123,176**	**762,966**
Other segment items reflected in income statement above:					
Depreciation and amortisation	**1,545**	**259**	**197**	**369**	**2,370**
Increase in value of in-force business	**–**	**–**	**(165)**	**–**	**(165)**
Defined benefit scheme charges	**137**	**48**	**25**	**149**	**359**
Other segment items:					
Additions to fixed assets	**2,431**	**107**	**274**	**843**	**3,655**
Investments in joint ventures and associates at end of year	**9**	**–**	**–**	**56**	**65**

1 Net of profits on disposal of operating lease assets of £32 million.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4: SEGMENTAL ANALYSIS continued

	Retail £m	Commercial Banking £m	Insurance and Wealth £m	Other £m	Underlying basis total £m
Year ended 31 December 2016[1]					
Net interest income	8,073	2,934	80	348	11,435
Other income, net of insurance claims	2,162	1,756	1,939	208	6,065
Total underlying income, net of insurance claims	10,235	4,690	2,019	556	17,500
Operating lease depreciation[2]	(775)	(105)	–	(15)	(895)
Net income	9,460	4,585	2,019	541	16,605
Operating costs	(4,748)	(2,189)	(1,046)	(110)	(8,093)
Impairment (charge) credit	(654)	(17)	–	26	(645)
Underlying profit	4,058	2,379	973	457	7,867
External income	12,203	3,408	1,434	455	17,500
Inter-segment income	(1,968)	1,282	585	101	–
Segment underlying income, net of insurance claims	10,235	4,690	2,019	556	17,500
Segment external assets	338,939	187,405	154,782	136,667	817,793
Segment customer deposits	256,453	141,302	13,798	3,907	415,460
Segment external liabilities	264,915	230,030	160,815	113,568	769,328
Other segment items reflected in income statement above:					
Depreciation and amortisation	1,343	313	169	555	2,380
Decrease in value of in-force business	–	–	472	–	472
Defined benefit scheme charges	141	49	31	66	287
Other segment items:					
Additions to fixed assets	2,362	126	481	791	3,760
Investments in joint ventures and associates at end of year	6	–	–	53	59

1 Restated – see page F-18.
2 Net of profits on disposal of operating lease assets of £58 million.

	Retail £m	Commercial Banking £m	Insurance and Wealth £m	Other £m	Underlying basis total £m
Year ended 31 December 2015[1]					
Net interest income	8,253	2,774	59	396	11,482
Other income, net of insurance claims	2,263	1,842	1,986	64	6,155
Total underlying income, net of insurance claims	10,516	4,616	2,045	460	17,637
Operating lease depreciation[2]	(720)	(30)	–	(14)	(764)
Net income	9,796	4,586	2,045	446	16,873
Operating costs	(4,958)	(2,225)	(954)	(174)	(8,311)

Impairment (charge) credit	(583)	22	(1)	(6)	(568)
TSB	–	–	–	118	118
Underlying profit	4,255	2,383	1,090	384	8,112
External income	12,217	3,364	2,155	(99)	17,637
Inter-segment income	(1,701)	1,252	(110)	559	–
Segment underlying income, net of insurance claims	10,516	4,616	2,045	460	17,637
Segment external assets	340,263	178,110	145,737	142,578	806,688
Segment customer deposits	261,646	140,675	14,477	1,528	418,326
Segment external liabilities	270,666	235,221	150,702	103,119	759,708
Other segment items reflected in income statement above:					
Depreciation and amortisation	1,247	203	124	538	2,112
Decrease in value of in-force business	–	–	(162)	–	(162)
Defined benefit scheme charges	124	32	17	142	315
Other segment items:					
Additions to fixed assets	2,133	155	343	786	3,417
Investments in joint ventures and associates at end of year	5	–	–	42	47

1 Restated – see page F-18.

2 Net of profits on disposal of operating lease assets of £66 million.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4: SEGMENTAL ANALYSIS continued

Reconciliation of underlying basis to statutory results

The underlying basis is the basis on which financial information is presented to the chief operating decision maker which excludes certain items included in the statutory results. The table below reconciles the statutory results to the underlying basis.

	Lloyds Banking Group statutory £m	Removal of: **Volatility and other items[1] £m**	**Insurance gross up[2] £m**	**PPI £m**	**Other conduct provisions £m**	**Underlying basis £m**
Year ended 31 December 2017						
Net interest income	**10,912**	**228**	**1,180**	**–**	**–**	**12,320**
Other income, net of insurance claims	**7,747**	**(186)**	**(1,356)**	**–**	**–**	**6,205**
Total income, net of insurance claims	**18,659**	**42**	**(176)**	**–**	**–**	**18,525**
Operating lease depreciation[3]		**(1,053)**	**–**	**–**	**–**	**(1,053)**
Net income	**18,659**	**(1,011)**	**(176)**	**–**	**–**	**17,472**
Operating expenses	**(12,346)**	**1,821**	**176**	**1,300**	**865**	**(8,184)**
Impairment	**(688)**	**(107)**	**–**	**–**	**–**	**(795)**
Profit	**5,625**	**703**	**–**	**1,300**	**865**	**8,493**

	Lloyds Banking Group statutory £m	Removal of: Volatility and other items[4] £m	Insurance gross up[2] £m	PPI £m	Other conduct provisions £m	Underlying basis £m
Year ended 31 December 2016						
Net interest income	9,274	263	1,898	–	–	11,435
Other income, net of insurance claims	7,993	121	(2,110)	–	61	6,065
Total income, net of insurance claims	17,267	384	(212)	–	61	17,500
Operating lease depreciation[3]		(895)	–	–	–	(895)

Net income		17,267	(511)	(212)	–	61	16,605
Operating expenses		(12,627)	1,948	212	1,350	1,024	(8,093)
Impairment		(752)	107	–	–	–	(645)
Profit		3,888	1,544	–	1,350	1,085	7,867

	Lloyds Banking Group statutory £m	Removal of: Volatility and other items[5] £m	TSB[6] £m	Insurance gross up[2] £m	PPI £m	Other conduct provisions £m	Underlying basis £m
Year ended 31 December 2015							
Net interest income	11,318	318	(192)	38	–	–	11,482
Other income, net of insurance claims	6,103	209	(31)	(126)	–	–	6,155
Total income, net of insurance claims	17,421	527	(223)	(88)	–	–	17,637
Operating lease depreciation[3]		(764)	–	–	–	–	(764)
Net income	17,421	(237)	(223)	(88)	–	–	16,873
Operating expenses	(15,387)	2,065	86	88	4,000	837	(8,311)
Impairment	(390)	(197)	19	–	–	–	(568)
TSB	–	–	118	–	–	–	118
Profit	1,644	1,631	–	–	4,000	837	8,112

1 In the year ended 31 December 2017 this comprises the effects of asset sales (gain of £30 million); volatile items (gain of £263 million); liability management (loss of £14 million); the amortisation of purchased intangibles (£91 million); restructuring costs (£621 million, principally comprising costs relating to the Simplification programme; the rationalisation of the non-branch property portfolio, the work on implementing the ring-fencing requirements and the integration of MBNA); and the fair value unwind and other items (loss of £270 million).

2 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 within the underlying results.

3 Net of profits on disposal of operating lease assets of £32 million (2016: £58 million; 2015: £66 million).

4 Comprises the write-off of the ECN embedded derivative and premium paid on redemption of the remaining notes in the first quarter (loss of £790 million); the effects of asset sales (gain of £217 million); volatile items (gain of £99 million); liability management (gain of £123 million); the amortisation of purchased intangibles (£340 million); restructuring costs (£622 million, principally comprising the severance related costs related to phase II of the Simplification programme); and the fair value unwind and other items (loss of £231 million).

5 Comprises market movements on the ECN embedded derivative (loss of £101 million); the effects of asset sales (gain of £54 million); volatile items (loss of £107 million); liability management (loss of £28 million); the amortisation of purchased intangibles (£342 million); restructuring costs (£170 million); TSB costs (£745 million); and the fair value unwind and other items (loss of £192 million).

6 Comprises the underlying results of TSB.

Geographical areas

Following the reduction in the Group's non-UK activities, an analysis between UK and non-UK activities is no longer provided.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5: NET INTEREST INCOME

	Weighted average effective interest rate					
	2017 %	2016 %	2015 %	**2017 £m**	2016 £m	2015 £m
Interest and similar income:						
Loans and advances to customers	**3.16**	3.32	3.50	**14,712**	15,190	16,256
Loans and advances to banks	**0.40**	0.46	0.42	**271**	381	397
Debt securities held as loans and receivables	**1.29**	1.47	1.87	**43**	56	40
Interest receivable on loans and receivables	**2.81**	2.87	2.98	**15,026**	15,627	16,693
Available-for-sale financial assets	**1.96**	1.88	1.77	**980**	762	725
Held-to-maturity investments	**–**	1.44	1.49	**–**	231	197
Total interest and similar income[1]	**2.73**	2.77	2.86	**16,006**	16,620	17,615
Interest and similar expense:						
Deposits from banks, excluding liabilities under sale and repurchase transactions	**1.18**	0.65	0.41	**(80)**	(68)	(43)
Customer deposits, excluding liabilities under sale and repurchase transactions	**0.49**	0.69	0.87	**(1,722)**	(2,520)	(3,299)
Debt securities in issue[2]	**0.37**	0.94	0.69	**(266)**	(799)	(586)
Subordinated liabilities	**7.93**	8.35	8.37	**(1,481)**	(1,864)	(2,091)
Liabilities under sale and repurchase agreements	**0.58**	0.46	0.57	**(110)**	(38)	(34)
Interest payable on liabilities held at amortised cost	**0.79**	1.07	1.19	**(3,659)**	(5,289)	(6,053)
Amounts payable to unitholders in consolidated open-ended investment vehicles	**9.15**	10.85	1.16	**(1,435)**	(2,057)	(244)
Total interest and similar expense[3]	**1.06**	1.44	1.19	**(5,094)**	(7,346)	(6,297)
Net interest income				**10,912**	9,274	11,318

1 Includes £12 million (2016: £nil; 2015: £nil) of interest income on liabilities with negative interest rates.

2 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.43 per cent (2016: 2.70 per cent; 2015: 2.76 per cent).

3 Includes £50 million (2016: £51 million; 2015: £nil) of interest expense on assets with negative interest rates.

Included within interest and similar income is £179 million (2016: £205 million; 2015: £248 million) in respect of impaired financial assets. Net interest income also includes a credit of £651 million (2016: credit of £557 million; 2015: credit of £956 million) transferred from the cash flow hedging reserve (see note 41).

NOTE 6: NET FEE AND COMMISSION INCOME

	2017	2016	2015
	£m	£m	£m
Fee and commission income:			
Current accounts	**712**	752	804
Credit and debit card fees	**953**	875	918
Other	**1,300**	1,418	1,530
Total fee and commission income	**2,965**	3,045	3,252
Fee and commission expense	**(1,382)**	(1,356)	(1,442)
Net fee and commission income	**1,583**	1,689	1,810

Fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7: NET TRADING INCOME

	2017	2016	2015
	£m	£m	£m
Foreign exchange translation (losses) gains	**(174)**	1,363	(80)
Gains on foreign exchange trading transactions	**517**	542	335
Total foreign exchange	**343**	1,905	255
Investment property gains (losses) (note 26)	**230**	(83)	416
Securities and other gains (see below)	**11,244**	16,723	3,043
Net trading income	**11,817**	18,545	3,714

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

	2017	2016	2015
	£m	£m	£m
Net income arising on assets held at fair value through profit or loss:			
Debt securities, loans and advances	**1,122**	4,771	451
Equity shares	**9,862**	12,534	2,384
Total net income arising on assets held at fair value through profit or loss	**10,984**	17,305	2,835
Net (expense) income arising on liabilities held at fair value through profit or loss – debt securities in issue	**(144)**	(154)	14
Total net gains arising on assets and liabilities held at fair value through profit or loss	**10,840**	17,151	2,849
Net gains (losses) on financial instruments held for trading	**404**	(428)	194
Securities and other gains	**11,244**	16,723	3,043

NOTE 8: INSURANCE PREMIUM INCOME

	2017	2016	2015
	£m	£m	£m
Life insurance			
Gross premiums:			
Life and pensions	**6,273**	5,613	3,613
Annuities	**1,082**	1,685	430
	7,355	7,298	4,043
Ceded reinsurance premiums	**(168)**	(88)	(122)
Net earned premiums	**7,187**	7,210	3,921
Non-life insurance			
Net earned premiums	**743**	858	871

Total net earned premiums	**7,930**	8,068	4,792

Premium income in 2015 was reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group.

NOTE 9: OTHER OPERATING INCOME

	2017	2016	2015
	£m	£m	£m
Operating lease rental income	**1,344**	1,225	1,165
Rental income from investment properties (note 26)	**213**	229	268
Gains less losses on disposal of available-for-sale financial assets (note 41)	**446**	575	51
Movement in value of in-force business (note 24)	**(165)**	472	(162)
Liability management	**(14)**	(598)	(28)
Share of results of joint ventures and associates	**6**	(1)	(3)
Other	**165**	133	225
Total other operating income	**1,995**	2,035	1,516

NOTE 10: INSURANCE CLAIMS

Insurance claims comprise:	**2017 £m**	2016 £m	2015 £m
Life insurance and participating investment contracts			
Claims and surrenders	**(8,898)**	(8,617)	(7,983)
Change in insurance and participating investment contracts (note 31)	**(9,067)**	(14,160)	2,898
Change in non-participating investment contracts	**2,836**	679	(438)
	(15,129)	(22,098)	(5,523)
Reinsurers' share	**35**	106	101
	(15,094)	(21,992)	(5,422)
Change in unallocated surplus	**(147)**	14	63
Total life insurance and participating investment contracts	**(15,241)**	(21,978)	(5,359)
Non-life insurance			
Total non-life insurance claims, net of reinsurance	**(337)**	(366)	(370)
Total insurance claims	**(15,578)**	(22,344)	(5,729)
Life insurance and participating investment contracts gross claims and surrenders can also be analysed as follows:			
Deaths	**(675)**	(635)	(631)
Maturities	**(1,280)**	(1,347)	(1,348)
Surrenders	**(5,674)**	(5,444)	(4,811)
Annuities	**(985)**	(949)	(902)
Other	**(284)**	(242)	(291)
Total life insurance gross claims and surrenders	**(8,898)**	(8,617)	(7,983)

NOTE 11: OPERATING EXPENSES

	2017 £m	2016 £m	2015 £m
Staff costs:			
Salaries	**2,679**	2,750	2,808
Performance-based compensation	**473**	475	409
Social security costs	**361**	363	349
Pensions and other post-retirement benefit schemes (note 35)	**625**	555	548
Restructuring costs	**24**	241	104
Other staff costs	**448**	433	459
	4,610	4,817	4,677
Premises and equipment:			
Rent and rates	**365**	365	368
Repairs and maintenance	**231**	187	173
Other	**134**	120	174
	730	672	715

Other expenses:			
Communications and data processing	**882**	848	893
Advertising and promotion	**208**	198	253
Professional fees	**328**	265	262
UK bank levy	**231**	200	270
TSB disposal	**–**	–	665
Other	**814**	873	703
	2,463	2,384	3,046
Depreciation and amortisation:			
Depreciation of property, plant and equipment (note 26)	**1,944**	1,761	1,534
Amortisation of acquired value of in-force non-participating investment contracts (note 24)	**34**	37	41
Amortisation of other intangible assets (note 25)	**392**	582	537
	2,370	2,380	2,112
Goodwill impairment (note 23)	**8**	–	–
Total operating expenses, excluding regulatory provisions	**10,181**	10,253	10,550
Regulatory provisions:			
Payment protection insurance provision (note 37)	**1,300**	1,350	4,000
Other regulatory provisions[1] (note 37)	**865**	1,024	837
	2,165	2,374	4,837
Total operating expenses	**12,346**	12,627	15,387

1 In 2016, regulatory provisions of £61 million were charged against income.

NOTE 11: OPERATING EXPENSES continued

Performance-based compensation

The table below analyses the Group's performance-based compensation costs between those relating to the current performance year and those relating to earlier years.

	2017	2016	2015
	£m	£m	£m
Performance-based compensation expense comprises:			
Awards made in respect of the year ended 31 December	**334**	312	280
Awards made in respect of earlier years	**139**	163	129
	473	475	409
Performance-based compensation expense deferred until later years comprises:			
Awards made in respect of the year ended 31 December	**127**	123	114
Awards made in respect of earlier years	**35**	41	56
	162	164	170

Performance-based awards expensed in 2017 include cash awards amounting to £102 million (2016: £116 million; 2015: £96 million).

Average headcount

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2017	2016	2015
UK	**75,150**	79,606	84,922
Overseas	**794**	812	781
Total	**75,944**	80,418	85,703

Fees payable to the auditors

Fees payable to the Company's auditors by the Group are as follows:

	2017 **£m**	2016 £m	2015 £m
Fees payable for the audit of the Company's current year annual report	**1.5**	1.5	1.2
Fees payable for other services:			
Audit of the Company's subsidiaries pursuant to legislation	**18.6**	14.7	14.9
Other services supplied pursuant to legislation	**3.0**	3.1	2.2
Total audit fees	**23.1**	19.3	18.3
Other services – audit related fees	**1.2**	3.1	3.2
Total audit and audit related fees	**24.3**	22.4	21.5
Services relating to taxation:			
Taxation compliance services	**–**	0.2	0.2
All other taxation advisory services	**–**	0.1	0.1
	–	0.3	0.3
Other non-audit fees:			
Services relating to corporate finance transactions	**1.2**	0.1	0.2
Other services	**2.4**	1.5	2.3
Total other non-audit fees	**3.6**	1.6	2.5
Total fees payable to the Company's auditors by the Group	**27.9**	24.3	24.3

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11: OPERATING EXPENSES continued

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of debt prospectuses required by the listing rules.

Services relating to taxation: Following a change in policy, the Group's auditors are not engaged to provide tax services except in exceptional circumstances and where permitted by applicable guidance.

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including prohibiting certain non-audit services. All statutory audit work as well as most non-audit assignments must be pre-approved by the audit committee on an individual engagement basis; for certain types of non-audit engagements where the fee is 'de minimis' the audit committee has pre-approved all assignments subject to confirmation by management. On a quarterly basis, the audit committee receives and reviews a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

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

	2017 £m	2016 £m	2015 £m
Audits of Group pension schemes	**0.1**	0.3	0.3
Audits of the unconsolidated Open Ended Investment Companies managed by the Group	**0.3**	0.4	0.4
Reviews of the financial position of corporate and other borrowers	**–**	1.2	3.1
Acquisition due diligence and other work performed in respect of potential venture capital investments	**0.1**	1.0	1.2

NOTE 12: IMPAIRMENT

	2017 £m	2016 £m	2015 £m
Impairment losses on loans and receivables:			
Loans and advances to customers	**697**	592	443
Debt securities classified as loans and receivables	**(6)**	–	(2)
Total impairment losses on loans and receivables (note 20)	**691**	592	441
Impairment of available-for-sale financial assets	**6**	173	4
Other credit risk provisions	**(9)**	(13)	(55)
Total impairment charged to the income statement	**688**	752	390

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13: TAXATION

(A) Analysis of tax expense for the year

	2017	2016	2015
	£m	£m	£m
UK corporation tax:			
Current tax on profit for the year	**(1,346)**	(1,010)	(485)
Adjustments in respect of prior years	**126**	156	(90)
	(1,220)	(854)	(575)
Foreign tax:			
Current tax on profit for the year	**(40)**	(20)	(24)
Adjustments in respect of prior years	**10**	2	27
	(30)	(18)	3
Current tax expense	**(1,250)**	(872)	(572)
Deferred tax:			
Current year	**(430)**	(758)	(212)
Adjustments in respect of prior years	**(48)**	(94)	96
Deferred tax expense	**(478)**	(852)	(116)
Tax expense	**(1,728)**	(1,724)	(688)

The income tax expense is made up as follows:

	2017	2016	2015
	£m	£m	£m
Tax (expense) credit attributable to policyholders	**(82)**	(301)	3
Shareholder tax expense	**(1,646)**	(1,423)	(691)
Tax expense	**(1,728)**	(1,724)	(688)

(B) Factors affecting the tax expense for the year

The UK corporation tax rate for the year was 19.25 per cent (2016: 20 per cent; 2015: 20.25 per cent). An explanation of the relationship between tax expense and accounting profit is set out below:

	2017 **£m**	2016 £m	2015 £m
Profit before tax	**5,625**	3,888	1,644
UK corporation tax thereon	**(1,083)**	(778)	(333)
Impact of surcharge on banking profits	**(452)**	(266)	–
Non-deductible costs: conduct charges	**(287)**	(289)	(459)
Non-deductible costs: bank levy	**(44)**	(40)	(55)
Other non-deductible costs	**(59)**	(135)	(116)
Non-taxable income	**72**	75	162
Tax-exempt gains on disposals	**128**	19	67
Recognition of losses that arose in prior years	**–**	59	42
Remeasurement of deferred tax due to rate changes	**(9)**	(201)	(27)
Differences in overseas tax rates	**(15)**	10	(4)
Policyholder tax[1]	**(66)**	(241)	3
Adjustments in respect of prior years	**88**	64	33
Tax effect of share of results of joint ventures	**(1)**	(1)	(1)
Tax expense	**(1,728)**	(1,724)	(688)

1 In 2016 this included a £231 million write down of the deferred tax asset held within the life business, reflecting the Group's utilisation estimate which has been restricted by the current economic environment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14: EARNINGS PER SHARE

	2017	2016	2015
	£m	£m	£m
Profit attributable to equity shareholders – basic and diluted	**3,392**	1,651	466
Tax credit on distributions to other equity holders	**102**	91	80
	3,494	1,742	546

	2017	2016	2015
	million	million	million
Weighted average number of ordinary shares in issue – basic	**71,710**	71,234	71,272
Adjustment for share options and awards	**683**	790	1,068
Weighted average number of ordinary shares in issue – diluted	**72,393**	72,024	72,340
Basic earnings per share	**4.9p**	2.4p	0.8p
Diluted earnings per share	**4.8p**	2.4p	0.8p

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 57 million (2016: 140 million; 2015: 101 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

There were no anti-dilutive share options and awards excluded from the calculation of diluted earnings per share at 31 December 2017 (2016: weighted-average of 0.3 million; 2015: weighted-average of 1 million).

NOTE 15: TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

These assets are comprised as follows:

	2017			2016		
	Trading assets £m	**Other financial assets at fair value through profit or loss £m**	**Total £m**	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m
Loans and advances to customers	**29,976**	**–**	**29,976**	30,473	–	30,473
Loans and advances to banks	**1,614**	**–**	**1,614**	2,606	–	2,606
Debt securities:						
Government securities	**9,833**	**12,187**	**22,020**	11,828	14,904	26,732
Other public sector securities	**–**	**1,527**	**1,527**	–	1,325	1,325
Bank and building society certificates of deposit	**–**	**222**	**222**	–	244	244
Asset-backed securities:						
Mortgage-backed securities	**189**	**211**	**400**	47	660	707
Other asset-backed securities	**95**	**926**	**1,021**	69	1,469	1,538
Corporate and other debt securities	**523**	**19,467**	**19,990**	224	19,608	19,832
	10,640	**34,540**	**45,180**	12,168	38,210	50,378
Equity shares	**6**	**86,084**	**86,090**	6	67,691	67,697
Treasury and other bills	**–**	**18**	**18**	–	20	20
Total	**42,236**	**120,642**	**162,878**	45,253	105,921	151,174

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

(i) financial assets backing insurance contracts and investment contracts of £117,323 million (2016: £101,888 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise. Included within these assets are investments in unconsolidated structured entities of £28,759 million (2016: £15,611 million), see note 19; and

(ii) private equity investments of £1,944 million (2016: £2,245 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

For amounts included above which are subject to repurchase and reverse repurchase agreements see note 51.

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS

The fair values and notional amounts of derivative instruments are set out in the following table:

	31 December 2017			31 December 2016		
	Contract/ notional amount £m	**Fair value assets £m**	**Fair value liabilities £m**	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	**31,716**	**1,023**	**789**	38,072	1,149	1,383
Currency swaps	**223,624**	**3,157**	**3,534**	288,441	6,903	6,382
Options purchased	**8,191**	**580**	**–**	15,192	808	–
Options written	**6,684**	**–**	**627**	18,342	–	1,016
	270,215	**4,760**	**4,950**	360,047	8,860	8,781
Interest rate contracts:						
Interest rate swaps	**2,264,834**	**15,791**	**15,364**	2,160,535	19,780	18,862
Forward rate agreements	**239,797**	**5**	**1**	628,962	13	87
Options purchased	**32,097**	**2,329**	**–**	39,509	3,251	–
Options written	**32,817**	**–**	**2,524**	39,847	–	3,400
Futures	**35,542**	**9**	**7**	114,284	6	3
	2,605,087	**18,134**	**17,896**	2,983,137	23,050	22,352
Credit derivatives	**4,568**	**77**	**423**	8,098	381	659
Equity and other contracts	**25,150**	**982**	**1,242**	43,218	1,135	1,168
Total derivative assets/liabilities – trading and other	**2,905,020**	**23,953**	**24,511**	3,394,500	33,426	32,960
Hedging						
Derivatives designated as fair value hedges:						
Currency swaps	**1,327**	**19**	**38**	1,454	19	22
Interest rate swaps	**109,670**	**1,145**	**407**	194,416	1,462	737
	110,997	**1,164**	**445**	195,870	1,481	759
Derivatives designated as cash flow hedges:						
Interest rate swaps	**549,099**	**597**	**1,053**	384,182	814	1,166
Futures	**73,951**	**–**	**1**	53,115	–	3
Currency swaps	**7,310**	**120**	**114**	8,121	417	36
	630,360	**717**	**1,168**	445,418	1,231	1,205
Total derivative assets/liabilities – hedging	**741,357**	**1,881**	**1,613**	641,288	2,712	1,964
Total recognised derivative assets/liabilities	**3,646,377**	**25,834**	**26,124**	4,035,788	36,138	34,924

The notional amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 51 Credit risk.

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 51; and
- Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS continued

The principal derivatives used by the Group are as follows:

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

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

– Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.

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

Hedged cash flows

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

2017	**0-1 years £m**	**1-2 years £m**	**2-3 years £m**	**3-4 years £m**	**4-5 years £m**	**5-10 years £m**	**10-20 years £m**	**Over 20 years £m**	**Total £m**

Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	**346**	**515**	**682**	**492**	**395**	**701**	**55**	**46**	**3,232**
Forecast payable cash flows	**(475)**	**(654)**	**(592)**	**(552)**	**(406)**	**(1,150)**	**(627)**	**(163)**	**(4,619)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**307**	**562**	**648**	**448**	**466**	**684**	**63**	**54**	**3,232**
Forecast payable cash flows	**(680)**	**(640)**	**(556)**	**(505)**	**(377)**	**(1,085)**	**(612)**	**(164)**	**(4,619)**
2016	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	172	198	415	372	391	1,215	102	45	2,910
Forecast payable cash flows	(565)	(722)	(692)	(599)	(429)	(1,541)	(806)	(262)	(5,616)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	211	223	418	363	472	1,070	99	54	2,910
Forecast payable cash flows	(777)	(713)	(671)	(521)	(415)	(1,477)	(787)	(255)	(5,616)

There were no transactions for which cash flow hedge accounting had to be ceased in 2016 or 2017 as a result of the highly probable cash flows no longer being expected to occur.

NOTE 17: LOANS AND ADVANCES TO CUSTOMERS

	2017 £m	2016 £m
Agriculture, forestry and fishing	**7,461**	7,269
Energy and water supply	**1,609**	2,320
Manufacturing	**7,886**	7,285
Construction	**4,428**	4,535
Transport, distribution and hotels	**14,074**	13,320
Postal and telecommunications	**2,148**	2,564
Property companies	**30,980**	32,192
Financial, business and other services	**57,006**	49,197
Personal:		
Mortgages	**304,665**	306,682
Other	**28,757**	20,761
Lease financing	**2,094**	2,628
Hire purchase	**13,591**	11,617
Total loans and advances to customers before allowance for impairment losses	**474,699**	460,370
Allowance for impairment losses (note 20)	**(2,201)**	(2,412)
Total loans and advances to customers	**472,498**	457,958

For amounts included above which are subject to reverse repurchase agreements see note 51.

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

	2017 £m	2016 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**680**	551
Later than 1 year and not later than 5 years	**1,106**	1,618
Later than 5 years	**1,053**	1,561
	2,839	3,730
Unearned future finance income on finance leases	**(692)**	(1,038)
Rentals received in advance	**(53)**	(64)
Net investment in finance leases	**2,094**	2,628

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

	2017	2016
	£m	£m
Not later than 1 year	**546**	361
Later than 1 year and not later than 5 years	**887**	1,282
Later than 5 years	**661**	985
Net investment in finance leases	**2,094**	2,628

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2016 and 2017 no contingent rentals in respect of finance leases were recognised in the income statement. There was no allowance for uncollectable finance lease receivables included in the allowance for impairment losses (2016: £nil).

NOTE 18: SECURITISATIONS AND COVERED BONDS

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bond programmes, together with the balances of the advances subject to these arrangements and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 30.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 18: SECURITISATIONS AND COVERED BONDS continued

	2017 Loans and advances securitised £m	**Notes in issue £m**	2016 Loans and advances securitised £m	Notes in issue £m
Securitisation programmes[1]				
UK residential mortgages	**21,158**	**14,105**	35,146	17,705
Commercial loans	**6,616**	**7,001**	7,395	8,179
Credit card receivables	**7,701**	**4,090**	7,610	5,723
Dutch residential mortgages	**–**	**–**	2,033	2,081
	35,475	**25,196**	52,184	33,688
Less held by the Group		**(21,536)**		(26,435)
Total securitisation programmes (note 30)		**3,660**		7,253
Covered bond programmes				
Residential mortgage-backed	**30,361**	**25,632**	33,881	30,021
Social housing loan-backed	**1,628**	**1,200**	2,087	1,200
	31,989	**26,832**	35,968	31,221
Less held by the Group		**(700)**		(700)
Total covered bond programmes (note 30)		**26,132**		30,521
Total securitisation and covered bond programmes		**29,792**		37,774

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

Cash deposits of £3,507 million (2016: £9,018 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2017 these obligations had not been triggered; the maximum exposure under these facilities was £95 million (2016: £373 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ring-fence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cash flows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2017 (2016: none).

NOTE 19: STRUCTURED ENTITIES

The Group's interests in structured entities are both consolidated and unconsolidated. Detail of the Group's interests in consolidated structured entities are set out in: note 18 for securitisations and covered bond vehicles, note 35 for structured entities associated with the Group's pension schemes, and below in part (A) and (B). Details of the Group's interests in unconsolidated structured entities are included below in part (C).

(A) Asset-backed conduits

In addition to the structured entities discussed in note 18, which are used for securitisation and covered bond programmes, the Group sponsors an active asset-backed conduit, Cancara, which invests in client receivables and debt securities. The total consolidated exposure of Cancara at 31 December 2017 was £6,049 million (2016: £6,840 million), comprising £5,939 million of loans and advances (2016: £6,684 million) and £110 million of debt securities (2016: £156 million).

All lending assets and debt securities held by the Group in Cancara are restricted in use, as they are held by the collateral agent for the benefit of the commercial paper investors and the liquidity providers only. The Group provides liquidity facilities to Cancara under terms that are usual and customary for standard lending activities in the normal course of the Group's banking activities. During 2017 there have continued to be planned drawdowns on certain liquidity facilities for balance sheet management purposes, supporting the programme to provide funding alongside the proceeds of the asset-backed commercial paper issuance. The Group could be asked to provide support under the contractual terms of these arrangements including, for example, if Cancara experienced a shortfall in external funding, which may occur in the event of market disruption.

The external assets in Cancara are consolidated in the Group's financial statements.

(B) Consolidated collective investment vehicles and limited partnerships

The assets of the Insurance business held in consolidated collective investment vehicles, such as Open-Ended Investment Companies and limited partnerships, are not directly available for use by the Group. However, the Group's investment in the majority of these collective investment vehicles is readily realisable. As at 31 December 2017, the total carrying value of these consolidated collective investment vehicle assets and liabilities held by the Group was £68,124 million (2016: £75,669 million).

The Group has no contractual arrangements (such as liquidity facilities) that would require it to provide financial or other support to the consolidated collective investment vehicles; the Group has not previously provided such support and has no current intentions to provide such support.

NOTE 19: STRUCTURED ENTITIES continued

(C) Unconsolidated collective investment vehicles and limited partnerships

The Group's direct interests in unconsolidated structured entities comprise investments in collective investment vehicles, such as Open-Ended Investment Companies, and limited partnerships with a total carrying value of £28,759 million at 31 December 2017 (2016: £15,611 million), included within financial assets designated at fair value through profit and loss (see note 15). These investments include both those entities managed by third parties and those managed by the Group. At 31 December 2017, the total asset value of these unconsolidated structured entities, including the portion in which the Group has no interest, was £2,338 billion (2016: £1,849 billion).

The Group's maximum exposure to loss is equal to the carrying value of the investment. However, the Group's investments in these entities are primarily held to match policyholder liabilities in the Insurance division and the majority of the risk from a change in the value of the Group's investment is matched by a change in policyholder liabilities. The collective investment vehicles are primarily financed by investments from investors in the vehicles.

During the year the Group has not provided any non-contractual financial or other support to these entities and has no current intention of providing any financial or other support. There were no transfers from/to these unconsolidated collective investment vehicles and limited partnerships.

The Group considers itself the sponsor of a structured entity where it is primarily involved in the design and establishment of the structured entity; and further where the Group transfers assets to the structured entity; market products associated with the structured entity in its own name and/or provide guarantees regarding the structured entity's performance.

The Group sponsors a range of diverse investment funds and limited partnerships where it acts as the fund manager or equivalent decision maker and markets the funds under one of the Group's brands.

The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from these entities, including those in which the Group held no ownership interest at 31 December 2017, are reported in note 6.

NOTE 20: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

Critical accounting estimates and judgements

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. In determining the required level of impairment provisions, the Group uses the output from various statistical models. Management judgement is required to assess the robustness of the outputs from these models and, where necessary, make appropriate adjustments. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's commercial lending portfolios. Assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watchlist where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that could lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower; (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate; (iii) disappearance of an active market because of financial difficulties; or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. For these portfolios the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or certain cases where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

NOTE 20: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES continued

The value of collateral supporting the Group's UK mortgage portfolio is estimated by applying changes in the house price indices to the original assessed value of the property. Given the relative size of the portfolio, this is a key variable in determining the Group's impairment charge for loans and receivables. If average house prices were ten per cent lower than those estimated at 31 December 2017, the impairment charge would increase by approximately £200 million in respect of UK mortgages.

In addition, the collective provision also includes provision for losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for commercial lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of assets being impaired at the balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Loss emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and 12 months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios. This provision is sensitive to changes in the loss emergence period. Management use a significant level of judgement when determining the collective unidentified impairment provision, including the assessment of the level of overall risk existing within particular sectors and the impact of the low interest rate environment on loss emergence periods. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unidentified impairment provisions would result in an increase in the collective unidentified impairment provision of approximately £25 million (2016: £33 million).

	2017			2016		
	Loans and advances to customers £m	**Debt securities £m**	**Total £m**	Loans and advances to customers £m	Debt securities £m	Total £m
At 1 January	**2,412**	**76**	**2,488**	3,033	97	3,130
Exchange and other adjustments	**132**	**–**	**132**	69	–	69
Advances written off	**(1,499)**	**(44)**	**(1,543)**	(2,111)	(22)	(2,133)
Recoveries of advances written off in previous years	**482**	**–**	**482**	861	1	862
Unwinding of discount	**(23)**	**–**	**(23)**	(32)	–	(32)
	697	**(6)**	**691**	592	–	592

Charge (release) to the income statement (note 12)						
At 31 December	**2,201**	**26**	**2,227**	2,412	76	2,488

Of the total allowance in respect of loans and advances to customers, £1,772 million (2016: £1,876 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,201 million (2016: £1,208 million) was assessed on a collective basis.

NOTE 21: AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2017 **£m**	2016 £m
Debt securities:		
Government securities	**34,708**	48,714
Bank and building society certificates of deposit	**167**	142
Asset-backed securities:		
Mortgage-backed securities	**1,156**	108
Other asset-backed securities	**255**	317
Corporate and other debt securities	**4,615**	6,030
	40,901	55,311
Equity shares	**1,197**	1,213
Total available-for-sale financial assets	**42,098**	56,524

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

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NOTE 22: ACQUISITION OF MBNA LIMITED

On 1 June 2017, following the receipt of competition and regulatory approval, the Group acquired 100 per cent of the ordinary share capital of MBNA Limited (MBNA), which together with its subsidiaries undertakes a UK consumer credit card business, from FIA Jersey Holdings Limited, a wholly-owned subsidiary of Bank of America. The acquisition will enable the Group to enhance its position and offering within the UK prime credit card market. The total fair value of the purchase consideration was £2,016 million, settled in cash. The acquisition is expected to result in a significant opportunity for cost synergies and goodwill of £302 million has been recognised on the transaction. None of the goodwill recognised is deductible for tax purposes.

The table below sets out the fair value of the identifiable assets and liabilities acquired. The Group has finalised the acquisition accounting in the second half of 2017 and this has resulted in a reduction in other assets of £23 million, an increase in deferred tax assets of £4 million and an increase in goodwill of £19 million compared to the provisional amounts previously reported.

	Book value as at 1 June 2017 £m	**Fair value adjustments £m**	**Fair value as at 1 June 2017 £m**
Assets			
Loans and advances to customers	**7,466**	**345**	**7,811**
Available-for-sale financial assets	**16**	**–**	**16**
Purchased credit card relationships	**–**	**702**	**702**
Deferred tax assets	**27**	**4**	**31**
Other assets	**190**	**322**	**512**
Total assets	**7,699**	**1,373**	**9,072**
Liabilities			
Deposits from banks[1]	**6,431**	**–**	**6,431**
Deferred tax liabilities	**3**	**184**	**187**
Other liabilities	**112**	**–**	**112**
Other provisions	**233**	**395**	**628**
Total liabilities	**6,779**	**579**	**7,358**
Fair value of net assets acquired	**920**	**794**	**1,714**
Goodwill arising on acquisition			**302**
Total consideration			**2,016**

1 Upon acquisition, the funding of MBNA was assumed by Lloyds Bank plc.

At acquisition date, the contractual amount of loans and advances receivable from customers was £7,628 million. The amount expected to be collected is not materially different from the book value recognised by MBNA at 1 June 2017 (£7,466 million).

As a result of an indemnity guaranteed by Bank of America, N.A., the Group's exposure to MBNA's PPI liability is capped at £240 million. Acquisition-related costs of £21 million have been included in operating expenses for the year ended 31 December 2017.

The post-acquisition total income of MBNA, which is included in the Group statutory consolidated income statement for the year ended 31 December 2017, is £436 million. MBNA also contributed profit before tax of £146 million for the same period.

Had the acquisition date of MBNA been 1 January 2017, the Group's consolidated total income would have been £329 million higher at £34,566 million and the Group's consolidated profit before tax would have been £112 million higher at £5,737 million.

NOTE 23: GOODWILL

	2017	2016
	£m	£m
At 1 January	**2,016**	2,016
Acquisition of businesses (note 22)	**302**	–
Impairment charged to the income statement (note 11)	**(8)**	–
At 31 December	**2,310**	2,016
Cost[1]	**2,664**	2,362
Accumulated impairment losses	**(354)**	(346)
At 31 December	**2,310**	2,016

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,310 million (2016: £2,016 million), £1,836 million, or 79 per cent of the total (2016: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance and Wealth division; £302 million, or 13 per cent of the total (2016: £nil) relates to the acquisition of MBNA (note 22) and has been allocated to Cards in the Group's Retail division; and £170 million, or 7 per cent of the total (2016: £170 million, 8 per cent of the total) to Motor Finance in the Group's Retail division.

The recoverable amount of the goodwill relating to Scottish Widows has been based on a value-in-use calculation. The calculation uses pre-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, the related run-off of existing business in force and a discount rate of 9 per cent. The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. New business cash flows beyond the five-year period have been extrapolated using a steady 2 per cent growth

NOTE 23: GOODWILL continued

rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of the goodwill relating to Motor Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent. The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Motor Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Motor Finance to fall below the balance sheet carrying value.

The goodwill relating to the acquisition of MBNA has been allocated to the Group's Cards business as the Cards business is expected to benefit from the synergies of the acquisition. The recoverable amount of this goodwill has been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent. The cash flows beyond the five year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Cards participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of the Cards business to fall below the balance sheet carrying value.

NOTE 24: VALUE OF IN-FORCE BUSINESS

Critical accounting estimates and judgements

The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The valuation of this asset requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to this asset. The methodology used to value this asset and the key assumptions that have been made in determining the carrying value of the value of in-force business asset at 31 December 2017 are set out below.

Key assumptions

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

ECONOMIC ASSUMPTIONS

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate. The certainty equivalent approach covers all investment assets relating to insurance and participating investment contracts, other than the annuity business (where an illiquidity premium is included, see below).

A market-consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. Further information on options and guarantees can be found in note 31.

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 and illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. In determining the market premium for illiquidity, a range of inputs are considered which reflect actual asset allocation and relevant observable market data. The illiquidity premium is estimated to be 114 basis points at 31 December 2017 (2016: 138 basis points).

The risk-free rate is derived from the relevant swap curve with a deduction for credit risk.

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

	2017	2016
	%	%
Risk-free rate (value of in-force non-annuity business)[1]	**0.00 to 4.20**	0.00 to 4.20
Risk-free rate (value of in-force annuity business)[1]	**1.14 to 5.34**	1.38 to 5.58
Risk-free rate (financial options and guarantees)[1]	**0.00 to 4.20**	0.00 to 4.20
Retail price inflation	**3.43**	3.50

Expense inflation	**3.67**	3.73

1 All risk-free rates are quoted as the range of rates implied by the relevant forward swap curve.

NON-MARKET RISK

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit funds these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

NON-ECONOMIC ASSUMPTIONS

Future mortality, morbidity, expenses, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of future experience. Further information on these assumptions is given in note 31 and the effect of changes in key assumptions is given in note 32.

The gross value of in-force business asset in the consolidated balance sheet is as follows:

	2017	2016
	£m	£m
Acquired value of in-force non-participating investment contracts	**306**	340
Value of in-force insurance and participating investment contracts	**4,533**	4,702
Total value of in-force business	**4,839**	5,042

NOTE 24: VALUE OF IN-FORCE BUSINESS continued

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

	2017 £m	2016 £m
At 1 January	340	377
Amortisation taken to income statement (note 11)	(34)	(37)
At 31 December	306	340

The acquired value of in-force non-participating investment contracts includes £185 million (2016: £206 million) in relation to OEIC business.

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

	2017 £m	2016 £m
At 1 January	4,702	4,219
Exchange and other adjustments	(4)	11
Movements in the year:		
New business	348	428
Existing business:		
Expected return	(318)	(210)
Experience variances	(226)	(137)
Assumption changes	(238)	127
Economic variance	269	264
Movement in the value of in-force business taken to income statement (note 9)	(165)	472
At 31 December	4,533	4,702

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown makes to profit before tax. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value the liabilities, of the relevant businesses. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

NOTE 25: OTHER INTANGIBLE ASSETS

	Brands £m	Core deposit intangible £m	Purchased credit card relationships £m	Customer-related intangibles £m	Capitalised software enhancements £m	Total £m
Cost:						
At 1 January 2016	596	2,770	315	538	1,814	6,033
Additions	–	–	–	–	463	463
Disposals	–	–	–	–	(110)	(110)
At 31 December 2016	596	2,770	315	538	2,167	6,386
Acquisition of businesses (note 22)	–	–	702	–	–	702
Additions	–	–	–	–	850	850
Disposals	–	–	–	–	(77)	(77)
At 31 December 2017	596	2,770	1,017	538	2,940	7,861
Accumulated amortisation:						
At 1 January 2016	149	2,460	309	472	805	4,195
Charge for the year	22	297	2	27	234	582
Disposals	–	–	–	–	(72)	(72)
At 31 December 2016	171	2,757	311	499	967	4,705
Charge for the year	22	13	44	20	293	392
Disposals	–	–	–	–	(71)	(71)
At 31 December 2017	193	2,770	355	519	1,189	5,026
Balance sheet amount at 31 December 2017	403	–	662	19	1,751	2,835
Balance sheet amount at 31 December 2016	425	13	4	39	1,200	1,681

Included within brands above are assets of £380 million (31 December 2016: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The additional £702 million of purchased credit card relationships in the year ended 31 December 2017 have arisen from the acquisition of MBNA (see note 22) and represent the benefit of recurring income generated from the portfolio of credit cards purchased.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 26: PROPERTY, PLANT AND EQUIPMENT

	Investment properties £m	Premises £m	Equipment £m	Operating lease assets £m	Total £m
Cost or valuation:					
At 1 January 2016	4,361	2,589	5,266	5,023	17,239
Exchange and other adjustments	13	2	6	112	133
Additions	–	59	806	2,088	2,953
Expenditure on investment properties (see below)	344	–	–	–	344
Change in fair value of investment properties (note 7)	(83)	–	–	–	(83)
Disposals	(871)	(100)	(113)	(1,017)	(2,101)
At 31 December 2016	3,764	2,550	5,965	6,206	18,485
Exchange and other adjustments	–	(37)	–	(44)	(81)
Acquisition of businesses (note 22)	–	3	3	–	6
Additions	–	70	382	2,262	2,714
Expenditure on investment properties (see below)	209	–	–	–	209
Change in fair value of investment properties (note 7)	230	–	–	–	230
Disposals	(504)	(795)	(1,282)	(1,896)	(4,477)
At 31 December 2017	3,699	1,791	5,068	6,528	17,086
Accumulated depreciation and impairment:					
At 1 January 2016	–	1,247	2,096	917	4,260
Exchange and other adjustments	–	(1)	(8)	49	40
Depreciation charge for the year	–	136	672	953	1,761
Disposals	–	(49)	(89)	(410)	(548)
At 31 December 2016	–	1,333	2,671	1,509	5,513
Exchange and other adjustments	–	(8)	(9)	(34)	(51)
Depreciation charge for the year	–	125	734	1,085	1,944
Disposals	–	(722)	(1,271)	(1,054)	(3,047)
At 31 December 2017	–	728	2,125	1,506	4,359
Balance sheet amount at 31 December 2017	3,699	1,063	2,943	5,022	12,727
Balance sheet amount at 31 December 2016	3,764	1,217	3,294	4,697	12,972

Expenditure on investment properties is comprised as follows:

	2017 £m	2016 £m
Acquisitions of new properties	82	251
Additional expenditure on existing properties	127	93
	209	344

Rental income of £213 million (2016: £229 million) and direct operating expenses arising from properties that generate rental income of £24 million (2016: £26 million) have been recognised in the income statement.

Capital expenditure in respect of investment properties which had been contracted for but not recognised in the financial statements was £21 million (2016: £65 million).

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 48 for details of levels in the fair value hierarchy.

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

	2017 £m	2016 £m
Receivable within 1 year	1,301	1,120
1 to 5 years	1,419	1,373
Over 5 years	128	347
Total future minimum rentals receivable	2,848	2,840

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2016 and 2017 no contingent rentals in respect of operating leases were recognised in the income statement.

Total future minimum sub-lease income of £71 million at 31 December 2017 (£109 million at 31 December 2016) is expected to be received under non-cancellable sub-leases of the Group’s premises.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 27: OTHER ASSETS

	2017 £m	2016 £m
Assets arising from reinsurance contracts held (notes 31 and 33)	602	714
Deferred acquisition and origination costs	104	81
Settlement balances	720	700
Corporate pension asset	7,786	6,645
Investments in joint ventures and associates	65	59
Other assets and prepayments	4,260	4,556
Total other assets	13,537	12,755

NOTE 28: CUSTOMER DEPOSITS

	2017 £m	2016 £m
Non-interest bearing current accounts	70,444	61,804
Interest bearing current accounts	95,889	90,978
Savings and investment accounts	196,966	208,227
Liabilities in respect of securities sold under repurchase agreements	2,638	2,462
Other customer deposits	52,187	51,989
Customer deposits	418,124	415,460

For amounts included above which are subject to repurchase agreements, see note 51.

Included in the amounts reported above are deposits of £220,855 million (2016: £219,106 million) which are protected under the UK Financial Services Compensation Scheme.

NOTE 29: TRADING AND OTHER FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS

	2017 £m	2016 £m
Liabilities held at fair value through profit or loss	7,815	9,425
Trading liabilities:		

Liabilities in respect of securities sold under repurchase agreements	41,378	42,067
Other deposits	381	530
Short positions in securities	1,303	2,482
	43,062	45,079
Trading and other financial liabilities at fair value through profit or loss	50,877	54,504

Liabilities designated at fair value through profit or loss primarily represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2017 was £14,224 million, which was £6,412 million higher than the balance sheet carrying value (2016: £16,079 million, which was £6,656 million higher than the balance sheet carrying value). At 31 December 2017 there was a cumulative £147 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds Bank plc, the issuing entity within the Group. Of the cumulative amount an increase of £52 million arose in 2017 and an increase of £28 million arose in 2016.

For the fair value of collateral pledged in respect of repurchase agreements see note 51.

NOTE 30: DEBT SECURITIES IN ISSUE

	2017 £m	2016 £m
Medium-term notes issued	29,418	27,182
Covered bonds (note 18)	26,132	30,521
Certificates of deposit issued	9,999	8,077
Securitisation notes (note 18)	3,660	7,253
Commercial paper	3,241	3,281
Total debt securities in issue	72,450	76,314

NOTE 31: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS

Insurance contract and participating investment contract liabilities are comprised as follows:

	2017 Gross £m	**Reinsurance[1]** £m	Net £m	2016 Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	89,157	(563)	88,594	79,793	(671)	79,122
Participating investment contracts	13,673	–	13,673	13,984	–	13,984
	102,830	(563)	102,267	93,777	(671)	93,106
Non-life insurance contracts (see (2) below):						
Unearned premiums	358	(13)	345	404	(14)	390
Claims outstanding	225	–	225	209	–	209
	583	(13)	570	613	(14)	599
Total	103,413	(576)	102,837	94,390	(685)	93,705

1 Reinsurance balances are reported within other assets (note 27).

(1) Life insurance

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

	Insurance contracts £m	Participating investment contracts £m	Gross £m	Reinsurance £m	Net £m
At 1 January 2016	66,122	13,460	79,582	(629)	78,953
New business	4,422	28	4,450	(5)	4,445
Changes in existing business	9,214	496	9,710	(37)	9,673
Change in liabilities charged to the income statement (note 10)	13,636	524	14,160	(42)	14,118
Exchange and other adjustments	35	–	35	–	35
At 31 December 2016	79,793	13,984	93,777	(671)	93,106
New business	4,154	43	4,197	(21)	4,176
Changes in existing business	5,224	(354)	4,870	129	4,999
	9,378	(311)	9,067	108	9,175

Change in liabilities charged to the income statement (note 10)					
Exchange and other adjustments	(14)	–	(14)	–	(14)
At 31 December 2017	89,157	13,673	102,830	(563)	102,267

Liabilities for insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the PRA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

	2017			2016		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	8,946	80,211	89,157	9,147	70,646	79,793
Participating investment contracts	8,481	5,192	13,673	8,860	5,124	13,984
Total	17,427	85,403	102,830	18,007	75,770	93,777

WITH-PROFIT FUND REALISTIC LIABILITIES

(I) BUSINESS DESCRIPTION

Scottish Widows Limited has the only with-profit funds within the Group. The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(II) METHOD OF CALCULATION OF LIABILITIES

With-profit liabilities are stated at their realistic value, the main components of which are:

– With-profit benefit reserve, the total asset shares for with-profit policies;

– Cost of options and guarantees (including guaranteed annuity options);

– Deductions levied against asset shares;

– Planned enhancements to with-profits benefits reserve; and

– Impact of the smoothing policy.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 31: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS continued

(III) ASSUMPTIONS

Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

INVESTMENT RETURNS AND DISCOUNT RATES

With-profit fund liabilities are valued on a market-consistent basis, achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant swap curve, adjusted for credit risk. Further information on significant options and guarantees is given below.

GUARANTEED ANNUITY OPTION TAKE-UP RATES

Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the cost of options are economic conditions in which the option has value, mortality rates and take up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

INVESTMENT VOLATILITY

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

MORTALITY

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

LAPSE RATES (PERSISTENCY)

Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistency experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistency will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

(IV) 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 originally held in Scottish Widows plc and subsequently transferred into Scottish Widows Limited, 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 2017 of £2.8 billion (2016: £2.7 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, the liabilities of the With-Profit Funds are valued using a market-consistent stochastic simulation model which places 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 and investment volatility.

NON-PROFIT FUND LIABILITIES

(I) BUSINESS DESCRIPTION

The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

Unit-linked business – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

Life insurance – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole of life and term assurance and long-term creditor policies.

Annuities – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

(II) METHOD OF CALCULATION OF LIABILITIES

The non-profit fund liabilities are determined on the basis of recognised actuarial methods and involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

(III) ASSUMPTIONS

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

NOTE 31: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS continued

INTEREST RATES

The rates of interest used are determined by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

MORTALITY AND MORBIDITY

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation.

LAPSE RATES (PERSISTENCY)

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

MAINTENANCE EXPENSES

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

KEY CHANGES IN ASSUMPTIONS

A detailed review of the Group's assumptions in 2017 resulted in the following key impacts on profit before tax:

- Change in persistency assumptions (£237 million decrease).
- Change in the assumption in respect of current and future mortality and morbidity rates (£289 million increase).
- Change in expenses assumptions (£142 million decrease).

These amounts include the impacts of movements in liabilities and value of the in-force business in respect of insurance contracts and participating investment contracts.

(IV) 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 £35 million (2016: £82 million) in respect of those guarantees.

(2) Non-life insurance

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

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

	2017 £m	2016 £m
Provisions for unearned premiums		
Gross provision at 1 January	404	461
Increase in the year	724	827
Release in the year	(770)	(884)
Change in provision for unearned premiums charged to income statement	(46)	(57)
Gross provision at 31 December	358	404
Reinsurers' share	(13)	(14)
Net provision at 31 December	345	390

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

	2017 £m	2016 £m
Claims outstanding		
Gross claims outstanding at 1 January	209	251
Cash paid for claims settled in the year	(321)	(408)
Increase/(decrease) in liabilities charged to the income statement [1]	337	366
	16	(42)
Gross claims outstanding at 31 December	225	209
Reinsurers' share	–	–
Net claims outstanding at 31 December	225	209
Notified claims	174	122
Incurred but not reported	51	87
Net claims outstanding at 31 December	225	209

1 Of which an increase of £350 million (2016: £363 million) was in respect of current year claims and a decrease of £13 million (2016: an increase of £3 million) was in respect of prior year claims.

NOTE 32: LIFE INSURANCE SENSITIVITY ANALYSIS

Critical accounting estimates and judgements

Elements of the valuations of liabilities arising from insurance contracts and participating investment contracts require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The methodology used to value these liabilities and the key assumptions that have been made in determining their carrying value are set out in note 31.

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

	Change in variable	2017 Increase (reduction) in profit before tax £m	2017 Increase (reduction) in equity £m	2016 Increase (reduction) in profit before tax £m	2016 Increase (reduction) in equity £m
Non-annuitant mortality and morbidity[1]	5% reduction	23	19	25	21
Annuitant mortality[2]	5% reduction	(221)	(184)	(287)	(238)
Lapse rates[3]	10% reduction	75	62	48	40
Future maintenance and investment expenses[4]	10% reduction	289	240	318	264
Risk-free rate[5]	0.25% reduction	(40)	(33)	(74)	(62)
Guaranteed annuity option take up[6]	5% addition	(6)	(5)	(12)	(10)
Equity investment volatility[7]	1% addition	(7)	(6)	(10)	(8)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(235)	(195)	(200)	(166)
Increase in illiquidity premia[9]	0.10% addition	145	120	152	126

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

1 This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

2 This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

3 This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

4 This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

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

6 This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

7 This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

8 This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Swap curves, the risk-free rate and illiquidity premia are all assumed to be unchanged.

9 This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall spreads on assets are unchanged and hence market values are unchanged. Swap curves and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

NOTE 33: LIABILITIES ARISING FROM NON-PARTICIPATING INVESTMENT CONTRACTS

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

	2017 £m	2016 £m
At 1 January	20,112	22,777
New business	608	560
Changes in existing business	(5,273)	(3,225)
At 31 December	15,447	20,112

The balances above are shown gross of reinsurance. As at 31 December 2017, related reinsurance balances were £26 million (2016: £29 million); reinsurance balances are reported within other assets (note 27). Liabilities arising from non-participating investment contracts are categorised as level 2. See note 48 for details of levels in the fair value hierarchy.

NOTE 34: OTHER LIABILITIES

	2017 £m	2016 £m
Settlement balances	501	706
Unitholders' interest in Open Ended Investment Companies	14,480	22,947
Unallocated surplus within insurance businesses	390	243
Other creditors and accruals	5,359	5,297
Total other liabilities	20,730	29,193

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS

	2017 £m	2016 £m	2015 £m
Charge to the income statement			
Defined benefit pension schemes	362	279	307
Other post-retirement benefit schemes	7	8	8
Total defined benefit schemes	369	287	315
Defined contribution pension schemes	256	268	233
Total charge to the income statement (note 11)	625	555	548

	2017 **£m**	2016 £m
Amounts recognised in the balance sheet		
Retirement benefit assets	723	342
Retirement benefit obligations	(358)	(822)
Total amounts recognised in the balance sheet	365	(480)

The total amount recognised in the balance sheet relates to:

	2017 **£m**	2016 £m
Defined benefit pension schemes	509	(244)
Other post-retirement benefit schemes	(144)	(236)
Total amounts recognised in the balance sheet	365	(480)

Pension schemes

DEFINED BENEFIT SCHEMES

CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The accounting valuation of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The discount rate is required to be set with reference to market yields at the end of the reporting period on high quality corporate bonds in the currency and with a term consistent with the defined benefit pension schemes' obligations. The average duration of the schemes' obligations is approximately 19 years. The market for bonds with a similar duration is illiquid and, as a result, significant management judgement is required to determine an appropriate yield curve on which to base the discount rate. The cost of the benefits payable by the schemes will also depend upon the life expectancy of the members. The Group considers latest market practice and actual experience in determining the appropriate assumptions for both current mortality expectations and the rate of future mortality improvement. It is uncertain whether this rate of improvement will be sustained going forward and, as a result, actual experience may differ from current expectations. The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in (iii) below.

(I) CHARACTERISTICS OF AND RISKS ASSOCIATED WITH THE GROUP'S SCHEMES

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the three most significant being the defined benefit sections of the Lloyds Bank Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. At 31 December 2017, these schemes represented 95 per cent of the Group's total gross defined benefit pension assets (2016: 94 per cent). These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2017 is generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the three most significant schemes, are funded schemes in the UK. All these schemes are operated as separate legal entities under trust law by the trustees and are in compliance with the Pensions Act 2004. The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. All of the Group's funded UK defined benefit pension schemes are managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the funding valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

A valuation to determine the funding status of each scheme is carried out at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the Group and the scheme Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as the future economic benefits arising from these contributions are expected to be available to the Group. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The most recent triennial funding valuation of the Group's three main schemes, based on the position as at 31 December 2016, is substantially complete and the terms have been agreed in principle with the trustees. The valuation shows an aggregate funding deficit of £7.3 billion (a funding level of 85.6 per cent) compared to a £5.2 billion deficit (a funding level of 85.9 per cent) for the previous valuation as at 30 June 2014. In the light of this funding deficit, and in contemplation of the changes the Group expects to make as a result of its Structural Reform Programme, the Group has agreed in principle a recovery plan with the trustees. Under the plan, deficit contributions of £412 million are payable during 2018, rising to £618 million in 2019, £798 million in 2020, £1,287 million in 2021 and £1,305 million per annum from 2022 to 2024. Contributions in the later years will be subject to review and renegotiation at subsequent funding valuations. The next funding valuation is due to be completed by March 2021 with an effective date of 31 December 2019. The deficit contributions are in addition to the regular contributions to meet of benefits accruing over the year. The Group currently expects to pay contributions of approximately £750 million to its defined benefit schemes in 2018.

During 2009, the Group made one-off contributions to the Lloyds Bank Pension Scheme No 1 and Lloyds Bank Pension Scheme No 2 in the form of interests in limited liability partnerships for each of the two schemes which hold assets to provide security for the Group’s obligations to the two schemes. At 31 December 2017, the limited liability partnerships held assets of approximately £5.5 billion. The limited liability partnerships are consolidated fully in the Group’s balance sheet.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS continued

The Group has also established three private limited companies which hold assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme, a section of the Lloyds Bank Pension Scheme No 1 and the Lloyds Bank Offshore Pension Scheme. At 31 December 2017 these held assets of approximately £4.8 billion in aggregate. The private limited companies are consolidated fully in the Group's balance sheet. The terms of these arrangements require the Group to maintain assets in these vehicles to agreed minimum values in order to secure obligations owed to the relevant Group pension schemes. The Group has satisfied this requirement during 2017.

The last funding valuations of other Group schemes were carried out on a number of different dates. In order to report the position under IAS 19 as at 31 December 2017 the most recent valuation results for all schemes have been updated by qualified independent actuaries. The main differences between the funding and IAS 19 valuations are different and more prudent approach to setting the discount rate and more conservative longevity assumptions used in the funding valuations.

(II) AMOUNTS IN THE FINANCIAL STATEMENTS

	2017 £m	2016 £m
Amount included in the balance sheet		
Present value of funded obligations	(44,384)	(45,822)
Fair value of scheme assets	44,893	45,578
Net amount recognised in the balance sheet	509	(244)

	2017 **£m**	2016 £m
Net amount recognised in the balance sheet		
At 1 January	(244)	736
Net defined benefit pension charge	(362)	(279)
Actuarial (losses) gains on defined benefit obligation	(731)	(8,770)
Return on plan assets	1,267	7,455
Employer contributions	580	623
Exchange and other adjustments	(1)	(9)
At 31 December	509	(244)

	2017 **£m**	2016 £m
Movements in the defined benefit obligation		
At 1 January	(45,822)	(36,903)

Current service cost	(295)	(257)
Interest expense	(1,241)	(1,401)
Remeasurements:		
Actuarial gains – experience	(347)	535
Actuarial gains (losses) – demographic assumptions	1,084	195
Actuarial (losses) gains – financial assumptions	(1,468)	(9,500)
Benefits paid	3,714	1,580
Past service cost	(14)	(20)
Curtailments	(10)	–
Settlements	15	12
Exchange and other adjustments	–	(63)
At 31 December	(44,384)	(45,822)

	2017	2016
	£m	£m
Analysis of the defined benefit obligation:		
Active members	(7,947)	(9,903)
Deferred members	(15,823)	(16,934)
Pensioners	(19,014)	(17,476)
Dependants	(1,600)	(1,509)
	(44,384)	(45,822)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS continued

	2017 £m	2016 £m
Changes in the fair value of scheme assets		
At 1 January	45,578	37,639
Return on plan assets excluding amounts included in interest income	1,267	7,455
Interest income	1,242	1,441
Employer contributions	580	623
Benefits paid	(3,714)	(1,580)
Settlements	(18)	(18)
Administrative costs paid	(41)	(36)
Exchange and other adjustments	(1)	54
At 31 December	44,893	45,578

COMPOSITION OF SCHEME ASSETS:

	2017			2016		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equity instruments	846	5	851	1,114	–	1,114
Debt instruments[1]:						
Fixed interest government bonds	5,344	–	5,344	5,797	–	5,797
Index-linked government bonds	17,439	–	17,439	14,359	–	14,359
Corporate and other debt securities	6,903	–	6,903	7,464	–	7,464
Asset-backed securities	121	–	121	99	–	99
	29,807	–	29,807	27,719	–	27,719
Property	–	544	544	–	497	497
Pooled investment vehicles	3,937	13,443	17,380	3,577	12,845	16,422
Money market instruments, cash, derivatives and other assets and liabilities	1,501	(5,190)	(3,689)	1,462	(1,636)	(174)
At 31 December	36,091	8,802	44,893	33,872	11,706	45,578

1 Of the total debt instruments, £27,732 million (31 December 2016: £25,219 million) were investment grade (credit ratings equal to or better than ‘BBB’).

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

The pension schemes' pooled investment vehicles comprise:

	2017 £m	2016 £m
Equity funds	2,669	2,883
Hedge and mutual funds	2,377	2,350
Liquidity funds	2,877	484
Bond and debt funds	1,830	3,383
Other	7,627	7,322
At 31 December	17,380	16,422

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

	2017 £m	2016 £m	2015 £m
Current service cost	295	257	302
Net interest amount	(1)	(40)	(43)
Past service credits and curtailments	10	–	–
Settlements	3	6	6
Past service cost – plan amendments	14	20	12
Plan administration costs incurred during the year	41	36	30
Total defined benefit pension expense	362	279	307

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS continued

ASSUMPTIONS

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

	2017 %	2016 %
Discount rate	2.59	2.76
Rate of inflation:		
Retail Prices Index	3.20	3.23
Consumer Price Index	2.15	2.18
Rate of salary increases	0.00	0.00
Weighted-average rate of increase for pensions in payment	2.73	2.74
	2017 **Years**	2016 Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.9	28.1
Women	29.5	30.3
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.9	29.3
Women	30.7	31.7

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2017 is assumed to live for, on average, 27.9 years for a male and 29.5 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years' time at age 60.

(III) AMOUNT TIMING AND UNCERTAINTY OF FUTURE CASH FLOWS

RISK EXPOSURE OF THE DEFINED BENEFIT SCHEMES

Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: the majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

Longevity risk: The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

SENSITIVITY ANALYSIS

The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's three most significant schemes, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS continued

	Effect of reasonably possible alternative assumptions			
	Increase (decrease) in the income statement charge		**Increase (decrease) in the net defined benefit pension scheme liability**	
	2017 £m	**2016 £m**	**2017 £m**	**2016 £m**
Inflation (including pension increases):[1]				
Increase of 0.1 per cent	**16**	19	**472**	491
Decrease of 0.1 per cent	**(15)**	(14)	**(453)**	(458)
Discount rate:[2]				
Increase of 0.1 per cent	**(28)**	(30)	**(773)**	(821)
Decrease of 0.1 per cent	**26**	30	**794**	847
Expected life expectancy of members:				
Increase of one year	**44**	42	**1,404**	1,213
Decrease of one year	**(41)**	(37)	**(1,357)**	(1,178)

1 At 31 December 2017, the assumed rate of RPI inflation is 3.20 per cent and CPI inflation 2.15 per cent (2016: RPI 3.23 per cent and CPI 2.18 per cent).

2 At 31 December 2017, the assumed discount rate is 2.59 per cent (2016: 2.76 per cent).

SENSITIVITY ANALYSIS METHOD AND ASSUMPTIONS

The sensitivity analysis above reflects the impact on the Group’s three most significant schemes which account for over 90 per cent of the Group’s defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group’s pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any change in the rate of salary increases as pensionable salaries have been frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

ASSET-LIABILITY MATCHING STRATEGIES

The main schemes' assets are invested in a diversified portfolio, consisting primarily of debt securities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main schemes, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

At 31 December 2017 the asset-liability matching strategy mitigated 98 per cent of the liability sensitivity to interest rate movements and 102 per cent of the liability sensitivity to inflation movements. Much of the residual interest rate sensitivity is mitigated through holdings of corporate and other debt securities.

MATURITY PROFILE OF DEFINED BENEFIT OBLIGATION

The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

	2017 Years	2016 Years

Duration of the defined benefit obligation	19	20
	2017	2016
	£m	£m
Maturity analysis of benefits expected to be paid		
Benefits expected to be paid within 12 months	1,174	1,639
Benefits expected to be paid between 1 and 2 years	1,235	1,180
Benefits expected to be paid between 2 and 5 years	4,089	3,971
Benefits expected to be paid between 5 and 10 years	8,082	8,030
Benefits expected to be paid between 10 and 15 years	9,360	9,453
Benefits expected to be paid between 15 and 25 years	19,044	20,268
Benefits expected to be paid between 25 and 35 years	16,735	18,831
Benefits expected to be paid between 35 and 45 years	11,156	13,589
Benefits expected to be paid in more than 45 years	5,219	7,809

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 35: RETIREMENT BENEFIT OBLIGATIONS continued

MATURITY ANALYSIS METHOD AND ASSUMPTIONS

The projected benefit payments are based on the assumptions underlying the assessment of the obligations, including allowance for expected future inflation. They are shown in their undiscounted form and therefore appear large relative to the discounted assessment of the defined benefit obligations recognised in the Group's balance sheet. They are in respect of benefits that have been accrued prior to the respective year-end date only and make no allowance for any benefits that may have been accrued subsequently.

DEFINED CONTRIBUTION SCHEMES

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds Bank Pension Scheme No. 1.

During the year ended 31 December 2017 the charge to the income statement in respect of defined contribution schemes was £256 million (2016: £268 million; 2015: £233 million), representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes

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

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 31 December 2017 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.81 per cent (2016: 6.84 per cent).

Movements in the other post-retirement benefits obligation:

	2017 **£m**	2016 £m
At 1 January	**(236)**	(200)
Actuarial (loss) gain	**92**	(33)
Insurance premiums paid	**7**	7
Charge for the year	**(7)**	(8)
Exchange and other adjustments	**–**	(2)
At 31 December	**(144)**	(236)

NOTE 36: DEFERRED TAX

The Group's deferred tax assets and liabilities are as follows:

Statutory position	**2017** **£m**	2016 £m	**Tax disclosure**	**2017** **£m**	2016 £m
Deferred tax assets	**2,284**	2,706	Deferred tax assets	**4,989**	5,634
Deferred tax liabilities	**–**	–	Deferred tax liabilities	**(2,705)**	(2,928)
Asset at 31 December	**2,284**	2,706	**Asset at 31 December**	**2,284**	2,706

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the tables below which splits the deferred tax assets and liabilities by type.

The UK corporation tax rate will reduce from 19 per cent to 17 per cent on 1 April 2020. The Group measures its deferred tax assets and liabilities at the value expected to be recoverable or payable in future periods, and re-measures them at each reporting date based on the most recent estimates of utilisation or settlement, including the impact of bank surcharge where appropriate. The deferred tax impact of this re-measurement in 2017 is a charge of £9 million in the income statement and a credit of £22 million in other comprehensive income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 36: DEFERRED TAX continued

Movements in deferred tax liabilities and assets (before taking into consideration the offsetting of balances within the same taxing jurisdiction) can be summarised as follows:

Deferred tax assets	**Tax losses £m**	**Property, plant and equipment £m**	**Pension liabilities £m**	**Provisions £m**	**Share-based payments £m**	**Other temporary differences £m**	**Total £m**
At 1 January 2016	4,890	1,089	102	28	91	395	6,595
(Charge) credit to the income statement	(592)	(120)	(1,981)	12	(17)	(357)	(3,055)
(Charge) credit to other comprehensive income	–	–	2,107	–	–	–	2,107
Other (charge) credit to equity	–	–	–	–	(13)	–	(13)
At 31 December 2016	4,298	969	228	40	61	38	5,634
(Charge) credit to the income statement	**(264)**	**(226)**	**(287)**	**(7)**	**7**	**(28)**	**(805)**
(Charge) credit to other comprehensive income	**–**	**–**	**149**	**25**	**–**	**–**	**174**
Other (charge) credit to equity	**–**	**–**	**–**	**–**	**(17)**	**–**	**(17)**
Impact of acquisitions and disposals	**–**	**–**	**–**	**–**	**–**	**3**	**3**
At 31 December 2017	**4,034**	**743**	**90**	**58**	**51**	**13**	**4,989**

Deferred tax liabilities	**Long-term assurance business £m**	**Acquisition fair value £m**	**Pension assets £m**	**Derivatives £m**	**Available-for-sale asset revaluation £m**	**Other temporary differences £m**	**Total £m**
At 1 January 2016	(641)	(891)	(174)	(395)	(11)	(506)	(2,618)
(Charge) credit to the income statement	(273)	93	1,876	232	23	252	2,203
(Charge) credit to other comprehensive income	–	–	(1,787)	(466)	(246)	–	(2,499)
Exchange and other adjustments	–	–	–	(14)	–	–	(14)
At 31 December 2016	(914)	(798)	(85)	(643)	(234)	(254)	(2,928)
(Charge) credit to the income statement	**115**	**76**	**199**	**(139)**	**(40)**	**116**	**327**
(Charge) credit to other comprehensive income	**–**	**–**	**(295)**	**283**	**67**	**–**	**55**
	–	**(157)**	**–**	**–**	**–**	**(2)**	**(159)**

Impact of acquisitions and disposals							
At 31 December 2017	**(799)**	**(879)**	**(181)**	**(499)**	**(207)**	**(140)**	**(2,705)**

CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

Estimation of income taxes includes the assessment of recoverability of deferred tax assets. Deferred tax assets are only recognised to the extent they are considered more likely than not to be recoverable based on existing tax laws and forecasts of future taxable profits against which the underlying tax deductions can be utilised.

The Group has recognised a deferred tax asset of £4,034 million (2016: £4,298 million) in respect of UK trading losses carried forward. Substantially all of these losses have arisen in Bank of Scotland plc and Lloyds Bank plc, and they will be utilised as taxable profits arise in those legal entities in future periods.

The Group’s expectations as to the level of future taxable profits take into account the Group’s long-term financial and strategic plans, and anticipated future tax-adjusting items. In making this assessment, account is taken of business plans, the Board-approved operating plan and the expected future economic outlook as set out in the strategic report, as well as the risks associated with future regulatory change.

Under current law there is no expiry date for UK trading losses not yet utilised, although (since Finance Act 2016) banking losses that arose before 1 April 2015 can only be used against 25 per cent of taxable profits arising after 1 April 2016, and they cannot be used to reduce the surcharge on banking profits. This restriction in utilisation means that the value of the deferred tax asset is only expected to be fully recovered by 2034.

NOTE 36: DEFERRED TAX continued

DEFERRED TAX NOT RECOGNISED

No deferred tax has been recognised in respect of the future tax benefit of expenses of the life assurance business carried forward. The deferred tax asset not recognised in respect of these expenses is approximately £470 million (2016: £636 million). These expenses can be carried forward indefinitely.

Deferred tax assets of approximately £76 million (2016: £92 million) have not been recognised in respect of £404 million of UK tax losses and other temporary differences which can only be used to offset future capital gains. UK capital losses can be carried forward indefinitely.

In addition, no deferred tax asset is recognised in respect of unrelieved foreign tax credits of £46 million (2016: £46 million), as there are no expected future taxable profits against which the credits can be utilised. These credits can be carried forward indefinitely.

No deferred tax has been recognised in respect of foreign trade losses where it is not more likely than not that we will be able to utilise them in future periods. Of the asset not recognised, £35 million (2016: £63 million) relates to losses that will expire if not used within 20 years, and £56 million (2016: £56 million) relates to losses with no expiry date.

As a result of parent company exemptions on dividends from subsidiaries and on capital gains on disposal there are no significant taxable temporary differences associated with investments in subsidiaries, branches, associates and joint arrangements.

NOTE 37: OTHER PROVISIONS

Critical accounting estimates and judgements

At 31 December 2017, the Group carried provisions of £4,070 million (2016: £3,947 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the mis-selling of payment protection insurance (2017: £2,778 million; 2016: £2,608 million).

Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the scope of reviews required by regulators, the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of legal decisions that may be relevant to claims received. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

More detail on the nature of the assumptions that have been made and key sensitivities is set out below.

	Provisions for commitments £m	**Payment protection insurance £m**	**Other regulatory provisions £m**	**Vacant leasehold property £m**	**Other £m**	**Total £m**
At 1 January 2017	**56**	**2,608**	**1,339**	**51**	**1,164**	**5,218**
Exchange and other adjustments	**(26)**	**–**	**16**	**9**	**139**	**138**
Acquisition of businesses (note 22)	**9**	**527**	**–**	**–**	**92**	**628**
Provisions applied	**–**	**(1,657)**	**(928)**	**(23)**	**(252)**	**(2,860)**
Charge for the year	**(9)**	**1,300**	**865**	**19**	**247**	**2,422**
At 31 December 2017	**30**	**2,778**	**1,292**	**56**	**1,390**	**5,546**

Provisions for commitments

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

Payment protection insurance (excluding MBNA)

The Group increased the provision for PPI costs by a further £1,300 million in 2017, of which £600 million was in the fourth quarter, bringing the total amount provided to £18,675 million. The remaining provision is consistent with an average of 11,000 complaints per week (previously 9,000) through to the industry deadline of August 2019, in line with the average experience over the last nine months.

The higher volume of complaints received has been driven by increased claims management company (CMC) marketing activity and the UK Financial Conduct Authority (FCA) advertising campaign.

At 31 December 2017, a provision of £2,438 million remained unutilised relating to complaints and associated administration costs. Total cash payments were £1,470 million during the year to 31 December 2017.

SENSITIVITIES

The Group estimates that it has sold approximately 16 million PPI policies since 2000. These include policies that were not mis-sold and those that have been successfully claimed upon. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 53 per cent of the policies sold since 2000.

The total amount provided for PPI represents the Group’s best estimate of the likely future cost. However a number of risks and uncertainties remain in particular with respect to future volumes. The cost could differ from the Group’s estimates and the assumptions underpinning them, and could result in a further provision being required. There is significant uncertainty around the impact of the regulatory changes, FCA media campaign and Claims Management Company and customer activity.

For every additional 1,000 reactive complaints per week above 11,000 on average through to the industry deadline of August 2019, the Group would expect an additional charge of £200 million.

NOTE 37: OTHER PROVISIONS continued

Payment protection insurance (MBNA)

With regard to MBNA, as announced in December 2016, the Group's exposure is capped at £240 million already provided for, through an indemnity received from Bank of America.

Other provisions for legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints in connection with its past conduct and claims brought by or on behalf of current and former employees, customers, investors and other third parties and is subject to legal proceedings and other legal actions. Where significant, provisions are held against the costs expected to be incurred in relation to these matters and matters arising from related internal reviews. During the year ended 31 December 2017 the Group charged a further £865 million in respect of legal actions and other regulatory matters, the unutilised balance at 31 December 2017 was £1,292 million (31 December 2016: £1,339 million). The most significant items are as follows.

ARREARS HANDLING RELATED ACTIVITIES

The Group has provided an additional £245 million (bringing the total provided to date to £642 million), for the costs of identifying and rectifying certain arrears management fees and activities. Following a review of the Group's arrears handling activities, the Group has put in place a number of actions to improve further its handling of customers in these areas and has made good progress in reimbursing mortgage arrears fees to the 590,000 impacted customers.

PACKAGED BANK ACCOUNTS

In 2017 the Group provided an additional £245 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £750 million. A number of risks and uncertainties remain in particular with respect to future volumes.

CUSTOMER CLAIMS IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY

The Group continues to receive claims in Germany from customers relating to policies issued by Clerical Medical Investment Group Limited (subsequently renamed Scottish Widows Limited). The German industry-wide issue regarding notification of contractual 'cooling off' periods continued to lead to an increasing number of claims in 2016 and 2017. Up to 31 December 2016 the Group had provided a total of £639 million and no further amounts have been provided to 31 December 2017. The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will be known only once all relevant claims have been resolved.

HBOS READING – CUSTOMER REVIEW

The Group is undertaking a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Group in 2009. The Group has provided £100 million in the year to 31 December 2017 and is in the process of paying compensation to the victims of the fraud for economic losses as well as ex-gratia payments and awards for distress and inconvenience. The review is ongoing and at 12 February 2018, the Group had made offers to 57 customers, which represents more than 80 per cent of the customers in review.

Vacant leasehold property

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging 5 years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Other

Following the sale of TSB Banking Group plc in 2015, the Group raised a provision of £665 million in relation to the Transitional Service Agreement entered into between Lloyds Bank plc and TSB and the contribution to be provided to TSB in moving to alternative IT provision; £622 million of this provision remained unutilised at 31 December 2017.

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure. At 31 December 2017 provisions of £104 million (31 December 2016: £239 million) were held.

Other provisions also includes those arising in the normal course of business, whether from certain customer rectifications or provisions for dilapidation and refurbishment of properties. Provisions also include a matter arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £32 million at 31 December 2017 represents management’s current best estimate of the cost after having regard to actuarial estimates of future losses.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 38: SUBORDINATED LIABILITIES

The movement in subordinated liabilities during the year was as follows:

	Preference shares £m	Preferred securities £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2017	864	4,134	599	14,234	19,831
Issued during the year	–	–	–	–	–
Repurchases and redemptions during the year[1]	–	(237)	–	(771)	(1,008)
Foreign exchange movements	(43)	(221)	(34)	(487)	(785)
Other movements (all non-cash)	(8)	14	–	(122)	(116)
At 31 December 2017	813	3,690	565	12,854	17,922

1 The repurchases and redemptions resulted in cash outflows of £1,008 million.

Repurchases and redemptions during the year	
Preferred securities	**£m**
7.627% Fixed to Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities	163
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	74
	237
Dated subordinated liabilities	**£m**
Subordinated Callable Notes 2017	771
	771

There were no repurchases of preference shares or undated subordinated liabilities during the year.

	Preference shares £m	Preferred securities £m	Undated subordinated liabilities £m	Enhanced capital notes £m	Dated subordinated liabilities £m	Total £m
At 1 January 2016	980	3,748	965	3,610	14,009	23,312
Issued during the year[1]	–	–	–	–	1,061	1,061
Tender offers and redemptions[2]	–	–	–	(3,568)	–	(3,568)
Other repurchases and redemptions during the year[2]	(319)	(182)	(475)	–	(3,070)	(4,046)
Foreign exchange movements	127	511	166	93	1,854	2,751
Other movements (all non-cash)	76	57	(57)	(135)	380	321

At 31 December 2016	864	4,134	599	–	14,234	19,831

Other repurchases and redemptions

Preference shares	£m
6.267% Non-Cumulative Callable Fixed to Floating Rate Preference shares callable 2016	319
Preferred securities	£m
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	32
7.286% Perpetual Regulatory Tier One Securities (Series A)	150
	182
Undated subordinated liabilities	£m
7.5% Undated Subordinated Step-up Notes	5
4.25% Subordinated Undated Instruments	7
Floating Rate Primary Capital Notes	108
Primary Capital Undated Floating Rate Notes[3]	353
5.125% Undated subordinated Step-up Notes callable 2016	2
	475
Dated subordinated liabilities	£m
Subordinated Fixed to Fixed Rate Notes 2021 callable 2016[4]	2,359
Callable Floating Rate Subordinated Notes 2016	329
Subordinated Callable Notes 2016	382
	3,070

1 4.65% Subordinated Fixed Rate Notes 2026 (US$1,500 million).

2 In total, the tender offers, repurchases and redemptions resulted from cash outflows of £7,885 million.

3 Comprising Series 1 (£101 million), Series 2 (£142 million), Series 3 (£110 million).

4 Comprising notes with the following coupon rates: 13% (£244 million), 10.125% (£233 million), 11.875% (£960 million), 10.75% (£466 million), 9.875% (£456 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 38: SUBORDINATED LIABILITIES continued

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes (ECNs) ranked equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during 2017 (2016: none).

NOTE 39: SHARE CAPITAL

(1) Authorised share capital

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

(2) Issued and fully paid share capital

	2017 Number of shares	2016 Number of shares	2015 Number of shares	2017 £m	2016 £m	2015 £m
Ordinary shares of 10p (formerly 25p) each						
At 1 January	71,373,735,357	71,373,735,357	71,373,735,357	7,138	7,138	7,138
Issued under employee share schemes	518,293,181	–	–	51	–	–
Redesignation of limited voting ordinary shares (see below)	80,921,051	–	–	8	–	–
At 31 December	71,972,949,589	71,373,735,357	71,373,735,357	7,197	7,138	7,138
Limited voting ordinary shares of 10p (formerly 25p) each						
At 1 January	80,921,051	80,921,051	80,921,051	8	8	8
Redesignation to ordinary shares (see below)	(80,921,051)	–	–	(8)	–	–
At 31 December	–	80,921,051	80,921,051	–	8	8

Total issued share capital	7,197	7,146	7,146

SHARE ISSUANCES

No shares were issued in 2015 or 2016; in 2017, 518 million shares were issued in respect of employee share schemes.

(3) Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

- certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);
- where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and
- pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found under *Major shareholders and related party transactions*.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 11 May 2017. The authority to issue shares and the authority to make market purchases of shares will expire at the next annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and enti