

Lloyds Banking Group plc  
Form 20-F  
May 13, 2010

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As filed with the Securities and Exchange Commission on 13 May 2010

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 20-F**

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended 31 December 2009

OR

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

OR

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

Commission file number 001-15246

**LLOYDS BANKING GROUP plc**

(previously Lloyds TSB Group plc)  
(Exact name of Registrant as Specified in Its Charter)

**Scotland**

(Jurisdiction of Incorporation or Organization)

**25 Gresham Street  
London EC2V 7HN  
United Kingdom**

(Address of Principal Executive Offices)

**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.

**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:**

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None

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2009 was:

Ordinary shares, nominal value 10 pence each	63,774,511,536
Limited voting shares, nominal value 10 pence each	80,921,051
Deferred shares, nominal value 15 pence each	27,242,603,417
Preference shares, nominal value 25 pence each	484,144,705
Preference shares, nominal value 25 cents each	3,038,001
Preference shares, nominal value 25 euro cents each	500,000

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

Yes  No

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

Yes  No

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

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

Yes  No

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-Accelerated filer

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

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

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

Item 17  Item 18

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

Yes  No

## TABLE OF CONTENTS

<u>Presentation of information</u>	1
<u>Business overview</u>	2
<u>Selected consolidated financial data</u>	3
<u>Exchange rates</u>	4
<u>Business</u>	4
<u>Operating and financial review and prospects</u>	11
<u>Management and employees</u>	101
<u>Compensation</u>	104
<u>Corporate governance</u>	123
<u>Major shareholders and related party transactions</u>	129
<u>Regulation</u>	133
<u>Listing information</u>	137
<u>Dividends</u>	140
<u>Memorandum and articles of association</u>	141
<u>Taxation</u>	146
<u>Where you can find more information</u>	149
<u>Enforceability of civil liabilities</u>	149
<u>Risk factors</u>	150
<u>Forward looking statements</u>	162
<u>Lloyds Banking Group structure</u>	163
<u>Index to consolidated financial statements</u>	F-1
<u>Glossary</u>	165
<u>Form 20-F cross-reference sheet</u>	167
<u>Exhibit index</u>	169
<u>Signatures</u>	170

## PRESENTATION OF INFORMATION

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In this annual report, references to the Company are to Lloyds Banking Group plc; references to Lloyds Banking Group, Lloyds or the Group are to Lloyds Banking Group plc and its subsidiary and associated undertakings; references to Lloyds TSB Bank are to Lloyds TSB Bank plc; and references to the consolidated financial statements or financial statements are to Lloyds Banking Group's consolidated financial statements included in this annual report. References to the Financial Services Authority or FSA are to the United Kingdom (the UK) Financial Services Authority.

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds (pounds sterling, sterling or £), the lawful currency of the UK. In this annual report, references to pence and p are to one-hundredth of one pound sterling; references to US dollars, US\$ or \$ are to the lawful currency of the United States (the US); references to cent or c are to one-hundredth of one US dollar; references to euro or e are to the lawful currency of the member states of the European Union that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to euro cent are to one-hundredth of one euro; and references to Japanese yen, Japanese ¥ or ¥ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2009, which was \$1.6167 = £1.00. The Noon Buying Rate on 31 December 2009 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

## BUSINESS OVERVIEW

Lloyds Banking Group is a leading UK based financial services group providing a wide range of banking and financial services, primarily in the UK, to personal and corporate customers. At 31 December 2009, total Lloyds Banking Group assets were £1,027,255 million and Lloyds Banking Group had some 107,000 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was some £32,327 million. The profit before tax for the 12 months to 31 December 2009 was £1,042 million and the capital ratios as at that date were 12.4 per cent for total capital, 9.6 per cent for tier 1 capital and 8.1 per cent for core tier 1 capital.

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

	2009 £m	2008 <sup>1</sup> £m
Net interest income	9,026	7,718
Other income	36,271	(709)
<b>Total income</b>	<b>45,297</b>	7,009
Insurance claims	(22,019)	2,859
<b>Total income, net of insurance claims</b>	<b>23,278</b>	9,868
Operating expenses	(15,984)	(6,100)
<b>Trading surplus</b>	<b>7,294</b>	3,768
Impairment	(16,673)	(3,012)
Share of results of joint ventures and associates	(752)	4
Gain on acquisition	11,173	
<b>Profit before tax</b>	<b>1,042</b>	760

<sup>1</sup> Restated for IFRS 2 (Revised).

Lloyds Banking Group was formed in January 2009 following the acquisition of HBOS and the Group's main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision. Services are offered through a number of well recognised brands including Lloyds TSB, Halifax, Bank of Scotland, Scottish Widows, Clerical Medical and Cheltenham & Gloucester, and via a distribution capability comprising the largest branch network in the UK and intermediary channels. The new Group also operates an international banking business with a global footprint in over 30 countries.

Since the acquisition of HBOS in January 2009 there have been four primary operating divisions, which constitute the Group's reporting segments: Retail, Wholesale, Wealth and International, and Insurance. Retail provides banking, mortgages and other financial services to personal customers in the UK. Wholesale provides banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers and manages Lloyds Banking Group's activities in financial markets through its treasury function. Wealth and International provides private banking, wealth and asset management in the UK and overseas and corporate, commercial and retail banking services outside the UK. Insurance offers life assurance, pensions and investment products in the UK and Europe and provides general insurance to personal customers in the UK.

The acquisition of HBOS plc on 16 January 2009 has had a significant effect on the comparability of the Group's financial position and results with prior periods. Profit before tax is analysed further on pages 13 to 23 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 25 to 40 on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described on page 25. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess performance and allocate resources; this reporting is on a combined businesses basis, which the Group Executive Committee feel best represents the underlying performance of the Group. These combined businesses segmental results for 2009 and 2008 are therefore presented in compliance with IFRS 8 but the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined in the SEC's Regulation G and a reconciliation of this aggregated total to the statutory income

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statement is therefore provided on page 39. The following table shows the results of Lloyds Banking Group's Retail, Wholesale, Wealth and International, and Insurance segments and Central group items in the last two fiscal years, and their aggregation.

	2009 £m	2008 £m
Retail	1,382	2,542
Wholesale	(4,703)	(10,479)
Wealth and International	(2,356)	277
Insurance	975	1,540
Group Operations and Central items:		
Group Operations	(149)	(76)
Central items	(1,449)	(517)
	(1,598)	(593)
<b>Loss before tax Combined businesses basis</b>	<b>(6,300)</b>	<b>(6,713)</b>

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

## SELECTED CONSOLIDATED FINANCIAL DATA

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

	2009	2008 <sup>1</sup>	2007 <sup>1</sup>	2006 <sup>1</sup>	2005 <sup>1</sup>
<b>Income statement data for the year ended</b>					
<b>31 December (£m)</b>					
Total income, net of insurance claims	23,278	9,868	10,696	11,098	10,543
Operating expenses	(15,984)	(6,100)	(5,568)	(5,300)	(5,481)
Trading surplus	7,294	3,768	5,128	5,798	5,062
Impairment losses	(16,673)	(3,012)	(1,796)	(1,555)	(1,299)
Gain on acquisition	11,173				
Profit before tax	1,042	760	3,999	4,249	3,810
Profit for the year	2,953	798	3,320	2,908	2,545
Profit for the year attributable to equity shareholders	2,827	772	3,288	2,804	2,483
Total dividend for the year <sup>2</sup>		648	2,026	1,928	1,915
<b>Balance sheet data at 31 December (£m)</b>					
Share capital	10,472	1,513	1,432	1,429	1,420
Shareholders' equity	43,278	9,393	12,141	11,155	10,195
Customer deposits	406,741	170,938	156,555	139,342	131,070
Subordinated liabilities	34,727	17,256	11,958	12,072	12,402
Loans and advances to customers	626,969	240,344	209,814	188,285	174,944
Total assets	1,027,255	436,033	353,346	343,598	309,754
<b>Share information</b>					
Basic earnings per ordinary share <sup>3</sup>	7.5p	6.7p	28.9p	24.8p	22.0p
Diluted earnings per ordinary share <sup>3</sup>	7.5p	6.6p	28.7p	24.5p	21.8p
Net asset value per ordinary share	68p	155p	212p	195p	180p
Total dividend per ordinary share <sup>2</sup>		11.4p	35.9p	34.2p	34.2p
Equivalent cents per share <sup>2,4</sup>		20.3c	71.0c	67.0c	62.2c
Market price per ordinary share (year end)	50.7p	126.0p	472.0p	571.5p	488.5p
Number of shareholders (thousands)	2,834	824	814	870	920
Number of ordinary shares in issue (millions) <sup>5</sup>	63,775	5,973	5,648	5,638	5,603
<b>Financial ratios (%)<sup>6</sup></b>					
Dividend payout ratio		83.9	61.6	68.7	77.1
Post-tax return on average shareholders' equity	8.8	7.0	28.1	26.6	25.5
Post-tax return on average assets	0.28	0.21	0.94	0.88	0.83
Average shareholders' equity to average assets	3.0	2.9	3.3	3.2	3.2
Cost:income ratio <sup>7</sup>	68.7	61.8	52.1	47.8	52.0
<b>Capital ratios (%)<sup>8</sup></b>					
Total capital	12.4	11.2	11.0	10.7	10.9
Tier 1 capital	9.6	8.0	8.1	8.2	7.9

<sup>1</sup> Restated for IFRS 2 (Revised).

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

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- 3 Earnings per share calculations for 2008 and earlier years have also been restated for the impact of the bonus element of the share issues in 2009.
- 4 Translated into US dollars at the Noon Buying Rate on the date each payment was made.
- 5 This figure excludes the limited voting ordinary shares owned by the Lloyds TSB Foundations.
- 6 Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.
- 7 The cost: income ratio is calculated as total operating expenses as a percentage of total income (net of insurance claims).
- 8 Capital ratios for 2008 and later years are in accordance with Basel II requirements; ratios for 2007 and earlier years reflect Basel I.



## 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:

	2010 April	2010 March	2010 February	2010 January	2009 December	2009 November
US dollars per pound sterling:						
High	<b>1.55</b>	<b>1.53</b>	<b>1.60</b>	<b>1.64</b>	<b>1.66</b>	<b>1.68</b>
Low	<b>1.52</b>	<b>1.49</b>	<b>1.52</b>	<b>1.59</b>	<b>1.59</b>	<b>1.64</b>

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

	2009	2008	2007	2006	2005
US dollars per pound sterling:					
Average	<b>1.57</b>	1.84	2.01	1.86	1.81

On 30 April 2010, the latest practicable date, the US dollar Noon Buying Rate was \$1.5308 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

## BUSINESS

### HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP

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

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

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company's issued ordinary share capital. Following the issue of ordinary shares in February 2010 pursuant to the Group's capital raising announced in November 2009, the UK Government's holding was reduced to approximately 41.3 per cent.

## **STRATEGY OF LLOYDS BANKING GROUP**

The Group's corporate strategy supports its vision of being recognised as the best financial services company in the UK by customers, colleagues and shareholders. The strategy is focused on being a conservative, through the cycle relationship-based business.

The main focus for the Group remains the financial services markets in the UK and the Group's strategic position was strengthened through the acquisition of HBOS in January 2009. The Group is a well diversified UK financial services group and the largest retail financial services provider in the UK. The Group has leading positions in many of the markets in which it participates, a market leading distribution capability, well recognised brands and a large customer base. The scale of the organisation provides the opportunity to further invest in products and services, systems and training that combined will offer improved choice and service to the Group's customers. The effective integration of the two businesses will be a significant challenge over the next few years, but comprehensive plans are in place and progress is already being made.

The Group's corporate strategy is focused on:

### **DEVELOPING STRONG CUSTOMER FRANCHISES THAT ARE BASED ON DEEP CUSTOMER RELATIONSHIPS**

The Group's businesses are focused on extending the reach and depth of its customer relationships, whilst enhancing product capabilities to build competitive advantage. Striving to understand and effectively meet the needs of the Group's customers from core banking products to the more specialist services such as insurance, wealth management or corporate banking is at the heart of the Group's business and is fundamental to ensuring that the Group is developing long-lasting customer relationships.

### **BUILDING A HIGH PERFORMANCE ORGANISATION**

In building a high performance organisation the Group is focused on improving its cost efficiency and utilising its capital more effectively whilst maintaining a prudent approach to risk.

## BUSINESS

The Group aspires to have one of the lowest cost: income ratios amongst UK financial institutions and further improving the Group's processing efficiency and effectiveness will remain a priority. The anticipated synergies arising from the acquisition will be key to further improving the Group's efficiency.

Utilising capital more effectively is increasingly important in the current environment and capital will be rigorously allocated across the Group's portfolio of businesses to support business growth.

The prudent Lloyds TSB through the cycle approach to risk has been applied to the enlarged Group. The Group's conservative and prudent approach to risk is core to the business model and the through the cycle approach means that the Group will continue to support its customers throughout the economic cycle. The risk structures and frameworks that have been implemented are the foundation for good business management.

### **MANAGING THE GROUP'S MOST VALUABLE RESOURCE, PEOPLE**

Executing the Group's strategy effectively will only be possible if the Group ensures that deliverables are effectively aligned with its corporate strategy and it manages its most valuable resource, people, well. In driving performance it is important to encourage, manage and develop staff whilst creating a great place to work.

### **SUMMARY**

The Group believes that the successful execution of its strategy to focus on core markets, customer and cost leadership, capital efficiency, a prudent risk appetite and the effective management of its most valuable resource, its people, will bring the Group closer to achieving its vision of being recognised as the best financial services company in the UK.

## **BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP**

At 31 December 2008, the Group's activities were organised into three segments: UK Retail Banking; Insurance and Investments; and Wholesale and International Banking. Following the acquisition of HBOS plc on 16 January 2009, the Group was reorganised into four segments: Retail; Wholesale; Wealth and International; and Insurance. The Group has restated its segmental information for 2008. The Group has determined that the cost to develop the information required to restate 2007 was excessive. In order to provide comparability with the segmental information for 2007 the Group has supplementally presented its segmental information for 2008 on a consistent statutory basis (see also note 4 to the consolidated financial statements).

Further information on the current and previous segments is set out on pages 25 to 50.

## **MATERIAL CONTRACTS**

Lloyds Banking Group plc and its subsidiaries are party to various contracts in the ordinary course of business.

In 2008, the Company entered into a placing and open offer agreement with The Commissioners of Her Majesty's Treasury (HM Treasury) and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008. Prior to the completion of the acquisition of HBOS, HBOS also entered into a placing and open offer agreement with HM Treasury and the joint sponsors and joint bookrunners named therein, as well as a preference share subscription agreement with HM Treasury, both with effect from 13 October 2008.

In 2009, the Company entered into a placing and compensatory open offer agreement with HM Treasury (as amended and restated on 20 March 2009 between the Company, HM Treasury, Citigroup Global Markets U.K. Equity Limited, J.P. Morgan Cazenove Limited and UBS Limited and further amended and restated between the same parties on 18 May 2009). In addition, the Company entered into a registration rights agreement with HM Treasury on 12 January 2009 (as amended with effect from 11 June 2009) pursuant to an obligation to do so under the 2008 placing and open offer agreement referred to above. The Company also entered into a resale rights agreement with HM Treasury pursuant to its obligations under the 2009 placing and open offer agreement. The Company entered into a Pre-Accession Commitments Deed dated 7 March 2009 and a Lending Commitments Deed dated 6 March 2009 (as amended on 23 March 2010) with HM Treasury, both relating to the Company's proposed participation in the Government Asset Protection Scheme. In addition, in connection with the 2009 rights issue and the Group's withdrawal from its proposed participation in the Government Asset Protection Scheme, the Company entered into a GAPS Withdrawal Deed with HM Treasury as well as the HMT Undertaking to Subscribe and the Cost Reimbursement Deed. For further details on each of the 2008 and 2009 agreements described above, see *Major shareholders and related party transactions* Information about the Lloyds Banking

*Group's relationship with the UK Government.*

In addition to those agreements discussed above, the Company entered into the following agreements, which it considers to be material:

#### **RIGHTS ISSUE UNDERWRITING AGREEMENT**

Pursuant to an underwriting agreement dated 3 November 2009 (entered into in relation to the 2009 rights issue described in *Major shareholders and related party transactions – Information about the Lloyds Banking Group's relationship with the UK Government* between the Company, the banks, the senior co-lead managers, the co-lead managers and the co-bookrunner (all as named therein)), new shares in the Company were issued at a price of 37 pence per share. Sufficient new shares were issued to ensure that the gross proceeds of the rights issue receivable by the Company, including pursuant to the HMT Undertaking to Subscribe, were not less than £13.5 billion.

HM Treasury undertook to subscribe for its pro rata entitlement under the rights issue and the new shares that were the subject of the HMT Undertaking to Subscribe were not underwritten pursuant to the Rights Issue Underwriting Agreement. Further details of the HMT Undertaking to Subscribe are set out in *Major shareholders and related party transactions – Information about the Lloyds Banking Group's relationship with the UK Government*.

In consideration of their services under the Rights Issue Underwriting Agreement, (i) the underwriters (as named in the Rights Issue Underwriting Agreement) were paid an aggregate base fee of 2.25 per cent of the issue price multiplied by the aggregate number of new shares issued (excluding the new shares that were subscribed by HMT), and (ii) the joint bookrunners (as named in the Rights Issue Underwriting Agreement) were paid additional performance-based discretionary fees. Out of such fees (to the extent received by the joint global co-ordinators (as named in the Rights Issue Underwriting Agreement), the joint global co-ordinators were to pay any sub-underwriting commissions (to the extent that sub-underwriters were procured). The joint global co-ordinators had the ability to arrange sub-underwriting in respect of some, all or none of the new shares issued (other than the new shares to be subscribed by HM Treasury).

The Company agreed to pay all costs and expenses of, or in connection with, the rights issue, the general meeting of the Company convened to approve the rights issue, the related subdivision of the Company's shares, the allotment and issue of the new shares and the Rights Issue

## BUSINESS

Underwriting Agreement, including (but not limited to) the UK Listing Authority and the London Stock Exchange listing and trading fees, other regulatory fees and expenses, printing and advertising costs, postage, Equiniti Limited's charges (as registrar), its own and the banks', the senior co-lead managers' and the co-lead managers' properly incurred legal and other out-of-pocket expenses, all accountancy and other professional fees, properly incurred public relations fees and expenses and all stamp duty and stamp duty reserve tax (if any) and other duties and taxes (other than corporation tax incurred by any of the banks, the senior co-lead managers and the co-lead managers on the commissions payable to them).

The obligations of the banks, the senior co-lead managers and the co-lead managers under the Rights Issue Underwriting Agreement were subject to certain limited conditions which were satisfied.

### TOP UP ISSUES UNDERWRITING AGREEMENT

Pursuant to the Top Up Issues Underwriting Agreement dated 3 November 2009 among the Company, LBG Capital No.2 plc (as issuer), Lloyds TSB Bank plc (as guarantor) and the joint bookrunners (as named therein), in the event that the exchange offers described in *Risk factors – Government-related risks* did not generate or were not expected to generate prior to 30 April 2010, or such other date as the Company and the joint bookrunners might agree, £7.5 billion or more of core tier 1 and/or nominal value of contingent core tier 1 capital, the joint bookrunners severally agreed to underwrite one or more further issues of enhanced capital notes in an aggregate amount sufficient to reduce such shortfall to zero by such date.

In consideration of their underwriting services under the Top Up Issues Underwriting Agreement, and subject to their obligations under the Top Up Issues Underwriting Agreement having become unconditional and the Top Up Issues Underwriting Agreement not having been terminated, the joint bookrunners were to be paid an aggregate underwriting fee of £75 million and additional performance-based discretionary fees.

The obligations of the joint bookrunners under the Top Up Issues Underwriting Agreement and, in relation to each issue of additional enhanced capital notes, the obligations of the joint bookrunners under the Top Up Issues Underwriting Agreement were subject to certain conditions which were satisfied.

Each of the Company, the issuer and the guarantor gave certain customary representations, warranties, undertakings and indemnities to the joint bookrunners, all of which have now expired.

In addition to the fees described above, the joint bookrunners and their affiliates were to be paid pursuant to the Rights Issue Underwriting Agreement and the Top Up Issues Underwriting Agreement:

- (a) an aggregate transaction praeipuum of 0.088 per cent of £15.1 billion (being the aggregate of the underwriting commitments of the underwriters and the joint bookrunners), or of a sum in excess thereof dependent on the notional amount of the securities submitted in the exchange offers; and
- (b) a further discretionary aggregate transaction praeipuum (to be paid at the sole discretion of the Company, as to payment and allocation) of 0.088 per cent of £15.1 billion (being the aggregate of the underwriting commitments of the underwriters and the joint bookrunners), or of a sum in excess thereof dependent on the notional amount of the securities submitted in the exchange offers.

## ENVIRONMENTAL MATTERS

The Group has a long-standing commitment to managing its environmental impacts. It first introduced an environmental policy in 1996. In 2009, the Group reviewed the policy against best practice to ensure that it is fit for purpose across the whole of the Group. Further work will be undertaken during 2010 to produce and embed an enhanced and integrated environmental management system.

## CLIMATE CHANGE

The UK Government is committed to reducing the country's carbon emissions by 80 per cent from 1990 levels by 2050. A central part of its strategy is the introduction of a mandatory climate change and energy savings scheme, the Carbon Reduction Commitment Energy Efficiency Scheme, due to start in April 2010. The Group qualifies as a participant in this scheme, which requires a collective 22 per cent emissions reduction from participants by 2012. The Group fully understands its obligations and is committed to driving down CO<sub>2</sub> emissions. It is developing a carbon management policy and strategy to deliver a single approach

for the new combined Group, and continues to invest significant capital in carbon reduction projects across the Group's estate.

In 2009 the Group chaired an initiative with Business in the Community and the Cambridge Programme for Sustainability Leadership to create a Guide for Carbon Management in the Supply Chain. The guide has helped inform the Group's approach and, as a freely downloadable resource, the Group is also encouraging its suppliers and customers to use it to help manage carbon risks in the supply chain.

Lloyds Banking Group is represented by Group Executive Director Truett Tate on the Corporate Leaders Group on Climate Change. This group of leading businesses released the Copenhagen Communiqué, widely viewed as the progressive voice of business, for the Copenhagen Climate Change talks in December 2009.

#### **BUSINESS TRAVEL**

In 2009 the Group introduced a common travel policy across the organisation. It supports a focus on sustainable travel and helped the Group deliver a 13 per cent reduction in the costs of travel.

The Group's Sustainability Network holds events and runs awareness campaigns to encourage colleagues to play their part. Travel reduction was one of the Network's key themes in 2009, inspiring colleagues to take steps to reduce their travel footprints.

The Group achieved a reduction of 143,000 journeys in 2009 compared with 2008. Across the combined Group, the volume of teleconferences increased by over 40 per cent to over 1.1 million. The Group will continue to promote virtual conferencing technologies to colleagues as an environmentally friendly, cost efficient alternative to travelling.

#### **ENVIRONMENTAL RISK MANAGEMENT**

The Group has introduced policies and procedures to reduce the environmental impact of its lending activities. The Group aims to reduce environmental impacts through effective risk management. In 2009 it implemented an integrated groupwide environmental risk policy to manage these risks; this requires transactions to be assessed for material risks as part of the credit sanctioning process.

**BUSINESS****EQUATOR PRINCIPLES**

The Equator Principles are voluntary guidelines for the financial industry to manage social and environmental issues in project financing. Lloyds Banking Group is a signatory to the Equator Principles.

During 2009 the Group implemented a harmonised groupwide approach to monitoring and reporting Equator Principles transactions, and training colleagues on the Equator Principles. An Equator Principles Review Group has been formed, comprising experts from both Risk and Project Finance teams, and supported by external environmental consultants. This Group is responsible for reviewing all new Equator Principle transactions, to ensure that each transaction is compliant and is consistent with the group environmental risk policy, prior to being sanctioned.

Equator Principles reporting January to December 2009:

**DEALS**

	Equator Principle risk category			Total
	Category A higher risk	Category B medium risk	Category C lower risk	
Completed		7	7	14
In progress		4	1	5
Not completed		1		1
		12	8	20

**GEOGRAPHY OF COMPLETED TRANSACTIONS**

	Category A higher risk	Category B medium risk	Category C lower risk	Total
US		2	2	4
Europe		4	5	9
Middle East		1		1
		7	7	14

**INDUSTRY OF COMPLETED TRANSACTIONS**

	Number	£m
Renewables	4	89
Infrastructure	7	376
Energy and utilities	3	72
	14	537

**PROPERTIES**

As at 31 December 2009, Lloyds Banking Group occupied 3,467 properties in the UK. Of these, 953 were held as freeholds, 98 as long-term leaseholds and 2,416 as short-term leaseholds. The majority of these properties are retail branches, widely distributed throughout England, Scotland and Wales. Other buildings include the Lloyds Banking Group's head office in the City of London and customer service and support centres located to suit business needs but clustered largely in London, Birmingham, West Yorkshire, Chester and Bristol (in England), Edinburgh (in Scotland) and Cardiff and Newport (in Wales).

In addition, there are 699 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 short-term leasehold. In addition, the Group also owns, leases or uses under licence properties for business operations elsewhere in the world, principally in Spain, Switzerland, Dubai, Asia and Ireland.

## **LEGAL ACTIONS**

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory challenge both in the UK and overseas.

## **UNARRANGED OVERDRAFT CHARGES**

In April 2007, the OFT commenced an investigation into the fairness of personal current accounts and unarranged overdraft charges. At the same time, it commenced a market study into wider questions about competition and price transparency in the provision of personal current accounts.

The Supreme Court published its judgment in respect of the fairness of unarranged overdraft charges on personal current accounts on 25 November 2009, finding in favour of the litigant banks. On 22 December 2009, the OFT announced that it will not continue its investigation into the fairness of these charges. The Group is working with the regulators to ensure that outstanding customer complaints are concluded as quickly as possible and anticipate that most cases in the county courts will be discontinued. The Group expects that some customers will argue that despite the test case ruling they are entitled to a refund of unarranged overdraft charges on the basis of other legal arguments or challenges. The Group is robustly defending any such complaints or claims and does not expect any such complaints or claims to have a material effect on the Group.

The OFT however continued to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. On 16 March 2010 the OFT published a further update announcing several further voluntary industry wide initiatives to improve a customer's ability to control whether they used an unarranged overdraft and to assist those in financial difficulty. However, in light of the progress it noted in the unarranged overdraft market since July 2007 and the progress it expects to see over the next two years, it has decided to take no further action at this time and will review the unarranged overdraft market again in 2012. The OFT also announced it will shortly be commencing an investigation into the barriers to entry in the personal current accounts market.



## BUSINESS

### INTERCHANGE FEES

The European Commission has adopted a formal decision finding that an infringement of European Commission competition laws has arisen from arrangements whereby MasterCard issuers charged a uniform fallback interchange fee in respect of cross border transactions in relation to the use of a MasterCard or Maestro branded payment card. The European Commission has required that the fee be reduced to zero for relevant cross-border transactions within the European Economic Area. This decision has been appealed to the General Court of the European Union (the General Court). Lloyds TSB Bank plc and Bank of Scotland plc (along with certain other MasterCard issuers) have successfully applied to intervene in the appeal in support of MasterCard's position that the arrangements for the charging of a uniform fallback interchange fee are compatible with European Commission competition laws. MasterCard has announced that it has reached an understanding with the European Commission on a new methodology for calculating intra European Economic Area multi-lateral interchange fees on an interim basis pending the outcome of the appeal. Meanwhile, the European Commission and the UK's OFT are pursuing investigations with a view to deciding whether arrangements adopted by other payment card schemes for the levying of uniform fallback interchange fees in respect of domestic and/or cross-border payment transactions also infringe European Commission and/or UK competition laws. As part of this initiative, the OFT will also intervene in the General Court appeal supporting the European Commission position and Visa reached an agreement with the European Commission to reduce the level of interchange for cross-border debit card transactions to the interim levels agreed by MasterCard. The ultimate impact of the investigations on the Group can only be known at the conclusion of these investigations and any relevant appeal proceedings.

### PAYMENT PROTECTION INSURANCE

#### UK COMPETITION COMMISSION

In January 2009, the Competition Commission completed its formal investigation into the supply of Payment Protection Insurance (PPI) services (except store card PPI) to non-business customers in the UK. Various members of the Group underwrite PPI, while other members distribute PPI, by offering it for sale with a variety of the credit products which they supply.

On 5 June 2008, the Competition Commission issued its provisional findings, to the effect that there are market features which prevent, restrict or distort competition in the supply of PPI to non-business customers, with an adverse effect on competition and with the result being detrimental to consumers.

Following consultation, the Competition Commission published its final report on 29 January 2009 setting out its remedies. In summary, the Competition Commission has decided to adopt the following remedies: (i) a prohibition on the active sale of PPI by a distributor to a customer within seven days of the distributor's sale of credit to that customer. However, customers may pro-actively return to the distributor to initiate a purchase by telephone or online from 24 hours after the credit sale; (ii) a requirement on all PPI providers to provide certain information and messages in PPI marketing materials; (iii) a requirement to provide personal PPI quotes to customers; (iv) a requirement on all PPI providers to provide certain information on PPI policies to the FSA; (v) a recommendation to the FSA that it use the information provided under the requirement in (iii) to populate its PPI price comparison tables; (vi) a requirement on distributors to provide an annual statement for PPI customers containing information on their PPI policy and what it costs; and (vii) a prohibition on the levying by distributors of payments for PPI on a single premium basis. Instead, distributors are permitted to charge only regular premiums at a constant rate, paid monthly or annually. This remedy therefore precludes the selling of multi-year PPI policies for a single premium.

On 30 March 2009, Barclays Bank PLC lodged an appeal in the Competition Appeal Tribunal against the Competition Commission's findings. In particular, it requested that the Competition Appeal Tribunal quash the decision of the Competition Commission insofar as it relates to the prohibition of distributors selling PPI at the credit point of sale and the Competition Commission's findings on market definition and the nature and extent of competition in the supply of PPI. The Group filed a notice of its intention to intervene in the appeal on 23 April 2009. On 28 April 2009, the Group was granted permission by the Competition Appeal Tribunal to intervene in the appeal. The hearing of the appeal took place from 7 September 2009 to 11 September 2009. The Competition Appeal Tribunal handed down its judgment on 16 October 2009. It found in favour of Barclays in respect of its challenge to the Competition Commission's prohibition of distributors selling PPI at the credit point of sale but it did not uphold Barclays' challenge to the Competition Commission's findings on market definition. The matter has been referred back to the Competition Commission with direction to reconsider their remedies and make a new decision in accordance with the Competition Appeal Tribunal's ruling. This may or may not result in the Competition Commission ultimately reaching a different conclusion.

Depending on the outcome of the referral back to the Competition Commission, the Competition Commission's decision may have a significant adverse impact on the level of sales and thus the revenue generation and profitability of the payment protection insurance products which the Group offers its customers, but the ultimate impact would be determined by a number of factors

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including the extent to which the Group was able to mitigate the potentially adverse effects of such statutory changes through restructuring the payment protection products which it offers its customers and/or developing alternative products and revenue streams. To this end, the Group took a commercial decision to sell only regular monthly premium PPI to its personal loan customers in the UK from early 2009. The FSA subsequently wrote to certain other firms still selling single premium PPI with unsecured personal loans asking them to withdraw the product as soon as possible, and no later than 29 May 2009.

On 1 July 2008, the Financial Ombudsman Service referred concerns regarding the handling of PPI complaints to the FSA as an issue of wider implication. The Group has been working with other industry members and trade associations in preparing an industry response to address regulatory concerns regarding the handling of PPI complaints. On 29 September 2009, the FSA issued a consultation paper on PPI complaints handling. The FSA has escalated its regulatory activity in relation to past PPI sales generally and has proposed new guidance on the fair assessment of a complaint and the calculation of redress and a new rule requiring firms to reassess historically rejected complaints. On 9 March, the FSA issued a further consultation paper on this area, the consultation period for which closed on 22 April (the Group has responded to this consultation). The FSA's proposals are materially the same, although it has placed the new rule requiring firms to reassess historically rejected claims on hold for the present.

The statement on 29 September 2009 also announced that several firms had agreed to carry out reviews of past sales of single premium loan protection insurance. The Group has subsequently agreed in principle that it will undertake a review in relation to sales of single premium loan protection insurance made through its branch network since 1 July 2007. The precise details of the review are still being discussed with the FSA. The ultimate impact on the Group of any review and/or the FSA's complaints handling proposals can only be known at the conclusion of these discussions and on publication of the FSA's final rules.

### **US ECONOMIC SANCTIONS**

Starting in 2007 Lloyds TSB Bank plc provided information in relation to its review of historic US Dollar payments involving countries, persons or entities subject to US economic sanctions administered by the Office of Foreign Assets Control (OFAC) to a number of authorities reported to be conducting a review of sanctions compliance by non-US financial institutions. On 9 January 2009 the settlement reached by Lloyds TSB Bank plc with both the US Department of Justice and the New York County District Attorney's Office in relation to their investigations was announced. The

## BUSINESS

settlement documentation contains details of the results of the investigations including the identification of certain activities relating to Iran, Sudan and Libya which Lloyds TSB Bank plc conducted during the relevant period. In 2008, Lloyds TSB Bank plc made a provision of £180 million which fully covered the settlement amount paid to the Department of Justice and the New York District Attorney's Office. On 22 December 2009 OFAC announced the settlement it had reached with Lloyds TSB Bank plc in relation to its investigation and confirmed that the settlement sum due to OFAC had been fully satisfied by Lloyds TSB Bank plc's payment to the Department of Justice and the New York District Attorney's Office. No further enforcement actions are expected in relation to the matters set out in the settlement agreements. A purported shareholder filed a derivative civil action in the Supreme Court of New York, Nassau County on 26 February 2009 against certain current and former directors, and nominally against Lloyds TSB Bank plc and the Company, seeking various forms of relief following the settlement. The derivative action is at a very early stage, but the ultimate outcome of the action is not expected to have a material impact on the Group.

## OTHER LEGAL ACTIONS

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

## COMPETITIVE ENVIRONMENT

The Group is a diversified UK based financial services group providing a wide range of banking and financial services, predominantly in the UK, to personal and corporate customers. Its main business activities are retail, commercial and corporate banking, general insurance, and life, pensions and investment provision.

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

The Group's businesses are subject to inherent risks arising from general and sector-specific economic conditions in the markets in which it operates, particularly the United Kingdom in which the Group's earnings are predominantly generated. Following the acquisition of HBOS, the Group now has greater exposure in a number of other jurisdictions; these include Ireland, Australia and the United States, and hence the Group is exposed to general and sector-specific economic conditions in these markets. Over approximately the past two and a half years, the global economy and the global financial system have been experiencing a period of significant turbulence and uncertainty, particularly the very severe dislocation of the financial markets around the world that began in August 2007 but substantially worsened in September 2008 and has contributed to related problems at many large global and UK commercial banks, investment banks, insurance companies and other financial and related institutions.

UK Government, EU or other intervention in the banking sector may impact the competitive position of banks within a country and among international competitors which may be subject to different forms of intervention, thus potentially putting the Group at a competitive disadvantage to other banks.

## RECENT DEVELOPMENTS

### SHARE CAPITAL

As part of the Group's recapitalisation and withdrawal from its proposed participation in the Government Asset Protection Scheme the Group announced on 23 November 2009 that an aggregate amount of £1.48 billion would be issued in the form of new ordinary shares of Lloyds Banking Group plc in exchange for certain existing preference shares and preferred securities. The conversion price was determined as the five day weighted average price for the five trading days ending on 11 February 2010.

On 18 February 2010, the exchange completed and 3,141 million ordinary shares in Lloyds Banking Group plc were issued as consideration for the redemption of preference shares and preferred securities. In accordance with the Group's accounting policy in

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respect of debt for equity exchanges, a gain of £85 million will be recognised on this exchange transaction in the year ended 31 December 2010.

### **SALE OF ESURE**

On 11 February 2010, the Group announced the sale of its 70 per cent stake in esure, the online insurer, to a management buyout vehicle to be called esure Group Holdings Limited, led by the esure chairman, for a cash consideration slightly in excess of book value in the Lloyds Banking Group accounts. The impact on the Group's accounts is not expected to be material.

### **TRADING UPDATE 19 MARCH 2010**

The Group issued an update on its current trading on 19 March 2010, which included the following comments:

In the first 10 weeks of 2010, the Group's trading performance has been strong and we are pleased with the Group's performance against each area of recent guidance. The banking net interest margin is trending in line with recent guidance and this has supported a good level of income growth, on a combined businesses basis and excluding last year's gains from liability management transactions.

Costs have remained well controlled and are lower than the equivalent period in 2009. Impairment provisions are currently trending at lower levels than anticipated and as a result the Group now expects to deliver a better impairment performance than previously guided, in both the retail and corporate businesses, in 2010. Overall, based on the Group's current economic and regulatory assumptions which remain unchanged since our recent 2009 preliminary results announcement, the Group believes that it will be profitable on a combined businesses basis (see *Operating and financial review and prospects - Line of business information 2009 compared to 2008* and *Combined businesses basis summary - 2009 compared with 2008*) in 2010.

### **BOARD CHANGES**

On 11 February 2010, the Group announced the appointment of Glen Moreno and David Roberts as directors with effect from 1 March 2010. On 22 March 2010, the Group announced that Dr Wolfgang Berndt would retire as a director at the annual general meeting on 6 May 2010.

## BUSINESS

### INTERIM MANAGEMENT STATEMENT

The Group issued an Interim Management Statement on 27 April 2010, which included the following comments:

*The Group is continuing to see positive trends in line with our recent trading update on 19 March 2010. In particular, impairments have slowed significantly in the first few months of the year giving us confidence that we will achieve a better financial performance than previously guided. I am pleased to report that we returned to profitability in the first quarter and expect this momentum to be sustained throughout 2010.*

Eric Daniels  
Group Chief Executive

#### Key highlights

In the first quarter of 2010 the Group returned to profitability on a combined businesses basis due mainly to a significant slowing of impairments in the wholesale business (see *Operating and financial review and prospects Line of business information 2009 compared to 2008* and *Combined businesses basis summary 2009 compared to 2008*).

The Group is delivering good income growth, on a combined businesses basis, excluding last year's impact from liability management transactions.

Banking net interest margins are running in line with recent guidance of circa 2 per cent for the full year.

Costs continue to be well controlled and remain lower than the equivalent period in 2009. Integration savings are being delivered in line with recent guidance and the Group remains on track to achieve a £2 billion run-rate of synergies and other operating efficiencies by the end of 2011.

The run rate of impairments has slowed significantly and has continued to perform better than our 2009 preliminary results guidance in both retail and corporate businesses.

Customer deposit gathering has remained robust, with good growth in balances, while lending balances are flat. Asset reductions within the Group's portfolios identified for run-off continue albeit, as expected, at a slower pace than last year.

The Group continues to de-risk its funding position, with strong term issuance in the early part of the year while continuing to maintain high levels of liquid assets.

#### **Good trading performance with guidance reaffirmed**

The Group is continuing to see good income growth on a combined businesses basis (excluding the impact of liability management exercises). In particular, margin improvements have more than offset the impact of asset reductions over the last year.

Overall banking margins are trending positively and we continue to be confident of delivering a circa 2 per cent margin for the full year.

Income in the Group's core banking businesses has continued to benefit from higher asset pricing and lower funding costs. Good progress continues to be made in improving the quality of both sides of our balance sheet as we continue to grow our customer relationship focused assets and deposits, whilst running down our non-core assets. Deposit gathering activities during the first quarter have seen continued good momentum, particularly in the Retail business where we have built on the strong product sales over the last 12 months and delivered good levels of growth in both current account and savings balances. In our Wealth business income levels were supported further by improved equity market conditions.

In Insurance, new business sales are modestly lower than the equivalent period of last year. However our decision in 2009 to refocus certain product offerings to improve returns is having a favourable impact on the profitability of those products.

The Group's strong track record of effective cost control continues to yield benefit. The integration programme is progressing well and synergy savings continue to be delivered in line with the recent guidance. As a result, the Group remains on track to deliver on its commitment to a £2 billion run-rate of synergies and other operating efficiencies by the end of 2011.

Impairments have slowed significantly as a result of proactive management and more benign economic conditions and we continue to see lower impairments in both our Retail secured and unsecured lending portfolios. In our Wholesale division, the level of impairments has been significantly lower than the last quarter of 2009 and is also at a lower level than our initial expectations for 2010. In our Wealth and International division, impairments continue at a high level, principally as a result of further provisions in Ireland relating to our commercial real estate portfolio; however, the level of impairments in the first quarter of 2010 was lower than the last quarter of 2009 and we continue to believe that we are past the peak for impairment losses in the division. We remain vigilant to changes in economic conditions and to individual lending positions and continue to monitor the position of the Irish economy in particular.

The Group is pleased to have returned to profitability, on a combined businesses basis, in the first quarter. Based on the Group's current economic and regulatory assumptions we expect this trend to continue and for the Group to deliver a combined businesses profit at both the half and full year.

#### **Further strengthening of the balance sheet position**

Customer deposits have grown robustly during the first quarter by over £5 billion, mainly in our Retail division. We are supporting our relationship customers and the economy by continuing to lend. Lending balances have remained flat overall, with assets within the Group's run-off portfolios continuing to reduce, albeit at a slower pace than last year. Our assets continue to be appropriately priced for risk and funding costs and risk-weighted assets remain broadly unchanged to the position at the end of 2009.

Since the start of 2010, we have seen further improvements in wholesale funding market conditions and we are pleased with progress on our public term issuance so far this year. The Group continues to maintain a substantial liquid asset portfolio which is now broadly equivalent to the proportion of our wholesale funding (including bank deposits) which has a maturity of less than one year. In addition, the Group has maintained the maturity profile of wholesale funding such that 50 per cent has a maturity date of over one year.

As a result, the Group has continued to improve its liquidity and funding position, further de-risking the balance sheet.

The foregoing trading update and interim management statement include certain forward looking statements with respect to management's expectations for the Group's financial condition and performance, which by their nature involve risk and uncertainty. See *Forward looking statements* and *Risk factors* for a discussion of factors that could cause actual results to differ materially from the expectations expressed in such forward looking statements.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

### TABLE OF CONTENTS

<u>Overview and trend information</u>	12
<u>Critical accounting policies</u>	13
<u>Future accounting developments</u>	13
<u>Results of operations – 2009, 2008 and 2007</u>	13
<u>Economic profit</u>	23
<u>Integration</u>	24
<u>Line of business information</u>	25
<u>Average balance sheet and net interest income</u>	53
<u>Changes in net interest income – volume and rate analysis</u>	56
<u>Risk management</u>	57
<u>Credit risk</u>	64
<u>Loan portfolio</u>	67
<u>Risk elements in the loan portfolio</u>	72
<u>Market risk</u>	77
<u>Insurance risk</u>	80
<u>Operational risk</u>	81
<u>Financial soundness</u>	83

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### OVERVIEW AND TREND INFORMATION

#### THE ECONOMY

2009 has been a mixed year in terms of economic developments. With an estimated fall of 5 per cent, UK GDP growth was towards the bottom end of the Group's, and the market's, range of expectations. The UK experienced the biggest recorded single-year GDP fall since the 1930s, and the peak to trough decline in GDP currently matches the early 1980s recession (see chart 1). The downturn in most other industrialised economies was of similar magnitude. In response, official interest rates have fallen to their lowest level since the Bank of England was founded. Interest rates elsewhere have also fallen to extremely low levels.

CHART 1:

#### UK GDP IN THE LAST THREE RECESSIONS

CHART 2:

#### UK EMPLOYMENT IN THE LAST THREE RECESSIONS

CHART 3:

#### UK COMPANY FAILURES IN THE LAST THREE RECESSIONS

Perhaps partly in response to such low interest rates, other economic indicators have not turned out so badly in 2009 as many had feared.

At the beginning of the year, most commentators would have expected such a sharp drop in GDP to result in much worse unemployment numbers than has been the case. In fact, employment has held up quite well given the severity of the decline in GDP (see chart 2). Similarly, the rate of company failures so far in this downturn has been lower than might have been expected given the severity of the GDP decline (see chart 3).

Companies went into this recession in better shape generally than during the last recession, and seem to have taken early action to cut investment, stocks and working hours. Helped by very low interest rates, the aggregate financial position of the corporate sector has remained strong. This has undoubtedly helped to limit failure rates. And this in turn has probably helped to limit the rise in unemployment – the biggest single cause of job losses in most recessions is business failure.

Meanwhile, property prices have also held up better than many forecasters had expected. At the beginning of the year, the average view was that house prices would fall by around 15 per cent during 2009, and decline further in 2010. In fact, the Halifax house price index ended the year higher than twelve months earlier, and other indices showed a similar picture. House prices fell during the early part of the year, but then started to recover in the second half and finished the year still above long-term average levels relative to household incomes, albeit well down on their peak in 2007.



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Commercial property prices showed a similar recovery. Having fallen sharply in late 2008 and early 2009, commercial property capital values have stabilised recently, despite continued falls in rental values, and many forecasts for 2009 and 2010 have been revised up. At the end of 2009, the consensus forecast was for modest growth in capital values this year and next, even as rental values decline further.

Looking forward, the most likely immediate economic scenario is one of slow and erratic growth. GDP is estimated to have begun to recover in Q4 2009, and may even have done so earlier once final revisions are made to earlier estimates for Q3. Survey evidence, including purchasing manager indices, was pointing to positive growth in manufacturing and services for most of the second half of 2009. Retail sales growth accelerated in late 2009, although some of this may have been spending brought forward to beat the restoration of Value Added Tax (a UK sales tax) to 17.5 per cent. Unemployment appears to have levelled off, at least temporarily, and actually fell in late 2009. Financial market conditions have continued to normalise, in line with the improving economic outlook. The consensus forecast for 2010 has risen gradually, and by the end of 2009 was suggesting 2010 GDP growth of around 1.5 per cent, close to the Group's own central scenario. This slow recovery is consistent with the sort of upturn seen after past financial crises. But even that below-trend growth relies mainly on a recovery in net external trade and an end to company destocking. Domestic demand growth is likely to be minimal in 2010.

Alternative scenarios remain possible. The Bank of England's most likely outcome, as published in the February 2010 Inflation Report, is for a somewhat faster recovery during 2010 than the consensus forecast. However, the risks around that are skewed towards the downside.

It is possible that the economy will dip again if hit by some new shock – and what might start as a temporary setback to recovery could have longer-lasting effects if it damages consumer, business or financial market confidence. Furthermore, uncertainties remain about how the economy will respond as and when the Bank of England begins to reverse quantitative easing and restore interest rates to more normal levels, and the Government begins to take action to reduce the large fiscal deficit.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### IMPACT ON OUR MARKETS

2009 was a year of weakening growth in most of the Group's markets. On the retail side, net new market mortgage lending (i.e. new lending minus repayments) was very low throughout 2009, as a result of which growth in outstanding balances slowed to around 1 per cent by year end. Net new market unsecured consumer lending was very weak in the first half of the year, and turned negative in the second half.

Weakening lending growth appears to have been driven by both supply and demand. Some lenders have pulled back from the market, especially from higher-risk segments. But at the same time, data on the Group's retail customers shows that they have reacted to the recession by prioritising reducing debt. This trend is apparent across all the Group's customer groups, whether split by age, income, or indebtedness. This helps to explain why market deposit growth also weakened in 2009, despite a higher national saving ratio. Households have on average chosen to use the cash freed up by reduced spending and lower debt interest payments to pay off debt rather than save more.

Market mortgage arrears rose during the first half of 2009, but then fell back in the second half. Market credit card arrears also fell during the second half. Improving arrears trends may have been helped by households starting to pay down debt. And many mortgage borrowers will have found their debt servicing costs reduced during 2009 as their variable mortgage rates fell or as their fixed rate loans expired and they rolled off onto lower standard variable rates. Quite strong growth in the average household's real disposable income in 2009 will also have helped, aided by better-than-expected employment levels in the second half and falling inflation.

Businesses also appear to have used 2009 to strengthen their financial position where possible. Sharp cutbacks in investment spending, and in stocks, have enabled businesses in aggregate to remain in financial surplus and reduce their reliance on external credit from banks, trade creditors and others. Large companies have also taken advantage of the recovery in financial markets to increase capital market borrowing thereby further reducing bank credit demand. As a result, the outstanding stock of bank and building society lending to private non-financial businesses declined in 2009, and corporate deposits returned to positive growth despite the weakness of demand in many companies' markets. Strengthened corporate finances were probably a major factor limiting the growth in company failures in 2009. Indeed, as chart 3 shows, the rate of company failures reduced in the second half of 2009.

The Group expects that the weakness of likely economic recovery will be mirrored in slow growth of major banking markets in 2010 as both households and businesses continue to restructure their finances. However, 2010 may see company failure rates rise again, since it is typically when companies have to restock to meet an upturn in demand that the financial pressures on them are greatest.

### CRITICAL ACCOUNTING POLICIES

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

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

### FUTURE ACCOUNTING DEVELOPMENTS

Future developments in relation to the Group's IFRS reporting are discussed in note 56 to the consolidated financial statements.

## RESULTS OF OPERATIONS 2009, 2008 AND 2007

### SUMMARY

2009	2008 <sup>1</sup>	2007 <sup>1</sup>
£m	£m	£m

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Net interest income	<b>9,026</b>	7,718	6,099
Other income	<b>36,271</b>	(709)	12,119
<b>Total income</b>	<b>45,297</b>	7,009	18,218
Insurance claims	<b>(22,019)</b>	2,859	(7,522)
<b>Total income, net of insurance claims</b>	<b>23,278</b>	9,868	10,696
Operating expenses	<b>(15,984)</b>	(6,100)	(5,568)
<b>Trading surplus</b>	<b>7,294</b>	3,768	5,128
Impairment	<b>(16,673)</b>	(3,012)	(1,796)
Share of results of joint ventures and associates	<b>(752)</b>	4	10
Gain on acquisition	<b>11,173</b>		
Profit on sale of businesses			657
<b>Profit before tax</b>	<b>1,042</b>	760	3,999
Taxation	<b>1,911</b>	38	(679)
<b>Profit for the year</b>	<b>2,953</b>	798	3,320
Profit attributable to minority interests	<b>126</b>	26	32
Profit attributable to equity shareholders	<b>2,827</b>	772	3,288
<b>Profit for the year</b>	<b>2,953</b>	798	3,320

<sup>1</sup> Restated for IFRS 2 (Revised).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 2009 COMPARED WITH 2008

Profit before tax was £282 million, or 37 per cent, higher at £1,042 million in 2009 compared to £760 million in 2008; however, the profit in 2009 included a negative goodwill credit of £11,173 million in relation to the acquisition of HBOS plc by the Group; a fee of £2,500 million paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme; and significant post-acquisition impairment losses in respect of the HBOS portfolios.

Total income increased by £38,288 million to £45,297 million in 2009 compared to £7,009 million in 2008. Excluding the total income of £23,240 million arising on the consolidation of HBOS's post-acquisition results, total income was £15,048 million higher at £22,057 million in 2009 compared to £7,009 million in 2008; with a reduction in the Group's net interest income being more than offset by a large increase in other income.

Net interest income was £1,308 million, or 17 per cent, higher at £9,026 million in 2009 compared to £7,718 million in 2008. Excluding the net interest income of £4,049 million arising on the consolidation of HBOS's post-acquisition results, net interest income was £2,741 million, or 36 per cent, lower at £4,977 million in 2009 compared to £7,718 million in 2008. Excluding the interest flows arising on the consolidation of HBOS's post-acquisition results, both interest income and interest expense fell in response to the historically low interest rate environment that prevailed throughout 2009; net interest income was reduced as the benefit of higher asset pricing was more than offset by the impact of lower deposit margins, reflecting the impact of falling base rates, and higher funding costs, which included the impact of the Group extending its wholesale funding maturity profile. The Group's net interest margin decreased by 157 basis points to 1.06 per cent in 2009 compared to 2.63 per cent in 2008 with reductions across the Group's businesses.

Other income was £36,980 million higher at £36,271 million in 2009 compared to a deficit of £709 million in 2008. Fee and commission income was £1,023 million, or 32 per cent, higher at £4,254 million in 2009 compared to £3,231 million in 2008. However, excluding the fee and commission income which arose on the consolidation of HBOS's post-acquisition results, fee and commission income was £479 million, or 15 per cent, lower at £2,752 million in 2009 compared to £3,231 million in 2008, largely due to a £424 million reduction in insurance broking income as a result of a market-wide move to monthly premiums on payment protection products. Net trading income improved by £28,284 million to net income of £19,098 million in 2009 compared to a net loss of £9,186 million in 2008. Excluding net trading income of £12,093 million arising from the consolidation of the post-acquisition results of HBOS, net trading income improved by £16,191 million to net income of £7,005 million in 2009 compared to a net loss of £9,186 million in 2008. Trading income in 2008 in the Group's banking operations was particularly impacted by market dislocation, leading to significant downwards valuations on a number of assets; this was not repeated in 2009. In addition there was an improvement of £14,179 million in gains on policyholder investments held in the Group's insurance businesses (and largely offset by an increase in the claims expense, see below) as the improvement in market conditions has led to trading profits in 2009, compared to substantial losses in 2008. During 2009 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs.

Insurance claims were £24,878 million higher at an expense of £22,019 million in 2009 compared to a credit of £2,859 million in 2008. Excluding the insurance claims expense of £12,385 million arising on the consolidation of HBOS's post-acquisition results, insurance claims were £12,493 million higher at an expense of £9,634 million in 2009 compared to a credit of £2,859 million in 2008. The insurance claims amount in respect of life and pensions business in 2008 was a credit of £3,052 million as a result of the negative returns in that year on policyholder investments in the long-term insurance business which led to a reduction in insurance related liabilities and a credit to the insurance claims expense; positive returns in 2009 have led to the return to an insurance claims expense with the movement in claims being broadly matched by an improvement in net trading income reflecting the gains on policyholder investments. Insurance claims in respect of general insurance business were £441 million higher at £634 million in 2009 compared to £193 million in 2008. Excluding the general insurance claims of £362 million arising on the consolidation of HBOS's post-acquisition results, general insurance claims were £79 million, or 41 per cent, higher at £272 million in 2009 compared to £193 million in 2008, this was due primarily to higher payment protection insurance claims related to unemployment.

Operating expenses increased by £9,884 million, or 162 per cent, to £15,984 million in 2009 compared to £6,100 million in 2008. Excluding the operating expenses of £6,456 million arising on the consolidation of HBOS's post-acquisition results, operating expenses were £3,428 million, or 56 per cent, higher at £9,528 million in 2009 compared to £6,100 million in 2008; this increase principally reflects the £2,500 million fee paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme, costs of £635 million borne within the Lloyds TSB businesses in respect of the integration of the enlarged group and an increased charge in respect of goodwill impairment, only partly offset by the fact that operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments which was not repeated in

2009. Staff costs were £3,697 million, or 124 per cent, higher at £6,675 million compared to £2,978 million in 2008. Excluding the staff costs of £3,014 million that arose on consolidation of the post-acquisition results of HBOS, staff costs were £683 million, or 23 per cent, higher at £3,661 million in 2009 compared to £2,978 million in 2008, with particular increases in restructuring costs and other staff costs (reflecting increased use of agency staff in relation to the integration programme). Premises and equipment costs were £506 million, or 78 per cent, higher at £1,156 million in 2009 compared to £650 million in 2008. Excluding the premises and equipment costs that arose on the consolidation of the post-acquisition results of HBOS, premises and equipment costs were £84 million, or 13 per cent, higher at £734 million in 2009 compared to £650 million in 2008. Other expenses were £1,167 million, or 69 per cent, higher at £2,853 million in 2009 compared to £1,686 million in 2008. Excluding the £1,185 million of costs that arose on consolidation of the post-acquisition results of HBOS, other costs were £18 million, or 1 per cent, lower at £1,668 million in 2009 compared to £1,686 million in 2008; however operating expenses in 2008 included the £180 million settlement in relation to certain historic US dollar payments and, excluding this, operating expenses excluding HBOS in 2009 were £162 million, or 11 per cent, higher at £1,668 million compared to £1,506 million in 2008. Depreciation and amortisation costs were £1,874 million higher at £2,560 million compared to £686 million in 2008; £1,813 million of this increase reflects the impact of consolidation of the post-acquisition results of HBOS. A charge of £240 million (2008: £100 million) arose in respect of the impairment of goodwill attributable to the Group's asset finance business.

Impairment losses increased by £13,661 million to £16,673 million in 2009 compared to £3,012 million in 2008. Excluding the impairment losses of £12,257 million arising from the consolidation of HBOS's post-acquisition results, impairment losses were £1,404 million, or 47 per cent, higher at £4,416 million in 2009 compared to a £3,012 million in 2008; this increase includes £1,664 million in respect of loans and advances to customers and reflects the substantial deterioration in the credit environment; partly offset by a reduction in the charge in respect of loans and advances to banks and other impairment provisions. During 2009, following the acquisition of HBOS, the Group has experienced a significant rise in impairment levels in its lending portfolios. This largely represents falls in the value of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. The Group has spent a significant amount of time analysing and addressing the issues in the legacy HBOS portfolios, with the greatest attention paid to the over-concentration in real estate related lending and those portfolios that fall outside of the Lloyds TSB risk appetite; and, as a consequence, the Group has taken prudent and material impairment charges in the period following the acquisition.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group's share of results of joint ventures and associates was a net loss of £752 million compared to a net profit of £4 million in 2008. However, excluding the losses of £755 million arising on the consolidation of HBOS's post-acquisition results, the share of results of joint ventures and associates was £1 million, or 25 per cent, lower at a profit of £3 million compared to a profit of £4 million in 2008.

On 16 January 2009, the Group acquired 100 per cent of the ordinary share capital of HBOS plc. The consideration for the acquisition of HBOS comprised the issue of 7,776 million ordinary shares in Lloyds Banking Group plc together with the costs of acquisition. In determining the fair value of the consideration, the Company used the share price of its equity securities quoted on the London Stock Exchange, as at the date of completion. As the fair value of the identifiable net assets acquired was greater than the total consideration paid, negative goodwill of £11,173 million arose on the acquisition. The negative goodwill is recognised as 'Gain on acquisition' in the income statement for the year ended 31 December 2009.

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

On the date that the acquisition was announced (18 September 2008) the implied goodwill was a small positive amount based on the share price of the Company and the originally announced conversion factor of 0.833 Lloyds Banking Group plc shares for each HBOS share. However, a number of factors led to negative goodwill being recognised on completion of the transaction. By the time of the recommended offer, it had become increasingly difficult for HBOS to raise funds in wholesale markets and HBOS faced an outflow of customer deposits, reflecting reduced investor and depositor confidence. Subsequent to the announcement of the offer, turbulence in the markets continued, fuelled by concerns about credit risk and worsening economic conditions. For HBOS, confidence continued to deteriorate amid ongoing funding difficulties and concerns over the extent of future credit losses. Measures by national authorities and central banks failed to stem this turbulence and the UK Government decided in October 2008 that it would be appropriate for the UK banking sector to increase its level of capitalisation. The capital raising, underwritten by the UK Government, was made available to HBOS on condition that the acquisition by the Company completed. As a consequence of the capital that HBOS was required to issue and the impact of market conditions on the future prospects of the new group, the terms of the final agreed offer were revised down to a ratio of 0.605. Additionally, the share price of the Company fell from 280p at the date of the announcement to 98.4p on 15 January 2009 reflecting both the dilutive impact of the capital that the Company raised and the turmoil in the banking sector and equity markets in general. These factors combined to reduce the value of the consideration for HBOS.

In 2009, the Group recorded a tax credit of £1,911 million compared to a tax credit of £38 million in 2008. The tax credit in 2009 on a profit before tax of £1,042 million reflects the fact that the gain on acquisition of £11,173 million is not taxable, partly offset by the impact of losses in joint ventures and associates, losses where no deferred tax is provided and the tax charge attributable to UK life insurance policyholders and the Group's interests in Open Ended Investment Companies (OEICs), which is required to be included within the income tax credit.

Total assets were £591,222 million higher at £1,027,255 million at 31 December 2009 compared to £436,033 million at 31 December 2008; loans and advances to customers were £386,625 million higher at £626,969 million at 31 December 2009 compared to £240,344 million at 31 December 2008; and customer deposits were £235,803 million higher at £406,741 million at 31 December 2009 compared to £170,938 million at 31 December 2008. These increases reflect the impact of the HBOS acquisition and, after allowing for the acquisition, total assets have reduced as the Group has commenced its announced strategy to reduce assets associated with non-relationship lending and investments, including business which is outside the Group's current risk appetite. During 2009, the Group identified approximately £300 billion of such assets; it is the Group's intention to manage these assets for value and, given the current economic climate, the primary focus will be on running these assets down over time. Over the next five years, the Group expects to achieve a reduction in these assets of approximately £200 billion (customer lending approximately £140 billion; treasury assets £60 billion). During 2009, this portfolio of assets reduced by some £60 billion. Subsequent to the HBOS acquisition, the Group's loans and advances to customers have decreased as a result of the alignment of heritage risk appetites in Retail, a reduction in wholesale lending in Corporate Markets and a reduction in Wealth and International; customer deposits also decreased as growth in Retail was offset by the planned reduction in higher interest paying term deposits elsewhere.

The Group's credit market exposures primarily relate to asset-backed securities exposures held in the Wholesale division; on the balance sheet these exposures are classified as loans and receivables, available-for-sale or trading and other financial assets at fair value through profit or loss depending on the nature of the investment. A detailed analysis of the Group's asset-backed security exposures is provided in note 54 to the consolidated financial statements on page F-110. The total exposure to asset-backed

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securities has increased by £29,769 million from £16,521 million at 31 December 2008 to £46,290 million at 31 December 2009; however £31,010 million of these assets arise within the heritage HBOS business and, excluding these, total exposure to asset-backed securities was £1,241 million lower at £15,280 million at 31 December 2009 compared to £16,521 million at 31 December 2008.

Mortgage-backed security exposures were £11,817 million higher at £18,218 million, although excluding the heritage HBOS exposures they were £1,303 million lower at £5,098 million compared to £6,401 million at 31 December 2008. Exposures to Alt-A US residential mortgage-backed securities were £3,479 million higher, although adjusting for the heritage HBOS assets they were £167 million lower at £321 million compared to £488 million at 31 December 2008; there is no exposure to sub-prime US residential mortgage-backed securities.

For credit market exposures the Group's approach is to analyse the underlying transaction to determine whether it needs to place reliance on any protection provided by an insurer or guarantor. In note 54 to the consolidated financial statements on page F-111 the Group discloses its exposures where reliance is placed on monoline insurers, which are limited to a total of £444 million at 31 December 2009. Of this total exposure, £436 million is rated AA with the remaining £8 million being sub-investment grade.

At the end of December 2009, the Group's capital ratios, following the capital raising in December 2009, increased with a total capital ratio on a Basel II basis of 12.4 per cent (compared to 11.2 per cent at 31 December 2008), a tier 1 ratio of 9.6 per cent (compared to 8.0 per cent at 31 December 2008) and a core tier 1 ratio of 8.1 per cent (compared to 5.6 per cent at 31 December 2008). During 2009, risk-weighted assets increased by £322,817 million to £493,307 million compared to £170,490 million at 31 December 2008; this increase reflects the impact of the HBOS acquisition and, after allowing for the acquisition, there was a small decrease in risk-weighted assets as the effect of a reduction in balance sheet assets was partly offset by the procyclical impact of the weaker economic environment.

### **2008 COMPARED WITH 2007**

The Group's profit before tax in 2008 was £3,239 million, or 81 per cent, lower at £760 million compared to £3,999 million in 2007. Profit attributable to equity shareholders was £2,516 million, or 77 per cent, lower at £772 million compared to £3,288 million in 2007. Earnings per share were 22.2p, or 77 per cent, lower at 6.7p compared to 28.9p in 2007.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Net interest income increased by £1,619 million, or 27 per cent, to £7,718 million in 2008 from £6,099 million in 2007. Average interest-earning assets increased by £34,167 million, or 14 per cent, to £282,400 million in 2008 from £248,233 million in 2007, excluding the fine margin reverse repurchase agreement assets (instruments held for funding and liquidity purposes which are efficient in terms of regulatory capital requirements and on which, as a consequence, small interest margins are earned). The increase in average interest-earning assets consisted principally of an £8,652 million, or 9 per cent, rise in average retail mortgages and a £7,331 million, or 18 per cent, rise in corporate lending balances.

The net interest margin was 30 basis points higher at 2.63 per cent, or 27 basis points higher at 2.73 per cent excluding the fine margin reverse repurchase agreement assets. The increase in net interest margin largely reflected an improvement in margins on the unsecured lending products within UK Retail Banking, in Asset Finance and in Corporate Markets, partially offset by a deterioration in Commercial Banking margins as a result of an increase in the proportion of secured, lower margin lending; the margin within UK Retail Banking increased by 9 basis points and the margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 27 basis points higher.

Other income was a net expense of £709 million compared with net income of £12,119 million in 2007. The decrease of £12,828 million principally resulted from a decrease of £12,309 million in net trading income, with smaller decreases in net fee and commission income, of £87 million, other operating income, of £414 million, and insurance premium income, of £18 million. The reduction in net trading income principally arose in the Group's insurance businesses and arose from the losses on policyholder investments; this decrease was broadly matched by a reduction in the insurance claims expense and on other lines within the income statement. Net trading income in Corporate Markets was also adversely affected by the impact of the continued market turmoil in 2008. Fees and commissions receivable were £7 million higher at £3,231 million compared to £3,224 million in 2007; increases in fees from corporate banking and card services were largely offset by a reduction in fees from insurance broking and as a result of disposals in 2007. Fees and commissions payable were £94 million, or 16 per cent, higher at £694 million compared to £600 million in 2007 as a result of increases in fees payable related to added-value account packages and cards, in both cases as a result of increased business volumes. Other operating income was £414 million, or 44 per cent, lower at £528 million compared with £942 million in 2007. The majority of this reduction resulted from the deterioration of the value of in-force asset in the insurance business.

The insurance claims expense was a credit of £2,859 million in 2008 compared with an expense of £7,522 million in 2007. The negative returns in 2008 on policyholder investments in the long-term insurance business have led to a reduction in insurance-related liabilities and a credit to the insurance claims expense. The charge in respect of general insurance was £109 million, or 36 per cent, lower at £193 million in 2008 compared to £302 million in 2007, principally reflecting the absence in 2008 of the severe weather related claims experienced in 2007.

Operating expenses were £532 million, or 10 per cent, higher at £6,100 million compared to £5,568 million in 2007. Operating expenses in 2008 included provisions in respect of certain historic US dollar payments and in respect of a Financial Services Compensation Scheme levy of £180 million and £122 million, respectively, and operating expenses in 2007 included £76 million in respect of the settlement of overdraft claims (see *Operating expenses* for more detail on these items). Staff costs were £73 million, or 3 per cent, higher at £2,978 million compared with £2,905 million in 2007. Salaries were £102 million higher at £2,230 million as the decrease in costs resulting from the sale of businesses in 2007 was more than offset by annual pay awards and an increased charge in respect of share-based compensation. Social security and pension and other post-retirement costs were broadly flat at £411 million in 2008 compared with £405 million in 2007. There was a decrease of £53 million in redundancy costs as the level of particular restructuring initiatives seen in 2007 was not repeated in 2008. Other staff costs were £18 million, or 6 per cent, higher at £323 million in 2008 as a result of a further increase in agency staff costs (used to cover project work). Excluding the provisions in respect of certain historic US dollar payments and in respect of the Financial Services Compensation Scheme levy in 2008 and the settlement of overdraft claims in 2007, other administrative expenses increased £77 million, or 4 per cent, to £2,034 million in 2008 from £1,957 million in 2007.

The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared with £1,796 million in 2007. The 2008 charge comprised a charge of £2,876 million, compared to £1,721 million in 2007, in respect of impairment losses on loans and receivables, a charge of £130 million, compared to £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to £5 million in 2007, relating to other credit risk provisions. In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007; for personal loans and overdrafts the charge increased by £100 million and the charge in respect of mortgages increased by £149 million. The impairment charge as a percentage of average lending was higher at 1.22 per cent compared to 1.10 per cent in 2007. In Wholesale and International Banking the charge in respect of impairment losses on loans and receivables increased by £905 million, or 182 per cent, to £1,402 million from £497 million in 2007, reflecting the economic slowdown in the UK and the impact of a number of high profile financial services company collapses. Overall, the Group's charge in respect of impairment losses on loans and receivables expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per



cent in 2007.

In 2007, a profit of £657 million arose on the sale of businesses, principally Abbey Life, a life assurance company, and Lloyds TSB Registrars, the company registration business of the Group.

In 2008, the Group recorded a tax credit of £38 million compared to a tax charge of £679 million in 2007. The tax credit arose as a result of the tax credits attributable to UK life insurance policyholders and the Group's interests in Open Ended Investment Companies (OEICs), which are required to be included within the income tax expense.

At the end of 2008, the total capital ratio was 11.2 per cent compared with 11.0 per cent at the end of 2007. Risk-weighted assets increased by £27,923 million, or 20 per cent; the increase in UK Retail Banking was £4,817 million, or 11 per cent, and in Wholesale and International Banking was £22,821 million, or 25 per cent. Total assets increased by £82,687 million, or 23 per cent, principally as a result of increases in loans and advances to customers, available-for-sale financial assets and derivatives.

The increase in loans and advances to customers and available-for-sale financial assets was in part caused by the strengthening of the US dollar against the pound sterling.

In accordance with the amendment to IAS 39, in 2008 the Group reviewed the categorisation of its assets classified as held for trading and available-for-sale financial assets. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, the Group reclassified £2,993 million of assets classified as held for trading (measured at fair value through profit or loss immediately prior to reclassification) to loans and receivables with effect from 1 July 2008 and £437 million of assets classified as available-for-sale financial assets (measured at fair value through equity) to loans and receivables with effect from 1 November 2008. If the reclassifications had not been made, the Group's income statement for 2008 would have included unrealised fair value losses on the reclassified trading assets of £347 million and an additional impairment charge of £209 million in respect of available-for-sale financial assets.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## NET INTEREST INCOME

	2009	2008	2007
Net interest income £m	<b>9,026</b>	7,718	6,099
Average interest-earning assets £m	<b>849,534</b>	293,967	262,144
Average rates:			
Gross yield on interest-earning assets %	<b>3.32</b>	5.98	6.44
Interest spread %	<b>1.02</b>	2.37	2.20
Net interest margin %	<b>1.06</b>	2.63	2.33
Margin excluding average balances held under reverse repurchase agreements <sup>4</sup> :			
Net interest income £m	<b>9,026</b>	7,718	6,099
Average interest-earning assets £m	<b>841,713</b>	282,400	248,233
Net interest margin %	<b>1.07</b>	2.73	2.46

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.

4 Comparisons of net interest income and margins are impacted by the holdings of fine margin reverse repurchase agreements. To improve comparability, figures are also shown excluding average balances held under reverse repurchase agreements (2009: £7,821 million; 2008: £11,567 million; 2007: £13,911 million).

## 2009 COMPARED WITH 2008

Net interest income was £1,308 million, or 17 per cent, higher at £9,026 million in 2009 compared to £7,718 million in 2008. Excluding the net interest income of £4,049 million arising on the consolidation of HBOS's post-acquisition results, net interest income was £2,741 million, or 36 per cent, lower at £4,977 million in 2009 compared to £7,718 million in 2008.

Excluding the interest flows arising on the consolidation of HBOS's post-acquisition results, both interest income and interest expense fell in response to the historically low interest rate environment that prevailed throughout 2009; net interest income was reduced as the benefit of higher asset pricing was more than offset by the impact of lower deposit margins, reflecting the impact of falling base rates, and higher funding costs, which included the impact of the Group extending its wholesale funding maturity profile.

Average interest-earning assets were £555,567 million higher at £849,534 million in 2009 compared to £293,967 million in 2008. Excluding the average interest-earning assets of £526,630 million arising on the consolidation of HBOS's post-acquisition results, average interest-earning assets were £29,207 million, or 10 per cent, higher at £323,174 million in 2009 compared to £293,967 million in 2008.

Excluding the average interest-earning assets arising on the consolidation of HBOS's post-acquisition results, average personal mortgage balances within Retail were £5,973 million, or 6 per cent, higher at £106,068 million in 2009 compared to £100,095 million in 2008 as a result of the full-year effect on average balances of mortgage growth during 2008; period end mortgage balances being little changed over 2009. Average other personal lending balances within Retail were flat as the full-year effect on average balances of lending growth during 2008 has been offset by the impact of lower lending balances over 2009 as customers have reduced their personal indebtedness and not taken on new financial commitments in the current difficult economic environment. Average interest-earning assets in the Group's other businesses were £23,312 million, or 14 per cent, higher at £190,591 million in 2009 compared to £167,279 million in 2008 as the full year benefit of lending growth over 2008 more than offset the asset reductions in 2009.

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The Group's net interest margin decreased by 157 basis points to 1.06 per cent in 2009 compared to 2.63 per cent in 2008 with reductions across the Group's businesses. Margins in Retail declined as the impact of higher wholesale funding costs and lower deposit margins, in the low base rate environment, was only partly offset by the benefit of higher pricing on lending products. In Wholesale margins were also reduced, again as higher wholesale funding costs were only partly offset by higher asset pricing. Declining margins in Wealth and International reflected reducing base rates, a very competitive deposit environment and the increased funding costs.

### 2008 COMPARED WITH 2007

Net interest income increased by £1,619 million, or 27 per cent, to £7,718 million in 2008 compared to £6,099 million in 2007. Within Insurance and Investments, net interest income was £235 million, or 65 per cent, higher as a result of a further decrease in the amounts payable to unitholders in those OEICs included in the consolidated results of the Group; since these are policyholder items there was no impact on profit attributable to shareholders. For the rest of the Group, net interest income increased by £1,384 million, or 24 per cent, to £7,120 million in 2008 compared to £5,736 million in 2007. This increase arose as a result of both asset growth and an improvement in margins.

Average interest-earning assets were £31,823 million, or 12 per cent, higher at £293,967 million in 2008 compared to £262,144 million in 2007. Excluding the fine margin reverse repurchase agreement assets held for liquidity purposes, average interest-earning assets were £34,167 million, or 14 per cent, higher at £282,400 million in 2008 compared to £248,233 million in 2007. Average interest-earning assets in UK Retail Banking were £9,234 million higher; average mortgage balances were £8,652 million higher, reflecting the Group's significantly increased share of net new mortgage lending, albeit in a reduced total market; and average balances on personal loans and overdrafts were £854 million higher although there was a small reduction in average credit card outstandings. Average interest-earning assets within the Insurance and Investments businesses, which included the mortgage book within Scottish Widows Bank, were £72 million lower; an increase of £722 million in the average mortgage balances was more than offset by a fall in deposit balances held by the consolidated funds. Within Wholesale and International Banking, average interest-earning assets increased by £22,547 million, or £24,891 million excluding the fine margin reverse repurchase agreement balances. Average balances within Corporate Markets, excluding the reverse repurchase agreement balances, were £19,333 million higher as the business improved levels of customer retention and continuing new business opportunities resulted in further growth in corporate lending and there was further balance growth in the lower margin treasury and structured finance areas. Further expansion of the Group's lending to smaller businesses led to a £2,819 million increase in average balances in Commercial Banking, and International Banking average balances were £2,907 million higher (in part reflecting exchange rate movements) although average balances within Asset Finance fell slightly.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group's net interest margin increased by 30 basis points to 2.63 per cent in 2008, compared to 2.33 per cent in 2007; if the average balances held under reverse repurchase agreements are excluded from both years, the margin in 2008 was 27 basis points higher at 2.73 per cent compared to 2.46 per cent in 2007. Within Insurance and Investments, the net interest income consolidated in respect of policyholder items was £190 million higher in 2008, as a result of the £229 million reduction in the amounts payable to unitholders in those OEICs included in the Group's results; this increase contributed some 7 basis points to the increase in the Group's net interest margin, excluding average balances held under reverse repurchase agreements. The net interest margin in UK Retail Banking was 9 basis points higher than in 2007, reflecting improved key product margins, particularly in unsecured personal lending and new mortgages. The margin within Wholesale and International Banking, excluding the fine margin reverse repurchase agreement balances, was 27 basis points higher. Margins continued to fall in Commercial Banking, as a result of a further change in mix towards secured, but lower margin, lending but there were improved margins in Asset Finance and within Corporate Markets. The improvement in margins in Corporate Markets reflected improvements in pricing of new lending and the benefit of favourable funding opportunities.

## OTHER INCOME

	2009 £m	2008 £m	2007 £m
Fee and commission income:			
Current account fees	1,088	707	693
Insurance broking	539	549	648
Credit and debit card fees	765	581	536
Trust and other fiduciary fees	395	413	362
Other	1,467	981	985
	4,254	3,231	3,224
Fee and commission expense	(1,517)	(694)	(600)
Net fee and commission income	2,737	2,537	2,624
Net trading income	19,098	(9,186)	3,123
Insurance premium income	8,946	5,412	5,430
Gain on capital transactions	1,498		
Other operating income	3,992	528	942
<b>Total other income</b>	<b>36,271</b>	<b>(709)</b>	<b>12,119</b>

## 2009 COMPARED WITH 2008

Other income was £36,980 million higher at £36,271 million in 2009 compared to a deficit of £709 million in 2008, as a result of the factors discussed below.

Fee and commission income was £1,023 million, or 32 per cent, higher at £4,254 million in 2009 compared to £3,231 million in 2008. However, excluding the fee and commission income that arose on the consolidation of HBOS's post-acquisition results, fee and commission income was £479 million, or 15 per cent, lower at £2,752 million in 2009 compared to £3,231 million in 2008. The £479 million decrease in fee and commission income excluding the fee income in HBOS is largely due to a £424 million reduction in insurance broking income as a result of a market-wide move to monthly premiums on payment protection products, rather than up-front annual income.

Fee and commission expense was £823 million, or 119 per cent, higher at £1,517 million in 2009 compared to £694 million in 2008. Excluding fees payable of £862 million arising on the consolidation of the post-acquisition results of HBOS, fee and commission expense was £39 million, or 6 per cent, lower at £655 million in 2009 compared to £694 million in 2008 primarily as a result of volume-related reductions in asset management and other fees.

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Net trading income improved by £28,284 million to net income of £19,098 million in 2009 compared to a net loss of £9,186 million in 2008. Excluding net trading income of £12,093 million arising from the consolidation of the post-acquisition results of HBOS, net trading income improved by £16,191 million to net income of £7,005 million in 2009 compared to a net loss of £9,186 million in 2008. Trading income in 2008 in the Group's banking operations was particularly impacted by market dislocation, leading to significant downwards valuations on a number of assets; this was not repeated in 2009. In addition there was an improvement of £14,179 million in gains on policyholder investments held in the Group's insurance businesses (and largely offset by an increase in the claims expense) as the improvement in market conditions has led to trading profits in 2009, compared to substantial losses in 2008.

Insurance premium income was £3,534 million, or 65 per cent, higher at £8,946 million in 2009 compared to £5,412 million in 2008. Excluding the premium income of £4,718 million that arose on consolidation of the post-acquisition results of HBOS, insurance premium income was £1,184 million, or 22 per cent, lower at £4,228 million in 2009 compared to £5,412 million in 2008. Earned premiums in respect of the Group's long-term life and pensions business were £2,660 million, or 55 per cent, higher at £7,460 million in 2009 compared to £4,800 million in 2008. The consolidation of the post-acquisition results of HBOS contributed £3,890 million and, excluding this, premiums were £1,230 million, or 26 per cent, lower at £3,570 million in 2009 compared to £4,800 million in 2008; this reflects reduced new business sales as a result of the general contraction in the UK market. General insurance earned premiums were £874 million higher at £1,486 million in 2009 compared to £612 million in 2008. Excluding premiums of £828 million arising from the consolidation of the post-acquisition results of HBOS, general insurance earned premiums were £46 million, or 8 per cent, higher at £658 million in 2009 compared to £612 million in 2008; this primarily reflects modest growth in home insurance income.

During 2009 the Group exchanged certain existing subordinated debt securities for new securities, these exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs; this gain arose because the balance sheet carrying values of these investments were in excess of market valuations at the time. In the first half of 2009, undated subordinated notes issued by a number of Group companies were exchanged for innovative tier 1 securities and senior unsecured notes issued by Lloyds TSB Bank plc. These exchanges resulted in a gain of £745 million. In July 2009, dated and undated subordinated liabilities issued by Clerical Medical Finance plc were exchanged for senior unsecured notes issued by Lloyds TSB Bank plc resulting in a gain of £30 million. In November 2009, as part of the restructuring plan that was a requirement for

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EC approval of state aid received by the Group, the Group agreed to suspend the payment of coupons and dividends on certain of the Group's preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. This suspension gave rise to a partial extinguishment of the original liability, equivalent to the present value of the suspended cash flows. During December 2009, as part of the Group's recapitalisation and exit from the Government Asset Protection Scheme, certain preference shares, preferred securities and undated subordinated notes were exchanged for enhanced capital notes. These exchanges, together with the partial extinguishment of liabilities arising from the suspension of payments on coupons, resulted in a gain of £723 million.

Other operating income was £3,464 million higher at £3,992 million in 2009 compared to £528 million in 2008; excluding the income of £1,517 million that arose on the consolidation of the post-acquisition results of HBOS, other operating income was £1,947 million higher at £2,475 million in 2009 compared to £528 million in 2008, principally reflecting an improvement in the movement in value of in-force business.

### 2008 COMPARED WITH 2007

Other income was £12,828 million lower at a net deficit of £709 million in 2008 compared to income of £12,119 million in 2007.

Fee and commission income was £7 million higher at £3,231 million in 2008 compared to £3,224 million in 2007. UK current account fees were £14 million higher reflecting growth in the numbers of higher-fee earning accounts during 2008. Insurance broking income was £99 million lower, driven by a sharp decrease in creditor insurance income as a side-effect of the reduced availability of consumer credit. Card fees were £45 million higher; merchant service charges were higher due to continuing growth in the merchant base and interchange income was £25 million higher as a result of increased levels of card usage. Other fees and commissions were £4 million lower at £981 million; continuing increases in factoring fees, corporate banking fees and asset management fees (in part due to the contracts entered into for the ongoing management of Abbey Life funds subsequent to disposal of that business in 2007) were offset by reductions in fees following the sale of Lloyds TSB Registrars and other businesses in 2007.

Fee and commission expense was £94 million, or 16 per cent, higher at £694 million compared to £600 million in 2007. There were increases in fees payable related to added-value account packages, in line with growth in the product, and higher levels of card fees payable as a result of the increased business volumes during 2008. There were also increased levels of fees payable in respect of the Group's fund management activities and within its treasury operations.

Net trading income was £12,309 million lower at a loss of £9,186 million compared to income of £3,123 million in 2007. Of this decrease £10,917 million arose in the insurance businesses and represented reductions in the value of policyholder investments that are required to be reported gross in the income statement; the period-on-period decrease is largely matched by a compensating movement within the insurance claims figure which has moved by £10,381 million from a charge of £7,522 million in 2007 to a credit of £2,859 million in 2008. The remainder of the decrease, £1,392 million, arose within the banking businesses. Like many other financial institutions, the Group's Corporate Markets business has been significantly affected by the ongoing impact of market dislocation; this has led to a charge within trading income of £956 million, compared to a charge of £188 million in 2007. The market dislocation losses largely reflected the impact of continuing mark-to-market adjustments in certain legacy trading portfolios, resulting from the marketwide repricing of liquidity and credit, together with the write-down of a number of asset-backed securities.

Insurance premium income was £18 million lower at £5,412 million compared to £5,430 million in 2007, with life and pensions premiums being £39 million lower at £4,800 million and general insurance premiums £21 million higher at £612 million. The small reduction in life and pensions premiums reflected the impact of the sale of Abbey Life (which accounted for £232 million of the premiums in 2007) and a decrease of £44 million in annuity premiums largely offset by growth in other life and pensions products within the Scottish Widows business. The increase in non-life insurance premiums was due to growth in home insurance income more than offsetting a volume-related decrease in respect of creditor products.

Other operating income was £414 million, or 44 per cent, lower at £528 million compared to £942 million in 2007. The movement in value of in-force business was a reduction of £325 million compared to a reduction of £93 million in 2007, as an improvement in new business income was more than offset by lower income from existing business principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets. There was a reduction of £1 million in operating lease rental income and a reduction of £49 million in car dealership income following the sale of the Dutton Forshaw business in 2007 as well as reductions in other non-fee income.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## OPERATING EXPENSES

	2009 £m	2008 <sup>1</sup> £m	2007 <sup>1</sup> £m
Administrative expenses:			
Staff:			
Salaries	4,369	2,230	2,128
Social security costs	383	176	167
Pensions and other post-retirement benefit schemes	744	235	238
Restructuring costs	412	14	67
Other staff costs	767	323	305
	<b>6,675</b>	<b>2,978</b>	<b>2,905</b>
Premises and equipment:			
Rent and rates	569	318	304
Hire of equipment	20	16	16
Repairs and maintenance	226	151	154
Other	341	165	145
	<b>1,156</b>	<b>650</b>	<b>619</b>
Other expenses:			
Communications and data processing	668	455	462
Advertising and promotion	335	194	192
Professional fees	540	229	279
Other	1,310	808	481
	<b>2,853</b>	<b>1,686</b>	<b>1,414</b>
Depreciation and amortisation:			
Depreciation of tangible fixed assets	1,716	648	594
Amortisation of acquired in-force non-participating investment contracts	75		
Amortisation of other intangible assets	769	38	36
	<b>2,560</b>	<b>686</b>	<b>630</b>
Impairment of goodwill	240	100	
Total operating expenses, excluding Government Asset Protection Scheme fee	<b>13,484</b>	<b>6,100</b>	<b>5,568</b>
Government Asset Protection Scheme fee	<b>2,500</b>		
<b>Total operating expenses</b>	<b>15,984</b>	<b>6,100</b>	<b>5,568</b>
Cost: income ratio (%) <sup>2</sup>	<b>68.7</b>	<b>61.8</b>	<b>52.1</b>

<sup>1</sup> Restated for IFRS 2 (Revised).

<sup>2</sup> Total operating expenses divided by total income, net of insurance claims.

**2009 COMPARED WITH 2008**

Operating expenses increased by £9,884 million, or 162 per cent, to £15,984 million in 2009 compared to £6,100 million in 2008. Excluding the operating expenses of £6,456 million arising on the consolidation of HBOS's post-acquisition results, operating expenses were £3,428 million, or 56 per cent, higher at £9,528 million in 2009 compared to £6,100 million in 2008; this increase principally reflects the £2,500 million fee paid to the UK Government as part of the agreement for the Group not to enter into the Government Asset Protection Scheme, costs of £635 million borne within the Lloyds TSB businesses in respect of the integration of the enlarged Group and an increased charge in respect of goodwill impairment, only partly offset by the fact that operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments which was not repeated in 2009.

Staff costs were £3,697 million, or 124 per cent, higher at £6,675 million compared to £2,978 million in 2008. Excluding the staff costs of £3,014 million that arose on consolidation of the post-acquisition results of HBOS, staff costs were £683 million, or 23 per cent, higher at £3,661 million in 2009 compared to £2,978 million in 2008. Excluding the costs within HBOS, salaries were £87 million, or 4 per cent, higher as the impact of annual pay rises has more than offset staff reductions; pension costs were £128 million higher principally as a result of reduced asset levels in the defined benefit schemes at the end of 2008 which led to a lower expected return; restructuring costs were £209 million higher principally as a result of staff rationalisation as part of the Group integration programme; and other staff costs were £241 million higher, partly reflecting increased use of agency staff in relation to



the integration programme.

Premises and equipment costs were £506 million, or 78 per cent, higher at £1,156 million in 2009 compared to £650 million in 2008. Excluding the premises and equipment costs that arose on the consolidation of the post-acquisition results of HBOS, premises and equipment costs were £84 million, or 13 per cent, higher at £734 million in 2009 compared to £650 million in 2008; rent and rates were £30 million higher, largely as a result of rent reviews, repairs and maintenance were £24 million higher and other premises and equipment costs were £36 million higher.

Other expenses were £1,167 million, or 69 per cent, higher at £2,853 million in 2009 compared to £1,686 million in 2008. Excluding the £1,185 million of costs that arose on consolidation of the post-acquisition results of HBOS, other costs were £18 million, or 1 per cent, lower at £1,668 million in 2009 compared to £1,686 million in 2008; however operating expenses in 2008 included the £180 million settlement in relation to certain historic US dollar payments and, excluding this, operating expenses excluding HBOS in 2009 were £162 million, or 11 per cent, higher at £1,668 million compared to £1,506 million in 2008. On this basis, professional fees were higher as a result of consultancy and other costs incurred in relation to integration, the Group's consideration of the Government Asset Protection Scheme and other strategic projects; there were also increases in communications and data processing costs.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Depreciation and amortisation costs were £1,874 million higher at £2,560 million compared to £686 million in 2008. Depreciation of tangible fixed assets was £1,068 million higher at £1,716 million compared to £648 million in 2008; £1,035 million of this increase reflects the impact of consolidation of the post-acquisition results of HBOS. Amortisation of £75 million in respect of the acquired value of in-force non-participating investment contracts and £703 million in respect of acquisition-related intangibles (brands, core deposit intangibles, purchased credit card relationships and other customer related intangibles) arose from the acquisition of HBOS.

A charge of £240 million (2008: £100 million) arose in respect of the impairment of goodwill. The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group's Asset Finance business, for which an impairment charge of £100 million was recognised in the Group's financial statements for the year ended 31 December 2008, has been further reviewed for impairment due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit in Asset Finance (within Wholesale division) has been reassessed resulting in an additional goodwill impairment charge of £240 million in the year ended 31 December 2009.

The Group also paid a fee of £2,500 million to the UK Government in respect of the Group's withdrawal from the Government Asset Protection Scheme (GAPS). The Group had entered into a Pre-Accession Deed dated 7 March 2009 relating to the proposed participation in GAPS. However, following the rights issue in November 2009, the Group withdrew from its proposed participation and, on 3 November 2009, entered into a GAPS Withdrawal Deed with HM Treasury pursuant to which, among other matters, the Group agreed to pay HM Treasury an amount of £2,500 million in recognition of the benefits to the Group's trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group.

### 2008 COMPARED WITH 2007

Operating expenses were £532 million, or 10 per cent, higher at £6,100 million in 2008 compared to £5,568 million in 2007. Operating expenses in both 2008 and 2007 were, however, impacted by a number of individually significant items. In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney's Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices; the Group had provided £180 million in respect of this matter in its 2008 results. The arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme (FSCS) will result in a significant increase in the levies made by the FSCS on the industry. The Group made a provision of £122 million in 2008 in respect of its obligation for the estimated interest cost on the FSCS borrowings. During 2008, the basis of goodwill allocation in parts of the Asset Finance business was changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which this unit operated had been affected by the UK economic downturn, which was characterised by falling demand and increasing arrears at that point of that cycle. This, together with uncertainties over the likely short-term macroeconomic environment, resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million in 2008. The 2007 results included a charge of £76 million relating to the settlement of overdraft claims during that year, together with related costs. If the provision in respect of certain historic US dollar payments, the provision for the Financial Services Compensation Scheme levy and the impairment of goodwill in 2008 and the settlement of overdraft claims in 2007, are excluded, underlying operating expenses were £206 million, or 4 per cent, higher at £5,698 million in 2008 compared to £5,492 million in 2007, for the following reasons.

Staff costs were £73 million, or 3 per cent, higher at £2,978 million in 2008 compared to £2,905 million in 2007. Salaries were £102 million, or 5 per cent, higher at £2,230 million. There was a small increase in staff numbers which, together with the effect of the annual pay awards and an increased charge in respect of share-based compensation, more than offset staff reductions following the sale of businesses during 2007. National insurance costs were £9 million, or 5 per cent, higher at £176 million compared to £167 million in 2007. Pension costs were £3 million, or 1 per cent, lower at £235 million compared to £238 million in 2007; this small reduction arose because an £8 million increase in the cost of contributions to defined contribution pension schemes (which cover all eligible new employees) has been more than offset by an £11 million reduction in the charge in respect of defined benefit schemes (following further increases in asset values and expected returns at the end of 2007). There was a £53 million decrease in redundancy costs as the level of particular restructuring initiatives seen in 2007 was not repeated in 2008. Other staff costs were £18 million, or 6 per cent, higher at £323 million compared to £305 million in 2007 as a result of a further increase in costs for agency staff (used to cover project work).

Premises and equipment costs were £31 million, or 5 per cent, higher at £650 million in 2008 compared to £619 million in 2007. Rent and rates were £14 million higher, as a result of rent reviews and some new properties taken on. Hire of equipment was unchanged at £16 million and repairs and maintenance costs were £3 million lower at £151 million. Other premises and equipment costs were £20 million higher at £165 million, compared to £145 million in 2007, following an increase in losses on disposal of

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equipment due to the downturn in the used car market and a lower level of profits on disposal of premises as the number of particular transactions in 2007 was not repeated in 2008; there were also increases in premises management charges.

Other costs were £272 million, or 19 per cent, higher at £1,686 million in 2008 compared to £1,414 million in 2007, although excluding the £180 million provision in respect of certain historic US dollar payments and the £122 million provision for the Financial Services Compensation Scheme levy in 2008 and the charge of £76 million in respect of the settlement of overdraft claims in 2007, other costs in 2008 were £46 million, or 3 per cent, higher at £1,384 million compared to £1,338 million in 2007, for the following reasons.

Other costs were £101 million, or 25 per cent, higher at £506 million compared to £405 million in 2007; this increase reflected increased levels of operational losses, partly due to adverse fraud experience, higher insurance costs as a result of a review of the level of insurance cover held at the end of 2007, a further increase in the charge in respect of deferred acquisition costs in the insurance businesses, in part due to restructuring of certain insurance products, and a general increase in miscellaneous expenditure. Advertising and promotion costs were £2 million, or 1 per cent, higher at £194 million compared to £192 million in 2007, as a further increase in expenditure relating to the Group's sponsorship of the London 2012 Olympics and higher levels of advertising in relation to Corporate business were partly offset by the non-repetition of particular campaigns from 2007. Professional fees were £50 million, or 18 per cent, lower at £229 million compared to £279 million in 2007 as these costs in 2007 included significant expenditure on a number of projects including the transfer of the mortgage lending and deposits of Lloyds TSB Bank plc's subsidiary, Cheltenham & Gloucester plc, into Lloyds TSB Bank plc, and further mortgage securitisations. Communications and external data processing costs were £7 million, or 2 per cent, lower at £455 million compared to £462 million in 2007 as underlying increases in software and telecommunications charges were more than offset by the effect of the businesses sold in 2007, particularly the company registration business.

Depreciation and amortisation was £56 million, or 9 per cent, higher at £686 million compared to £630 million in 2007. There was a £44 million increase in the charge in respect of operating lease assets, reflecting a change in mix of the portfolio towards shorter lived assets, such as motor vehicles, and an increased charge following a review of aircraft residual values. There was a £12 million increase in depreciation of own-use assets, reflecting the recent increased levels of capital expenditure, partly in relation to software.

The cost: income ratio was 61.8 per cent in 2008 compared to 52.1 per cent in 2007.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## IMPAIRMENT

	2009 £m	2008 £m	2007 £m
Impairment losses on loans and receivables:			
Loans and advances to banks	(3)	135	(1)
Loans and advances to customers	15,783	2,584	1,722
Debt securities classified as loans and receivables	248	157	
Total impairment losses on loans and receivables	16,028	2,876	1,721
Impairment of available-for-sale financial assets	602	130	70
Other credit risk provisions	43	6	5
Total impairment charged to the income statement	16,673	3,012	1,796

**2009 COMPARED WITH 2008**

Impairment losses increased by £13,661 million to £16,673 million in 2009 compared to £3,012 million in 2008. Excluding the impairment losses of £12,257 million arising on the consolidation of HBOS's post-acquisition results, impairment losses were £1,404 million, or 47 per cent, higher at £4,416 million in 2009 compared to a £3,012 million in 2008; this increase includes £1,664 million in respect of loans and advances to customers and reflects the substantial deterioration in the credit environment; partly offset by a reduction in the charge in respect of loans and advances to banks and other impairment provisions.

The impairment charge in respect of loans and advances to customers was £13,199 million higher at £15,783 million in 2009 compared to £2,584 million in 2008. Excluding the impairment losses of £11,535 million arising on the consolidation of HBOS's post-acquisition results, impairment losses in respect of loans and advances to customers were £1,664 million, or 64 per cent, higher at £4,248 million in 2009 compared to £2,584 million in 2008. This reflects the substantial deterioration in the credit environment leading to increased charges in respect of both unsecured personal lending, as rising UK unemployment has impacted the charge in both the retail banking and asset finance operations, and non-personal lending. During 2009, following the acquisition of HBOS, the Group has experienced a significant rise in impairment levels in its lending portfolios. This largely represents falls in the value of commercial real estate and the impact of the economic deterioration during the year, including the effects of rising unemployment and reduced corporate cash flows. In Retail, impairment losses increased, particularly reflecting the impact of increases in UK unemployment during 2009 on the unsecured charge, which was partly offset by a lower secured impairment charge as house prices stabilised. The Wholesale charge increased significantly reflecting the year-on-year decline in commercial property valuations and reduced levels of corporate cash flows; in particular, the real estate related lending exposures in the heritage HBOS portfolios were more sensitive to the downturn in the economic environment. The Group has spent a significant amount of time analysing and addressing the issues in the heritage HBOS portfolios, with the greatest attention paid to the over concentration in real estate related lending and those portfolios that fall outside of the Lloyds TSB risk appetite. As a result of this portfolio review, which applied prudent assumptions to real estate asset expectations, and with the deterioration in the economy translating into lower commercial property valuations, the Group took prudent and material impairment charges in the period following the acquisition. In the Wealth and International business the impairment charge reflected significant provisions against the Irish and Australian commercial real estate portfolios.

The impairment charge in respect of loans and advances to banks improved by £138 million to a credit of £3 million compared to a charge of £135 million in 2008; this reflected a small release in 2009 whereas 2008 included a number of specific charges as a result of the economic conditions faced by some banks at that time.

The impairment charge in respect of debt securities classified as loans and receivables increased by £91 million, or 58 per cent, to £248 million in 2009 compared to £157 million in 2008; £140 million arose from the consolidation of the post-acquisition results of HBOS and there was a reduction of £49 million in respect of heritage Lloyds TSB businesses.

Impairment losses in respect of available-for-sale financial assets were £472 million higher at £602 million in 2009 compared to £130 million in 2008. This increase was principally due to the charge of £577 million arising on the consolidation of the post-acquisition results of HBOS and reflects impairment of certain debt securities taken on as part of the acquisition.

The charge in respect of other credit risk provisions was £43 million in 2009 compared to £6 million in 2008; £5 million of the charge in 2009 relates to the post-acquisition results of HBOS.

**2008 COMPARED WITH 2007**

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The impairment charge in the income statement was £1,216 million, or 68 per cent, higher at £3,012 million in 2008 compared to £1,796 million in 2007. This comprised a charge of £2,876 million, compared to a charge of £1,721 million in 2007, in respect of impairment losses on loans and receivables, a charge of £130 million, compared to a charge of £70 million in 2007, in respect of the impairment of available-for-sale financial assets and a charge of £6 million, compared to a charge of £5 million in 2007, in respect of other credit risk provisions.

The impairment charge in respect of loans and receivables was £1,155 million, or 67 per cent, higher at £2,876 million compared to £1,721 million in 2007.

In UK Retail Banking the charge increased by £248 million, or 20 per cent, to £1,472 million from £1,224 million in 2007, resulting in a charge as a percentage of average lending of 1.22 per cent compared to 1.10 per cent in 2007. This particularly reflected an increase of £149 million in the impairment charge in respect of mortgage lending from £18 million in 2007 to £167 million in 2008 as a result of the impact of reducing house prices and a deteriorating economic environment in the UK. Increased impairment charges also arose in respect of personal loans and overdrafts (up £100 million, or 15 per cent, from £679 million in 2007 to £779 million in 2008) as a result of higher arrears, resulting in an increase in the impairment charge, expressed as a percentage of average lending, from 5.32 per cent in 2007 to 5.73 per cent in 2008. The impairment charge in respect of credit card outstandings was flat at £526 million in 2008 compared to £527 million in 2007, despite a decrease in average balances, as a result of increased arrears and fraud losses the impairment charge in respect of card lending, expressed as a percentage of average lending, increased from 7.96 per cent in 2007 to 8.12 per cent in 2008.

A charge of £2 million, compared to £nil in 2007, in Insurance and Investments related to the mortgage lending in Scottish Widows Bank.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In Wholesale and International Banking the impairment charge in respect of loans and receivables increased by £905 million from £497 million in 2007 to £1,402 million in 2008 and this charge as a percentage of average lending was 1.33 per cent compared to 0.57 per cent in 2007. The charge within Corporate Markets was significantly higher at £939 million in 2008 compared to £165 million in 2007 as a result of a charge of £253 million, compared to a charge of £22 million in 2007, in relation to exposures to assets affected by current capital markets uncertainties, as well as a number of charges in relation to customers affected by the severe economic downturn and to the collapse of certain financial services companies. The impairment charge in Commercial Banking was £89 million, or 90 per cent, higher at £188 million in 2008 compared to £99 million in 2007, again reflecting the impact of the economic downturn; and the charge in Asset Finance was £42 million, or 18 per cent, higher at £270 million in 2008 compared to £228 million in 2007, as a result of higher arrears.

Overall, the Group's charge in respect of impairment losses on loans and receivables expressed as a percentage of average lending increased to 1.24 per cent compared to 0.84 per cent in 2007.

A charge of £130 million in 2008, compared to a charge of £70 million in 2007, arose in respect of the impairment of available-for-sale financial assets, largely in relation to certain asset-backed security collateralised debt obligations, although £30 million of the charge in 2008 reflected the write-off of the Group's investment in Bradford & Bingley equity shares.

## TAXATION

	2009 £m	2008 £m	2007 £m
UK corporation tax:			
Current tax on profits for the year	(227)	(667)	(763)
Adjustments in respect of prior years	(310)	(19)	30
	(537)	(686)	(733)
Double taxation relief	10	91	60
	(527)	(595)	(673)
Foreign tax:			
Current tax on profits for the year	(221)	(144)	(98)
Adjustments in respect of prior years	40	4	3
	(181)	(140)	(95)
<b>Current tax charge</b>	<b>(708)</b>	<b>(735)</b>	<b>(768)</b>
Deferred tax	2,619	773	89
<b>Taxation credit (charge)</b>	<b>1,911</b>	<b>38</b>	<b>(679)</b>
<b>2009 COMPARED WITH 2008</b>			

The rate of tax is influenced by the geographic and business mix of profits. The effective rate of tax was negative in both 2009 and 2008 as tax credits arose on the profits in both years; the statutory corporation tax rates were 28 per cent in 2009 and 28.5 per cent in 2008. The tax credit is distorted, in particular, by both the gain on acquisition of £11,173 million in 2009, which does not attract a tax charge, and the goodwill impairment charges of £240 million in 2009 and £100 million in 2008 on which no tax relief can be taken. The effective tax rate is also distorted by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group's interests in OEICs, being a tax charge of £410 million for 2009 compared to a tax credit of £461 million in 2008. Excluding these items the effective tax rate in 2009 was 22.5 per cent compared to 32.0 per cent in 2008. Of this 9.5 per cent decrease in the effective rate, 7.3 per cent is attributable to the impact in 2009 of losses arising in certain subsidiaries resident in Ireland, for which a deferred tax asset cannot be recognised, and the statutory tax rate is 12.5 per cent; the remainder of the decrease in the effective tax rate in 2009 on this adjusted basis reflects normal fluctuations in disallowed and non-taxable items. The Group does not expect the tax rate, excluding the impact of policyholders' tax and OEICs, to vary significantly from the average UK corporation tax rate.

## 2008 COMPARED WITH 2007

The effective rate of tax in 2008 was a negative 4.7 per cent, as a tax credit arose on the profit for the year, compared to an effective rate of tax in 2007 of 17.0 per cent and corporation tax rates of 28.5 per cent in 2008 and 30 per cent in 2007. The effective tax rate is distorted by the requirement to include, within income tax in the income statement, the tax attributable to UK life insurance policyholder earnings and the Group's interests in OEICs, being a tax credit of £461 million for 2008 compared to a tax credit of £217 million in 2007. The effective rate in 2007 was also particularly distorted by substantial profits on disposal of businesses, on which no tax charge arose, and the impact on the tax charge of the 2007 Finance Act reduction in the corporation

tax rate from 30 per cent to 28 per cent (as a result of which the Group's deferred tax liabilities were remeasured leading to a credit to the Group's tax charge of £110 million). Excluding these items the effective tax rate in 2008 was 32.0 per cent compared to 28.3 per cent in 2007. Of this 3.7 per cent increase in the effective rate, 3.9 per cent is attributable to the impact of the Group's £180 million provision in respect of certain historic US dollar payments, on which no tax relief is assumed; the remainder of the increase in the effective tax rate in 2008 on this adjusted basis reflected normal fluctuations in disallowed and non-taxable items.

#### **ECONOMIC PROFIT**

In pursuit of its aim to maximise shareholder value over time, the Group has for a number of years used a system of value based management as a framework to identify and measure value creation and has used economic profit, a non-GAAP measure, as a measure of performance. The Group continues to believe that economic profit provides important information for investors, because it captures both growth in investment and return and informs management decision making. In light of the substantial changes to the structure of the Group arising from the acquisition of HBOS and the changes in the quantum and structure of the Group's capital over 2009, the Group is in the process of determining appropriate economic profit methodologies for the enlarged group.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INTEGRATION

Annualised cost savings from synergies and other operating efficiencies of £2 billion are now targeted by the end of 2011, an increase from the previously forecast cost savings in excess of £1.5 billion. The increase arises in the main from further efficiency gains leading to role reductions and, to a lesser extent, property and procurement benefits which are now more certain following the application of the Lloyds TSB approach to HBOS.

Total cost reductions from synergies of £534 million are ahead of the target £450 million. They are analysed by division in the table below and relate primarily to reductions in staff numbers and procurement savings.

Integration costs of £1,096 million relating to severance, IT and business costs of implementation were incurred during 2009. The severance provisions are for over 15,000 role reductions announced in the year, of which more than 11,500 relate to 2009, the balance being delivered in 2010. The overwhelming majority of role reductions in 2009 were achieved through redeployment, natural turnover and voluntary redundancy.

The Group's policy is to use natural turnover and to redeploy people wherever possible to retain their expertise and knowledge within the Group. Where it is necessary for colleagues to leave the Group, this is achieved by offering voluntary severance and by making less use of contractors and agency colleagues. Compulsory redundancies are a last resort.

<b>Savings realised year to 31 December 2009</b>	<b>£m</b>		<b>£m</b>
<b>By division</b>		<b>By expenditure type</b>	
Retail	<b>124</b>	People	<b>263</b>
Wholesale	<b>86</b>	Procurement <sup>1</sup>	<b>126</b>
Wealth and International	<b>28</b>	IT	<b>57</b>
Insurance	<b>55</b>	Property	<b>11</b>
Group Operations	<b>221</b>	Other	<b>77</b>
Central items	<b>20</b>		
	<b>534</b>		<b>534</b>

<sup>1</sup> Procurement benefits totalling £174 million were achieved, split £126 million against the ongoing cost base and £48 million within the £1,096 million integration costs.

Over the last year, the Group has mobilised its integration programme, building systems integration plans whilst delivering financial benefits and making good progress towards creating a truly integrated organisation. For example, the Group has published proposals to harmonise employee terms and conditions across the Group, launched a single Group Intranet to improve communication and ease contact between colleagues and enhanced the IT infrastructure to allow colleagues full connectivity at the Group's buildings. A single consistent framework of risk policies is in place, comprising 71 detailed risk policies applicable across the combined Group.

Savings to date have been driven largely from role reductions resulting from deployment of the new Group organisational design adopting the Lloyds TSB approach. The overwhelming majority of role reductions in 2009 were achieved through redeployment, natural turnover and voluntary redundancy. Only a small proportion left via compulsory redundancy. In addition the Group has ceased occupancy of 83 properties during 2009, well ahead of the start of year target of 50.

Procurement benefits in 2009 have also been significant at £174 million with approximately £1.5 billion of spend having gone through e-auctions and the Group has in parallel reviewed and consolidated key supplier contracts with over 90 per cent of spend now being through its top 1,000 suppliers.

The Group has progressed well through the IT design and is now focused on building and delivering an integrated technical infrastructure. Preparations for system integration and data migration are in full flight with the scale up of IT equipment to handle increased volumes. Detailed plans are in place, along with testing requirements that are fully commensurate with an integration of this scale.

In the circular to shareholders regarding the acquisition of HBOS, it was stated that annual cost savings of £1.5 billion (run-rate) were expected to be achieved by the end of 2011 at a cost of approximately 140 per cent. The Group is now expecting £2 billion of



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savings, analysed by division in the table below, at an implementation cost to synergy ratio of around 155 per cent. The increase in the ratio of implementation costs to annualised cost savings has been driven principally by a recognition of the relative complexity of the HBOS systems and processes.

The synergies achieved in the year of £534 million include a number of one-off savings, which have been excluded from the sustainable run-rate benefits. There has also been an increase in the rate of savings in the year resulting in a sustainable run-rate benefit of £766 million.

	2009		2011	
	Synergy run-rate £m	Current view of synergy targets £m	Allocation of Group Operations target to divisions £m	Current view by market facing division £m
Retail	157	378	489	867
Wholesale	157	282	250	532
Wealth and International	115	213	29	242
Insurance	99	162	77	239
Group Operations	209	907	(907)	
Central items	29	58	62	120
	766	2,000		2,000

This discussion of integration includes certain forward looking statements with respect to management's expectations for the Group's financial condition and performance, which by their nature involve risk and uncertainty. See *Forward looking statements* and *Risk factors* for a discussion of factors that could cause actual results to differ materially from the expectations expressed in such forward looking statements.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### LINE OF BUSINESS INFORMATION

#### 2009 COMPARED WITH 2008

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

The Group Executive Committee (GEC) has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. GEC reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

The Group's activities in 2009 were organised into four financial reporting segments: Retail, Wholesale, Wealth and International and Insurance. The segmental results and comparatives are presented on the basis reviewed by the chief operating decision maker and as a consequence include the pre-acquisition results of HBOS for 2008 and the period from 1 January 2009 to 16 January 2009.

Comparisons of results on a historical consolidated statutory basis are dominated by the impact of the acquisition of HBOS as the 2009 statutory results include the results of HBOS from 16 January 2009, together with the effects of the unwind of fair value adjustments made to the HBOS balance sheet on acquisition, and the 2008 statutory results do not include any results of HBOS. In order to provide more meaningful and relevant comparatives, the results of the Group and divisions are presented on a combined businesses basis. The key principles adopted in the preparation of the combined businesses basis of reporting are described below.

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

- the 2008 results include the results of HBOS as if it had been acquired on 1 January 2008;

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

- the unwind of acquisition-related fair value adjustments is shown as one line in the 2009 combined businesses income statement and has not been back-dated to 2008; and

- the gain on acquisition of HBOS and amortisation of purchased intangible assets have been excluded.

In order to present better the underlying business performance the following items, not related to the acquisition, have also been excluded:

- the results of BankWest and St. Andrews, sold in December 2008, and the related loss on disposal;

- insurance and policyholder interests volatility;

- integration costs;

- goodwill impairment; and

- Government Asset Protection Scheme fee.

Readers should be aware that the combined businesses basis has been presented for comparative purposes only and is not intended to provide proforma information or show the results of the Group if the acquisition of HBOS had taken place at an earlier date. Readers should also note that HBOS was not managed by the current management of Lloyds Banking Group in 2008.

The results of the businesses are set out below:

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	2009	2008
	£m	£m
Retail	<b>1,382</b>	2,542
Wholesale	<b>(4,703)</b>	(10,479)
Wealth and International	<b>(2,356)</b>	277
Insurance	<b>975</b>	1,540
Group Operations and Central items:		
Group Operations	<b>(149)</b>	(76)
Central items	<b>(1,449)</b>	(517)
	<b>(1,598)</b>	(593)
<b>Loss before tax combined businesses</b>	<b>(6,300)</b>	(6,713)

The aggregate total of the combined businesses basis segmental results is a non-GAAP measure; further discussion of this measure is set out on page 39.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Note	2009 £m	2008 £m
<b>Loss before tax combined businesses</b>		<b>(6,300)</b>	(6,713)
Integration costs	1	(1,096)	
Volatility	2	478	(2,349)
Government Asset Protection Scheme fee	3	(2,500)	
Negative goodwill credit	4	11,173	
Amortisation of purchased intangibles and goodwill impairment	5	(993)	(258)
Pre-acquisition results of HBOS plc	6	280	10,825
Insurance grossing adjustment	7		10
Results of BankWest and St. Andrews	8		90
Loss on disposal of businesses	9		(845)
<b>Profit before tax statutory</b>		<b>1,042</b>	760

**1. Integration costs**

One-off integration costs of £1,096 million were incurred in 2009; these relate to severance, IT and other costs of implementation. The severance provisions relate to over 15,000 role reductions announced in 2009, of which more than 11,500 relate to 2009, the balance being delivered in 2010. The overwhelming majority of role reductions in 2009 were achieved through re-deployment, natural turnover and voluntary redundancy.

**2. Volatility**

The Group's statutory profit before tax is significantly affected by two items that impact the underlying financial performance of the Group, namely insurance volatility, caused by movements in financial markets, and policyholder interests volatility, which reflects primarily the gross up of policyholder tax included in the Group tax charge.

During 2009, the Group's statutory profit before tax included positive insurance and policyholder interests volatility of £478 million compared to negative volatility of £2,349 million in 2008 primarily reflecting the more favourable financial markets in 2009.

Volatility comprises the following:

	2009 £m	2008 £m
Insurance volatility	237	(1,425)
Policyholder interests volatility	298	(924)
Group hedge costs	(57)	
<b>Total</b>	<b>478</b>	(2,349)

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

The most significant limitations associated with profit before tax excluding volatility are:

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

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

Management compensates for the limitations above by:

- (i) Monitoring closely the assumptions used to calculate the normalised return used within the calculation of insurance volatility; these assumptions are disclosed below; and
- (ii) Producing separate reports on the Group's current and forecast capital ratios.

*Insurance volatility*

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

United Kingdom (Sterling)	2010 %	2009 %	2008 %
Gilt yields (gross)	4.45	3.74	4.55
Equity returns (gross)	7.45	6.74	7.55
Dividend yield	3.00	3.00	3.00
Property return (gross)	7.45	6.74	7.55
Corporate bonds in unit linked and with-profit funds (gross)	5.05	4.34	5.15
Fixed interest investments backing annuity liabilities (gross)	5.30	5.72	5.52

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

The liabilities in respect of the Group's annuity business are matched by a portfolio of fixed interest securities, which includes a large proportion of corporate bonds. In accordance with the approach adopted in 2008, the value of in-force business for the annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of these corporate bond holdings. The illiquidity premium is estimated to have reduced to 75 basis points as at 31 December 2009 (31 December 2008: 154 basis points) which has offset the gains on assets backing the annuity liabilities reducing the volatility of the results. Overall, the positive volatility in 2009 of £237 million, reflected a partial recovery in financial markets. During 2009, equities have recovered by 22 per cent and corporate bond spreads have narrowed, offset by a reduction in gilts reflecting an increase in yields and a reduction in property values of 6.6 per cent. This contrasts with 2008 where a 33 per cent reduction in equities was the main driver of the £1,425 million negative volatility in 2008.

#### *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 and pensions business. In order to provide a clearer representation of the performance of the business, and consistent with the way in which it is managed, equalisation adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders over the long term.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Over the longer term the charges levied to policyholders to cover policyholder tax on investment returns and the related tax provisions are expected to offset. In practice timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. Other sources of volatility include the minorities' share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.

During the year ended 31 December 2009, the statutory profit before tax in both the Insurance and Wealth and International divisions included credits to other income which relate to the policyholder interests volatility credit of £298 million (2008: policyholder interests volatility charge of £924 million). The market recovery in 2009 increased policyholder tax liabilities and led to a policyholder tax charge of £346 million during the year in the Group's tax charge. This was partly offset by a credit of £48 million relating to differences in the expected levels of policyholder tax provisions and charges. This compares to 2008 when substantial policyholder tax losses were generated as a result of the fall in property, bond and equity values.

#### *Hedge costs*

To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of business in force on the Group balance sheet, the Group purchased put option contracts. The charge booked for 2009 was £57 million. These options expired on 15 January 2010.

**3. Government Asset Protection Scheme fee**

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

**4. Negative goodwill credit**

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

### **5. Amortisation of purchased intangibles and goodwill impairment**

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

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

The Group reviews goodwill held on its balance sheet for impairment at least annually or when events or changes in economic circumstances indicate that an impairment may have taken place. Goodwill attributable to the Group's asset finance business, for which an impairment charge of £100 million was recognised in the Group's financial statements for the year ended 31 December 2008, has again been reviewed for impairment in 2009 due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit within Asset Finance has been reassessed resulting in an additional goodwill impairment charge of £240 million.

The charge in 2008 of £258 million comprised impairment of goodwill, principally in relation to the heritage Lloyds TSB asset finance operations, the ICC business banking division in Ireland and a specialist area of the HBOS UK credit card business.

### **6. Pre-acquisition results of HBOS plc**

The acquisition of HBOS plc on 16 January 2009 has had a significant effect on the comparability of the Group's financial position and results, as a consequence, the combined businesses basis results are prepared as if HBOS had been owned by the Group for the full year 2009 and throughout 2008.

### **7. Insurance grossing adjustment**

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 upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net on a separate line.

### **8. Results of BankWest and St. Andrews**

As explained below, HBOS sold part of its Australian operations in December 2008, the trading results of these businesses up to the date of sale have been excluded from the combined businesses basis results.

### **9. Loss on disposal of businesses**

On 19 December 2008, HBOS completed the sale of part of its Australian operations, principally Bank of Western Australia Limited and St. Andrews Australia Pty Limited, to Commonwealth Bank of Australia Limited; this resulted in a pre-tax loss on disposal of £845 million.





## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RETAIL**

Retail is the largest retail bank in the UK and the leading provider of current accounts, savings, personal loans, credit cards and mortgages. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland, Birmingham Midshires and Cheltenham & Gloucester, at 31 December 2009 Retail served over 30 million customers through one of the largest branch and fee free ATM networks in the UK.

At 31 December 2009, Retail had approximately 22 million current account customers and provided social banking to over 4 million people through basic banking or social banking accounts. It was also the largest provider of personal loans in the UK, as well as being the UK's leading credit card issuer. Retail provides one in four residential mortgages making it the leading UK mortgage lender as well as being a major provider of home finance for the first time buyer. Retail is the largest private sector savings provider in the UK, with over 21 million savers at 31 December 2009. It is also a major general insurance and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

	<b>2009</b>	2008
	<b>£m</b>	£m
Net interest income	<b>7,970</b>	8,454
Other income	<b>1,804</b>	2,739
<b>Total income</b>	<b>9,774</b>	11,193
Operating expenses	<b>(4,566)</b>	(4,963)
Trading surplus	<b>5,208</b>	6,230
Impairment	<b>(4,227)</b>	(3,695)
Share of results of joint ventures and associates	<b>(6)</b>	7
<b>Profit before tax and fair value unwind</b>	<b>975</b>	2,542
Fair value unwind	<b>407</b>	
<b>Profit before tax</b>	<b>1,382</b>	2,542

Profit before tax from Retail was £1,160 million, or 46 per cent, lower at £1,382 million in 2009 compared to £2,542 million in 2008; profit in 2009 included a credit of £407 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind decreased by £1,567 million, or 62 per cent, to £975 million in 2009 compared to £2,542 million in 2008. This decrease was driven by higher impairment losses and lower income, partly offset by a reduction in operating expenses.

Total income decreased by £1,419 million, or 13 per cent, to £9,774 million in 2009 compared to £11,193 million in 2008, reflecting a reduction in margins, lower payment protection income and non-recurring one-off income in 2008. Total income was analysed as follows:

	<b>2009</b>	2008
	<b>£m</b>	£m
Mortgages and Savings	<b>3,667</b>	5,009
Consumer Banking	<b>6,107</b>	6,184
<b>Total income</b>	<b>9,774</b>	11,193

Total income in Mortgages and Savings has decreased by £1,342 million, or 27 per cent, to £3,667 million in 2009 compared to £5,009 million in 2008. The reduction in Mortgage income reflected increased wholesale money market funding costs, which was partly offset by higher asset pricing. Lower income in Savings was the result of margin pressures arising from lower base rates and the competitive environment, the impact of which was partly offset by higher customer deposits.

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Income within Consumer Banking (where the principal products are current accounts and unsecured lending) was £77 million, or 1 per cent, lower at £6,107 million in 2009 compared to £6,184 million in 2008. On 1 January 2009 Retail introduced a monthly premium payment protection product and ceased selling single premium products. This new product offers customers the benefit of monthly payments and income is recognised over the life of the loan rather than all being recognised in the first year. This reduction in income, together with the effect of lower loan volumes, was broadly offset by an improved performance across the rest of Consumer Banking, including benefits from asset re-pricing.

Lending to customers in Retail, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £6,019 million, or 2 per cent, lower at £371,058 million in 2009 compared to £377,077 million in 2008; this reflects the impact of customers reducing their personal indebtedness and not taking on new financial commitments in the current difficult economic environment.

Retail continued to build its mortgage business in a contracting market by focusing on the prime mortgage market, particularly through the branch network rather than intermediaries, whilst maintaining a prudent approach to risk. Gross new mortgage lending totalled £34,666 million during 2009, compared to £78,058 million in 2008, representing a market share of 24 per cent. Retail has maintained its commitment to the housing market and first time buyers, with more than 60 per cent of new lending in 2009 being for house purchase rather than for re-mortgage. The average loan-to-value ratio at the end of 2009 was 54.8 per cent compared with 54.9 per cent at the end of 2008, whilst the average loan-to-value ratio on new residential lending in 2009 was 59.3 per cent compared with 63.1 per cent in 2008. Specialist lending balances (self certified and sub-prime) decreased slowly following the decision, at the start of the year, to withdraw from this market. New buy-to-let lending remained broadly flat at 13 per cent of total new mortgage lending; however, redemptions in this book were low.

Buy-to-let mortgage balances have increased by £2,872 million in the year. Retail continued to carefully assess the risks of such lending and as a result the average loan-to-value on new lending in the buy-to-let portfolio has fallen to 65.6 per cent at the end of 2009 compared to 73.1 per cent at the end of 2008.

Customer deposits were £7,867 million, or 4 per cent, higher at £224,149 million in 2009 compared to £216,282 million in 2008 despite the high level of term deposits maturing during the period, as a result of Halifax and Bank of Scotland deposit gathering activities in the first half of 2008. Current account balances have increased by 15 per cent in the year resulting from growth in the number of current accounts and the low interest rate environment.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Retail's net interest margin decreased by 18 basis points to 1.97 per cent in 2009 compared to 2.15 per cent in 2008, reflecting higher wholesale funding costs and reduced margins on savings products due to the low base rate environment, partly offset by higher asset pricing which led to a stronger margin in the second half of 2009.

Operating expenses decreased by £397 million, or 8 per cent, to £4,566 million in 2009 compared to £4,963 million in 2008. This decrease was driven primarily by a focus on cost control, cost savings resulting from integrating the two businesses and the benefit of a lower Financial Services Compensation Scheme levy. The reduction in operating expenses resulting from integrating the Lloyds TSB and HBOS retail businesses was delivered through streamlining management structures, consolidating the number of mortgage operational sites, integrating and simplifying the mortgage operating model, procurement savings from the rationalisation of suppliers and property savings through the consolidation of sites.

Impairment losses on loans and advances increased by £532 million, or 14 per cent, to £4,227 million in 2009 compared to £3,695 million in 2008. Impairment losses as a percentage of average advances were 1.11 per cent in 2009 compared to 0.97 per cent in 2008. Higher unemployment and the weak economy drove a significant increase in unsecured impairments which was partly offset by a lower secured impairment charge as house prices stabilised. Unsecured impairment losses are sensitive to economic conditions, particularly unemployment levels; consequently the 2009 impairment charge increased by £1,038 million to £3,438 million. The stabilisation of the housing market, in combination with lower interest rates and prudent risk management, has resulted in the secured impairment charge decreasing in 2009 by £506 million to £789 million.

Arrears levels in the secured portfolios were higher than 2008 but improved in the second half of 2009, and remained below the industry average. The percentage of mortgage cases more than three months in arrears increased to 2.3 per cent at 31 December 2009 compared to 1.8 per cent as at 31 December 2008. The stock of repossessed properties reduced by 32 per cent to 2,720 properties compared to 4,011 properties at the end of 2008 and, as a proportion of total accounts, remains lower than the industry average. Currently, average proceeds from the sale of repossessed properties are in excess of average valuations assumed in Retail's provisioning models.

Impaired loans in the unsecured lending portfolio, as at 31 December 2009, totalled £3,819 million, or 11.9 per cent of closing advances (after writing off some £2,100 million of loans provided against in earlier years). This compared with £5,350 million, or 14.7 per cent of closing advances at 31 December 2008; however, on an equivalent basis (adjusting for the write-off in 2009) impaired loans at 31 December 2008 totalled some £3,250 million, or 8.9 per cent of advances. The underlying increase in impaired loans which occurred in 2009 reflected the weak economy, particularly rising unemployment. During 2009 a number of actions have been taken which improved delinquency rates on new business.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WHOLESALE

The Wholesale division serves in excess of a million businesses, ranging from start-ups and small enterprises to global corporations, with a range of propositions fully segmented according to customer need. The enlarged division, following the acquisition of HBOS, comprises Corporate Markets, Treasury and Trading and Asset Finance.

Corporate Markets comprises Corporate, Commercial, Corporate Real Estate, Specialist Finance and Wholesale Markets. Corporate, Commercial and Corporate Real Estate provide relationship-based banking, risk management and advisory services to corporate and commercial customers principally in the UK. Relationships with customers with an annual turnover greater than £15 million are managed within Corporate, and commercial property-based relationships (including hotel, property-based leisure and construction) are generally managed within the Corporate Real Estate business. Commercial provides financial services to business customers ranging from new start-ups to those with a turnover of up to £15 million and invoice discounting and factoring services to a broader range of customers. Specialist Finance includes the acquisition finance and private equity businesses; all new business is being written under the brands of Lloyds Acquisition Finance or Lloyds Development Capital. Wholesale Markets provides risk management solutions, specialised lending, capital markets advisory and multi-product financing solutions to its customers, whilst managing the Group's own portfolio of structured credit investments and treasury assets.

Treasury and Trading's role is to provide access to financial markets in order to meet the Group's balance sheet management requirements, and provides trading infrastructure to support execution of customer-driven risk management transactions, whilst operating within a well controlled and conservative risk appetite.

Asset Finance consists of a number of leasing, hire purchase and speciality lending businesses including Contract Hire (Lex, Autolease and Hill Hire), Specialist Assets and Consumer Finance (Black Horse Motor and Personal Finance). Hire purchase is a form of consumer financing where a customer takes possession of goods on payment of an initial deposit but the legal title to the goods does not pass to the customer until the agreed number of instalments have been paid and the option to purchase has been exercised.

	2009 £m	2008 £m
Net interest income	4,710	5,752
Other income	4,199	(302)
Total income	8,909	5,450
Operating expenses	(4,106)	(4,591)
Trading surplus	4,803	859
Impairment	(15,683)	(10,394)
Share of results of joint ventures and associates	(720)	(944)
<b>Loss before tax and fair value unwind</b>	<b>(11,600)</b>	<b>(10,479)</b>
Fair value unwind	6,897	
<b>Loss before tax</b>	<b>(4,703)</b>	<b>(10,479)</b>

Loss before tax from Wholesale improved by £5,776 million to a loss of £4,703 million in 2009 compared to a loss of £10,479 million in 2008; however, the loss in 2009 included a credit of £6,897 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £1,121 million to a loss of £11,600 million in 2009 compared to a loss of £10,479 million in 2008. This deterioration was driven by higher impairment losses, only partly offset by an increase in other operating income and a decrease in operating expenses.

Total income increased by £3,459 million, or 63 per cent, to £8,909 million in 2009 compared to £5,450 million in 2008, driven by a large increase in other income.

Lending to customers in Wholesale, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £42,754 million, or 18 per cent, lower at £191,808 million in 2009 compared to £234,562 million in 2008.

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Customer deposits were £4,552 million, or 3 per cent, lower at £153,389 million in 2009 compared to £157,941 million in 2008.

Net interest income was £1,042 million, or 18 per cent, lower at £4,710 million in 2009 compared to £5,752 million in 2008. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, declined by 33 basis points to 1.52 per cent in 2009 compared to 1.85 per cent in 2008. This reduction in income and margin reflected higher wholesale funding costs partly offset by higher asset pricing.

Other income was £4,501 million higher at £4,199 million in 2009 compared to a deficit of £302 million in 2008. Other income in 2008 had been significantly reduced due to the effect of the dislocation in credit markets which resulted in investment valuation write-downs in the Wholesale business; these factors were not repeated in 2009. Other income in 2009 also benefited from good transaction volumes in capital markets and strong flows of client-driven derivative transactions at improved spreads.

Operating expenses decreased by £485 million, or 11 per cent, to £4,106 million in 2009 compared to £4,591 million in 2008. Operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments; excluding this item from 2008, operating expenses decreased by £305 million, or 7 per cent, to £4,106 million in 2009 compared to £4,411 million in 2008. This decrease reflects reduced levels of operating lease business and cost savings achieved from the integration programme, partly offset by increased investment in Wholesale's customer focused business support functions.

Impairment losses increased by £5,289 million to £15,683 million in 2009 compared to £10,394 million in 2008. Impairment losses for loans and advances as a percentage of average loans and advances to customers were 5.92 per cent in 2009 compared to 3.32 per cent in 2008. These increased impairment losses reflect the continued weak economic climate, higher levels of corporate failures, and application of prudent Lloyds Banking Group provisioning policy, notably in HBOS Corporate Real Estate and HBOS Corporate (UK and US) transactions. However, total impairment losses are expected to have peaked in the first half of 2009, amounting to £9,738 million, compared to £5,945 million in the second half, a reduction of 39 per cent.

Wholesale's share of results of joint ventures and associates improved by £224 million, or 24 per cent, to a loss of £720 million in 2009 compared to a loss of £944 million in 2008; there were lower levels of write-offs in 2009 as the majority of the book is fully written-off.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WEALTH AND INTERNATIONAL

Wealth and International is a new division formed in 2009 to give increased focus and momentum to the private banking and asset management businesses and to closely co-ordinate the management of the Group's international businesses.

The Wealth business comprises private banking, wealth and asset management businesses in the UK and overseas. The key operations are UK and International Private Banking, which operate under the Lloyds TSB and Bank of Scotland brands, the Channel Islands and Isle of Man offshore businesses, the expatriates business and the Asset Management business which, following the completion of the sale of Insight Investment, is now consolidated within Scottish Widows Investment Partnership. In addition the Group holds a 60 per cent stake in St James's Place plc and a 55 per cent stake in Invista Real Estate, respectively the UK's largest independent listed wealth manager and real estate fund management group.

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

	2009 £m	2008 £m
Net interest income	1,217	1,314
Other income	1,128	1,191
<b>Total Income</b>	<b>2,345</b>	2,505
Operating expenses	(1,544)	(1,476)
Trading surplus	801	1,029
Impairment	(4,078)	(731)
Share of results of joint ventures and associates	(21)	(21)
<b>Profit (loss) before tax and fair value unwind</b>	<b>(3,298)</b>	277
Fair value unwind	942	
<b>Profit (loss) before tax</b>	<b>(2,356)</b>	277
Wealth	198	369
International	(3,496)	(92)
<b>Profit (loss) before tax and fair value unwind</b>	<b>(3,298)</b>	277

Profit before tax from Wealth and International was £2,633 million lower at a loss of £2,356 million in 2009 compared to a profit of £277 million in 2008; the loss in 2009 included a credit of £942 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind decreased by £3,575 million to a loss of £3,298 million in 2009 compared to a profit of £277 million in 2008. This deterioration was driven by higher impairment losses.

Total income decreased by £160 million, or 6 per cent, to £2,345 million in 2009 compared to £2,505 million in 2008. This decrease reflects lower net interest margins, and the impact of lower global stock markets particularly in the first half of the year, partly offset by favourable foreign exchange movements.

Lending to customers in Wealth and International, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £1,005 million, or 2 per cent, lower at £63,548 million in 2009 compared to £64,553 million in 2008 as net repayments and increased impairment provisions in the International businesses have been offset by the transfer of a European loan portfolio of some £7,000 million from Wholesale division.

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Customer deposits were £5,058 million, or 15 per cent, lower at £29,037 million in 2009 compared to £34,095 million in 2008 primarily due to outflows in Ireland reflecting aggressive pricing from competitors who have also benefited from the Irish Government deposit guarantee.

Net interest income was £97 million, or 7 per cent, lower at £1,217 million in 2009 compared to £1,314 million in 2008. The net interest margin, adjusted to exclude earnings on policyholder funds and products where either the funding costs or the related revenues are recognised in other income, declined by 35 basis points to 1.71 per cent in 2009 compared to 2.06 per cent in 2008. This margin reduction reflects higher wholesale funding costs and lower deposit margins in the low base rate environment, partly offset by the impact of strong portfolio management in International and higher asset pricing leading to higher margins.

Other income was £63 million, or 5 per cent, lower at £1,128 million in 2009 compared to £1,191 million in 2008. This decrease was driven by falls in global stock markets, particularly in the first half of 2009, impacting sales volumes and fee income across all Wealth businesses; partly offset by favourable exchange movements in the International operations.

Operating expenses increased by £68 million, or 5 per cent, to £1,544 million in 2009 compared to £1,476 million in 2008. Adverse foreign exchange movements increased operating expenses in both the Wealth and the International businesses and additional costs resulted from investments to increase distribution capacity in Private Banking to support future growth plans, additional costs associated with the transitional services following the disposal by HBOS of BankWest and St. Andrews Australia in December 2008, the development of International's deposit taking operation in Germany and increased risk management resources to manage impaired asset portfolios in Ireland and Australia. These increases in costs were partly offset by cost savings from integration, particularly in the Asset Management business.

Impairment losses increased by £3,347 million to £4,078 million in 2009 compared to £731 million in 2008. This reflects the significant deterioration in the credit risk environment in Ireland and Australia as well as the impact of the economic environment on the UK Private Banking and Expatriate lending portfolios. Of the total impairment losses in 2009, £2,949 million arose in Ireland which experienced a significant deterioration in asset values driven by the collapse in liquidity and severe decline in the property sector where commercial real estate values fell by over 50 per cent and house prices by over 25 per cent from their peak. A further £849 million of the total impairment losses in 2009 arose in Australia, driven by concentrations in property and in other sectors such as media, printing and transport which have been hardest hit by the downturn. Business Support Units have been established in both Ireland and Australia, supplemented by a divisional sanctioning process, to provide independent divisional oversight and control of the portfolios.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**INSURANCE**

The Insurance division consists of three business units:

**LIFE, PENSIONS AND INVESTMENTS UK**

The UK Life, Pensions and Investments business is the leading bancassurance provider in the UK and has one of the largest intermediary sales forces in the industry. The business includes Scottish Widows which, for a number of years, has been a subsidiary of the Lloyds TSB Group and the provider of long-term savings and investment products distributed through all channels of that group. Following the acquisition of HBOS, the Life, Pensions and Investments business also includes business written through the intermediary and bancassurance channels under the Clerical Medical and Halifax brands respectively.

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

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

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

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

**LIFE, PENSIONS AND INVESTMENTS EUROPE**

The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands. The business unit was included within the International division of the former HBOS group.

**GENERAL INSURANCE**

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

	2009 £m	2008 £m
Net interest income	(287)	(345)
Other income	2,944	3,493
Total income	2,657	3,148
Insurance claims	(637)	(481)
Total income, net of insurance claims	2,020	2,667
Operating expenses	(974)	(1,129)
Share of results of joint ventures and associates	(22)	2
<b>Profit before tax and fair value unwind</b>	<b>1,024</b>	<b>1,540</b>
Fair value unwind	(49)	

<b>Profit before tax</b>		<b>975</b>	1,540
<b>Profit before tax and fair value unwind by business unit</b>			
Life, Pensions and Investments	UK business	<b>617</b>	826
	European business	<b>75</b>	149
General Insurance		<b>367</b>	537
Other		<b>(35)</b>	28
<b>Profit before tax and fair value unwind</b>		<b>1,024</b>	1,540

Profit before tax from Insurance was £565 million lower at £975 million in 2009 compared to £1,540 million in 2008. The profit in 2009 included a charge of £49 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind was £516 million lower at £1,024 million in 2009 compared to £1,540 million in 2008. This deterioration in profits followed a reduction in income and an increase in claims, due to factors including demanding market conditions, partly offset by a decrease in operating expenses.

Total income decreased by £491 million, or 16 per cent, to £2,657 million in 2009 compared to £3,148 million in 2008 due to the non-recurrence of £334 million of HBOS legacy one-off benefits, principally in Life, Pensions and Investments, enjoyed in 2008 and the impact of challenging economic conditions driving lower sales and returns, partially offset by significantly lower charges for policyholder lapses.

Net interest income was £58 million, or 17 per cent, better at a deficit of £287 million in 2009 compared to a deficit of £345 million in 2008.

Other income was £549 million, or 16 per cent, lower at £2,944 million in 2009 compared to £3,493 million in 2008. Within the life and pensions activities, new business profit was significantly impacted by the general contraction in the life, savings and investments market and the reduction also reflects the integration of the intermediary sales forces and the withdrawal of a number of legacy HBOS products with poor returns. Existing business profit within the UK life and pensions activities reduced by 10 per cent, this includes a reduction in expected return, reflecting lower asset values resulting from adverse investment markets in 2008, a lower assumed rate of return and the non-recurrence of one-off benefits enjoyed by HBOS in 2008. These impacts have been partly offset by a significant reduction in charges for policyholder lapses in 2009. Within the general insurance activities, income was lower principally due to payment protection insurance income decreasing as a result of the market-wide move to monthly premiums on payment protection, partly offset by lower distribution commission payable to the Retail division.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Insurance claims were £156 million, or 32 per cent, higher at £637 million in 2009 compared to £481 million in 2008, primarily due to higher payment protection insurance claims related to unemployment. Whilst property claims were impacted by flooding and freeze claims in the final quarter of 2009, benefits from ongoing investments in claims processes continue to be realised.

Operating expenses decreased by £155 million, or 14 percent, to £974 million in 2009 compared to £1,129 million in 2008; this is mainly due to continued focus on cost management and delivering integration synergies.

Insurance's share of results of joint ventures and associates deteriorated to a loss of £22 million in 2009 compared to a profit of £2 million in 2008.

## LIFE, PENSIONS AND INVESTMENTS

## UK BUSINESS

	2009 £m	2008 £m
Net interest income	(273)	(282)
Other income	1,474	1,758
Total income	1,201	1,476
Operating expenses	(584)	(650)
<b>Profit before tax and fair value unwind</b>	<b>617</b>	<b>826</b>
<b>Profit before tax and fair value unwind analysis</b>		
New business profit	328	465
insurance business's		
investment business's	(196)	(247)
Total new business profit	132	218
Existing business profit	483	534
Expected return on shareholders' net assets	2	74
<b>Profit before tax and fair value unwind</b>	<b>617</b>	<b>826</b>

<sup>1</sup> As required under IFRS, products are split between insurance and investment contracts depending on the level of insurance risk contained. For insurance contracts, the new business profit includes the net present value of profits expected to emerge over the lifetime of the contract, including profits anticipated in periods after the year of sale; for investment contracts the figure reflects the profit in the year of sale only, after allowing for the deferral of initial income and expenses. Consequently the recognition of profit for investment contracts is deferred relative to insurance contracts.

Profit before tax and fair value unwind decreased by £209 million, or 25 per cent, to £617 million in 2009 compared to £826 million in 2008. New business profit was significantly impacted by the general contraction in the life, savings and investments market but the reduction also reflects the integration of the intermediary sales forces and the withdrawal of a number of legacy HBOS products with poor returns.

Existing business profit reduced by £51 million, or 10 per cent, to £483 million in 2009 compared to £534 million in 2008. This reflects a reduction in expected return, reflecting lower asset values resulting from adverse investment markets in 2008, a lower assumed rate of return and the non-recurrence of one-off benefits in HBOS in 2008, principally relating to a move to a more market consistent basis of embedded value and enhancements to the bond proposition. Those impacts have been partly offset by a significant reduction in charges for policyholder lapses in 2009.

Expected returns on shareholders' net assets were impacted both by a lower assumed rate of return and by reduced asset values as a result of severe market falls in 2008.

## EUROPEAN BUSINESS

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Profit before tax and fair value unwind decreased by £74 million, or 50 per cent to £75 million in 2009 compared to £149 million in 2008. New business profits reduced by £32 million driven by lower sales, reflecting economic and market conditions. Existing business profits decreased, primarily due to lower expected returns. In 2008, as a result of moving to a more market consistent basis of embedded value in HBOS, a one-off benefit of £123 million arose. The impact of this was largely offset by a significant reduction in charges for policyholder lapses in 2009.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## NEW BUSINESS

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

	UK £m	2009 Europe £m	Total £m	UK £m	2008 Europe £m	Total £m
Protection	519	49	568	492	51	543
Payment protection	153		153	679		679
Savings and investments	2,689	312	3,001	4,149	372	4,521
Individual pensions	2,275	185	2,460	4,216	306	4,522
Corporate and other pensions	2,600		2,600	2,940		2,940
Retirement income	887		887	1,451		1,451
Managed fund business	146		146	216		216
Life and pensions	9,269	546	9,815	14,143	729	14,872
OEICs	3,704		3,704	3,303		3,303
<b>Total</b>	<b>12,973</b>	<b>546</b>	<b>13,519</b>	<b>17,446</b>	<b>729</b>	<b>18,175</b>
<b>Analysis by channel</b>						
Bancassurance excluding payment protection	6,844		6,844	7,677		7,677
Payment protection	153		153	679		679
Bancassurance	6,997		6,997	8,356		8,356
Intermediary	5,639	546	6,185	8,704	729	9,433
Direct	337		337	386		386
<b>Total</b>	<b>12,973</b>	<b>546</b>	<b>13,519</b>	<b>17,446</b>	<b>729</b>	<b>18,175</b>

The present value of new business premiums reduced by £4,656 million, or 26 per cent, to £13,519 million in 2009 compared to £18,175 million in 2008 reflecting both a general contraction in the UK and European markets as well as the re-positioning of the UK intermediary product range. Sales through the intermediary channel were significantly impacted as the UK intermediary sales forces were integrated and a number of legacy HBOS products with poor returns were withdrawn. As a result, sales in the intermediary channel reduced by 34 per cent. Sales through the bancassurance channel, excluding payment protection, continued to perform relatively robustly with a reduction of 11 per cent. This includes Scottish Widows sales through the bancassurance network which showed good growth of 18 per cent. Sales of OEIC products were strong with an increase of 12 per cent in 2009.

## GENERAL INSURANCE

	2009 £m	2008 £m
<b>Home insurance</b>		
Underwriting income (net of reinsurance)	897	885
Commission receivable	71	50
Commission payable	(94)	(70)
	874	865
<b>Payment protection insurance</b>		
Underwriting income (net of reinsurance)	731	860

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Commission receivable	13	428
Commission payable	(395)	(923)
	349	365
<b>Other</b>		
Underwriting income (net of reinsurance)	8	20
Commission receivable	69	71
Commission payable	(28)	(36)
Other (including investment income)	(6)	93
	43	148
<b>Net operating income</b>	1,266	1,378
Claims paid on insurance contracts (net of reinsurance)	(637)	(481)
<b>Operating income, net of claims</b>	629	897
Operating expenses	(262)	(360)
<b>Profit before tax and fair value unwind</b>	367	537

35

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Profit before tax and fair value unwind from General Insurance decreased by £170 million, or 32 per cent, to £367 million in 2009 compared to £537 million in 2008.

Claims were £156 million, or 32 per cent, higher at £637 million compared to £481 million in 2008, primarily due to higher payment protection insurance claims related to unemployment. Whilst property claims were impacted by flooding and freeze claims in the final quarter of 2009, benefits from ongoing investments in claims processes continue to be realised.

Against the background of a particularly competitive market in which the general insurance business has a leading position, home insurance income generated modest growth of £9 million, or 1 per cent to £874 million in 2009 compared to £865 million in 2008. Payment protection insurance income decreased by £16 million, or 4 per cent, to £349 million in 2009 compared to £365 million in 2008 as a result of the market-wide move to monthly premiums on payment protection, partly offset by lower distribution commission payable to the Retail division.

Other income has reduced, primarily reflecting lower interest rates and the allocation of certain charges.

Operating expenses decreased by £98 million, or 27 per cent, to £262 million in 2009 compared to £360 million in 2008. Adjusting for the reclassification of claims handling expenses into claims paid and non-recurring marketing spend in 2008, costs improved by 10 per cent year on year, reflecting continued focus on cost management and cost savings achieved through the integration.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GROUP OPERATIONS

	2009	2008
	£m	£m
Net interest income	(69)	(59)
Other income	20	35
Total income	(49)	(24)
Direct costs:		
Information technology	(1,265)	(1,347)
Operations	(555)	(542)
Property	(979)	(1,019)
Procurement	(166)	(159)
Support functions	(101)	(89)
	(3,066)	(3,156)
<b>Result before recharges to divisions</b>	<b>(3,115)</b>	<b>(3,180)</b>
Total net recharges to divisions	2,941	3,100
Share of results of joint ventures and associates	3	4
<b>Loss before tax and fair value unwind</b>	<b>(171)</b>	<b>(76)</b>
Fair value unwind	22	
<b>Loss before tax</b>	<b>(149)</b>	<b>(76)</b>

Loss before tax from Group Operations deteriorated by £73 million to £149 million in 2009 compared to £76 million in 2008. The loss in 2009 included a credit of £22 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £95 million to £171 million in 2009 compared to £76 million in 2008.

Total income, excluding recharges to divisions, decreased by £25 million, to a deficit of £49 million in 2009 compared to a deficit of £24 million in 2008. Net interest income was £10 million, or 17 per cent, lower at a net expense of £69 million in 2009 compared to a net expense of £59 million in 2008. Other income was £15 million, or 43 per cent, lower at £20 million in 2009 compared to £35 million in 2008.

Direct costs were £90 million, or 3 per cent, lower at £3,066 million in 2009 compared to £3,156 million in 2008; this reflects the impact of integration synergies and a continued focus on cost management.

IT costs decreased due to the early realisation of synergy savings following the consolidation of IT operations across the Group in addition to lower investment spend as project activity was rationalised and replaced by integration activity; property costs were also lower, primarily due to the realisation of synergy savings as a result of the integration and the consolidation of premises (which has been achieved at a faster rate than originally anticipated).

Recharges to divisions were £159m, or 5 per cent, lower at £2,941 million in 2009 compared to £3,100 million in 2008.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CENTRAL ITEMS

	2009 £m	2008 £m
Net interest income	(815)	(213)
Other income	1,780	(223)
Total income	965	(436)
Operating expenses	(294)	(21)
Trading surplus (deficit)	671	(457)
Impairment		(60)
Share of results of joint ventures and associates	(1)	
<b>Profit (loss) before tax and fair value unwind</b>	<b>670</b>	<b>(517)</b>
Fair value unwind	(2,119)	
<b>Loss before tax</b>	<b>(1,449)</b>	<b>(517)</b>

Central items are comprised of three main elements:

- 1 The residual net interest position arising from the Group's processes to allocate the following elements of net interest income to the divisions:
  - interest on the Group's equity position;
  - net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares net of such cost allocated to the divisions; and
  - cost to the Group of funding wholesale and liquidity balances.
- 2 The charge for payments to the Lloyds TSB Foundations: the four independent Lloyds TSB Foundations support registered charities throughout the UK that enable people, particularly the disabled and disadvantaged, to play a fuller role in society.
- 3 Central costs and other unallocated items: these relate to the on-going costs of central group activities including those of group corporate treasury (including the central hedge function), internal group audit, group risk, group compliance, group finance and group IT and operations.

Loss before tax from Central items deteriorated by £932 million to £1,449 million in 2009 compared to £517 million in 2008. The loss in 2009 included a charge of £2,119 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Profit before tax and fair value unwind was £670 million in 2009 compared to a loss of £517 million in 2008.

Total income increased by £1,401 million, to £965 million in 2009 compared to a deficit of £436 million in 2008. Net interest income was £602 million lower at a net expense of £815 million in 2009 compared to a net expense of £213 million in 2008. Other income was £2,003 million higher at £1,780 million in 2009 compared to a deficit of £223 million in 2008; this was primarily as a result of gains arising when the Group exchanged certain existing subordinated debt securities for new securities. These exchanges resulted in a gain on extinguishment of the existing liability of £1,498 million (of which £1,468 million is reflected in Central items), being the difference between the carrying amount of the securities extinguished and the fair value of the new securities together with related fees and costs.

Operating expenses were £273 million higher at £294 million in 2009 compared to £21 million in 2008; this was due in part to higher professional fees and other costs associated with a number of group-wide projects, including the proposed participation in the Government Asset Protection Scheme, and an increase in the amount of pension costs held centrally.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**COMBINED BUSINESSES BASIS SUMMARY 2009 COMPARED WITH 2008**

Readers should be aware that the combined businesses basis has been presented for comparative purposes only and is neither intended to provide proforma information nor to show the results of the Group as if the acquisition of HBOS had taken place at an earlier date. Readers should also note that HBOS was not managed by the current management of Lloyds Banking Group in 2008.

As noted on page 2, the combined businesses basis segmental results for 2009 and 2008 are presented in accordance with IFRS. However, the aggregated total of the combined businesses segmental results constitutes a non-GAAP measure as defined by the SEC.

The acquisition of HBOS plc on 16 January 2009 has had a significant impact on the results of the Group. Comparisons of the Group's performance on a statutory basis are, therefore, dominated by the impact of the acquisition of HBOS; the 2009 statutory results include the results of HBOS from 16 January 2009, together with the effects of the unwind of fair value adjustments made to the HBOS balance sheet on acquisition, and the 2008 statutory results do not include any results of HBOS.

Management uses the aggregated total of the combined businesses segmental results, 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 profit before tax on a combined businesses basis; a reconciliation of the Group's statutory income statement to its combined businesses income statement is shown below. Readers should be aware that the combined businesses basis excludes certain items, as indicated in the tables below, reflected in the Group's statutory results and includes certain items, also indicated in the tables below, not reflected in the Group's statutory results. The Group refers readers to the discussion of its statutory results on pages 14 to 23.

Set out below is a reconciliation from the Group's statutory results to the combined businesses basis, together with a brief commentary.

	Removal of:							Combined businesses £m
	Lloyds Banking Group statutory £m	Pre-acquisition results of HBOS £m	GAPS fee and acquisition related items <sup>1</sup> £m	Volatility £m	Insurance gross up £m	Fair value unwind £m		
<b>2009</b>								
Net interest income	9,026	243		11	1,280	2,166	12,726	
Other income	36,271	(1,123)		(479)	(21,659)	(1,135)	11,875	
<b>Total income</b>	<b>45,297</b>	<b>(880)</b>		<b>(468)</b>	<b>(20,379)</b>	<b>1,031</b>	<b>24,601</b>	
Insurance claims	(22,019)	1,349			20,318	(285)	(637)	
<b>Total income, net of insurance claims</b>	<b>23,278</b>	<b>469</b>		<b>(468)</b>	<b>(61)</b>	<b>746</b>	<b>23,964</b>	
Operating expenses	(15,984)	(293)	4,589		61	18	(11,609)	
<b>Trading surplus (deficit)</b>	<b>7,294</b>	<b>176</b>	<b>4,589</b>	<b>(468)</b>		<b>764</b>	<b>12,355</b>	
Impairment	(16,673)	(456)				(6,859)	(23,988)	
Share of results of joint ventures and associates	(752)			(10)		(5)	(767)	
Gain on acquisition	11,173		(11,173)					
Fair value unwind						6,100	6,100	
<b>Profit (loss) before tax</b>	<b>1,042</b>	<b>(280)</b>	<b>(6,584)</b>	<b>(478)</b>			<b>(6,300)</b>	

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<sup>1</sup> Includes the GAPS fee (£2,500 million), integration costs (£1,096 million), amortisation of purchased intangibles (£753 million), goodwill impairment (£240 million) and gain on acquisition.

2008	Lloyds TSB statutory <sup>1</sup> £m	HBOS statutory £m	Reclass- ifications £m	BankWest and St. Andrews £m	Removal of:			
					Volatility £m	Amortisation of purchased intangibles and goodwill impairment £m	Insurance gross up £m	Combined businesses £m
Net interest income	7,718	8,171	1,906	(524)	(9)		(2,359)	14,903
Other income	(709)	(4,559)	(234)	(148)	2,358		10,225	6,933
Total income	7,009	3,612	1,672	(672)	2,349		7,866	21,836
Insurance claims	2,859	6,192	(1,570)				(7,962)	(481)
Total income, net of insurance claims	9,868	9,804	102	(672)	2,349		(96)	21,355
Operating expenses	(6,100)	(6,880)		400		258	86	(12,236)
Trading surplus	3,768	2,924	102	(272)	2,349	258	(10)	9,119
Impairment	(3,012)	(12,050)		182				(14,880)
Share of results of joint ventures and associates	4	(956)						(952)
Non-operating income		(743)	(102)	845				
Profit (loss) before tax	760	(10,825)		755	2,349	258	(10)	(6,713)

<sup>1</sup> Restated for IFRS 2 (Revised).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Profit before tax on a combined businesses basis improved by £413 million to a loss of £6,300 million in 2009 compared to a loss of £6,713 million in 2008; however, the loss in 2009 included a credit of £6,100 million in relation to the unwinding of fair value adjustments arising from the acquisition of HBOS plc by the Group. Loss before tax and fair value unwind deteriorated by £5,687 million to a loss of £12,400 million in 2009 compared to a loss of £6,713 million in 2008. This deterioration was driven by higher impairment losses, only partly offset by an increase in other operating income and a decrease in operating expenses.

Total income increased by £2,765 million, or 13 per cent, to £24,601 million in 2009 compared to £21,836 million in 2008, driven by a large increase in other income.

Lending to customers, net of impairment provisions and fair value adjustments arising from the acquisition of HBOS plc by the Group, was £50,277 million, or 7 per cent, lower at £626,969 million in 2009 compared to £677,246 million in 2008.

Customer deposits were £2,421 million lower at £406,741 million in 2009 compared to £409,162 million in 2008.

Net interest income was £2,177 million, or 15 per cent, lower at £12,726 million in 2009 compared to £14,903 million in 2008. The net interest margin, adjusted to exclude products where either the funding costs or the related revenues are recognised in other income, declined by 24 basis points to 1.77 per cent in 2009 compared to 2.01 per cent in 2008.

Other income was £4,942 million, or 71 per cent, higher at £11,875 million in 2009 compared to £6,933 million in 2008. Other income in 2008 had been significantly reduced due to the effect of the dislocation in credit markets which resulted in investment valuation write-downs of £3,452 million in the Wholesale business; these factors were not repeated in 2009.

Operating expenses decreased by £627 million, or 5 per cent, to £11,609 million in 2009 compared to £12,236 million in 2008. Operating expenses in 2008 included a £180 million settlement in relation to certain historic US dollar payments; excluding this item from 2008, operating expenses decreased by £447 million, or 4 per cent, to £11,609 million in 2009 compared to £12,056 million in 2008.

Impairment losses increased by £9,108 million, or 61 per cent, to £23,988 million in 2009 compared to £14,880 million in 2008. Impairment losses on loans and advances to customers as a percentage of average loans and advances to customers were 3.25 per cent in 2009 compared to 1.81 per cent in 2008.

The Group's share of results of joint ventures and associates improved by £185 million, or 19 per cent, to a loss of £767 million in 2009 compared to a loss of £952 million in 2008; there were lower levels of write-offs in 2009 as the majority of the book is fully written-off.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LINE OF BUSINESS INFORMATION

## 2008 COMPARED WITH 2007

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 for comparing 2008 with 2007 follows the continuing businesses basis as explained below (see also note 4 to the consolidated financial statements).

The Group Executive Committee (GEC) has been determined to be the chief operating decision maker for the Group. The Group's operating segments reflect its organisational and management structures. GEC reviews the Group's internal reporting based around these segments in order to assess performance and allocate resources. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

The Group's activities in 2008 were organised into three financial reporting segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking.

The continuing businesses basis excluded the following items:

- insurance and policyholder interests volatility
- a provision in respect of certain historic US dollar payments
- a provision in respect of the Financial Services Compensation Scheme levy
- impairment charge in respect of goodwill
- the results of discontinued businesses
- profit on sale of businesses
- the settlement of overdraft claims.

**The results of the businesses are set out below:**

	2008 <sup>1</sup> £m	2007 <sup>1</sup> £m
UK Retail Banking	1,793	1,720
Insurance and Investments	911	748
Wholesale and International Banking	274	1,300
Central group items	(599)	(13)
Profit before tax – continuing businesses	2,379	3,755

**A reconciliation from the continuing businesses basis to the statutory results is set out below:**

	Note	2008 <sup>1</sup> £m	2007 <sup>1</sup> £m
Profit before tax – continuing businesses		2,379	3,755
Volatility	1		

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Insurance		(746)	(277)
Policyholder interests		(471)	(222)
Discontinued businesses	2		162
Profit on sale of businesses	3		657
Provision in respect of certain historic US dollar payments	4	(180)	
Provision for Financial Services Compensation Scheme levy	5	(122)	
Goodwill impairment	6	(100)	
Settlement of overdraft claims	7		(76)
<b>Profit before tax statutory</b>		760	3,999

<sup>1</sup> Restated for IFRS 2 (Revised).

**1. Volatility**

	2008	2007
	£m	£m
Insurance volatility	(746)	(277)
Policyholder interests volatility	(471)	(222)
Total volatility	(1,217)	(499)

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*Insurance volatility*

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

Changes in market variables also affect the realistic valuation of the guarantees and options embedded within products written in the Scottish Widows With Profit Fund, the value of the in-force business and the value of shareholders' funds. Fluctuations in these values caused by changes in market variables, including market spreads reflecting credit risk premia, are also included within insurance volatility. These market credit spreads represent the gap between the yield on corporate bonds and the yield on government bonds, and reflect the market's assessment of credit risk. Changes in the credit spreads affect the value of the in-force business asset in respect of the annuity portfolio.

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

	2008 %	2007 %
Gilt yield (gross)	4.55	4.62
Equity return (gross)	7.55	7.62
Dividend yield	3.00	3.00
Property return (gross)	7.55	7.62
Corporate bonds in unit-linked and with-profits funds (gross)	5.15	5.22
Fixed interest instruments backing annuity liabilities (gross)	5.56	5.09

During 2008, profit before tax included negative insurance volatility of £746 million, being a credit of £9 million to net interest income and a charge of £755 million to other income. During 2007, profit before tax included negative insurance volatility of £277 million, being a credit of £7 million to net interest income and a charge of £284 million to other income. The charge in 2008 mainly reflected the significant falls in global equity markets during the year, which resulted in total returns some 33 percentage points lower than the expected investment returns set out above. These lower than expected returns reduced the value of in-force business asset in respect of life insurance and participating investment contracts held on the balance sheet. The impact of the widening corporate bond credit spreads more than offset the inclusion of an allowance for the illiquidity premium, and resulted in a net reduction in the value of the annuity portfolio. Lower equity and bond prices also affected the valuation of the Group's investment held within the funds attributable to the shareholders. During 2007, the effect of widening credit risk spreads and falling gilt values more than offset the favourable impact of a modest increase in equity values and changes in market consistent assumptions.

*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 and pensions business. In order to provide a clearer representation of the performance of the business and consistent with the way in which it is managed, equalisation adjustments are made to remove this volatility from underlying profits. The effect of these adjustments is separately disclosed as policyholder interests volatility; there is no impact upon profit attributable to equity shareholders.

The most significant of these additional sources of volatility is policyholder tax. Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The impact is, therefore, to either increase or decrease profit before tax with a corresponding change in the tax charge. Other sources of volatility include the minorities' share of the profits earned by investment vehicles which are not wholly owned by the long-term assurance funds.



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During 2008, profit before tax included negative policyholder interests volatility of £471 million, being a charge to other income. During 2007, profit before tax included negative policyholder interests volatility of £222 million, being a charge to other income. In both 2007 and 2008, substantial policyholder tax losses were generated as a result of a fall in property, bond and equity values. These losses reduce future policyholder tax liabilities and led to a policyholder tax credit in both years.

### **2. Discontinued businesses**

As explained below, the Group disposed of Lloyds TSB Registrars, Abbey Life and Dutton-Forshaw during 2007. Trading results of these businesses up to the date of sale have been excluded from the continuing businesses basis results.

### **3. Profit on sale of businesses**

During 2007, the Group disposed of Lloyds TSB Registrars, its share registration business; Abbey Life, the UK life operation which was closed to new business in 2000; and Dutton-Forshaw, its medium-size car dealership. In addition, provision was made for payments under an indemnity given in relation to a business sold in an earlier year. Together, these transactions resulted in a profit of £657 million.

### **4. Provision in respect of certain historic US dollar payments**

In January 2009, the Group announced that it had reached a settlement with both the US Department of Justice and the New York County District Attorney's Office in relation to a previously disclosed investigation involving those agencies into certain historic US dollar payment practices; the Group provided £180 million in respect of this matter in its 2008 results.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **5. Provision for Financial Services Compensation Scheme levy**

The arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit taking institutions involving the Financial Services Compensation Scheme (FSCS) will result in a significant increase in the levies made by the FSCS on the industry. The Group made a provision of £122 million in respect of its then obligation for the estimated interest cost on the FSCS borrowings in its 2008 results.

### **6. Goodwill impairment**

During 2008, the basis of goodwill allocation in parts of the Asset Finance business was changed to treat the consumer finance business as a single cash generating unit encompassing the motor and personal finance operations which provide direct and point of sale finance. The markets in which this unit operates had been affected by the UK economic downturn, which had been characterised by falling demand and increasing arrears at that point of the cycle. This, together with uncertainties over the likely short-term macroeconomic environment, resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £100 million in 2008.

### **7. Settlement of overdraft claims**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## UK RETAIL BANKING

During 2008, UK Retail Banking provided banking, financial services, mortgages and private banking to some 16 million personal customers through the Group's multi-channel distribution capabilities.

The Group provided wide-reaching geographic branch coverage in England, Scotland and Wales, through over 1,950 branches of Lloyds TSB Bank, Lloyds TSB Scotland plc (Lloyds TSB Scotland) and C&G; internet banking provided online banking facilities for personal customers and telephone banking continued to grow, at the end of 2008 some 5.7 million customers had registered to use the services of PhoneBank and the automated voice response service, PhoneBank Express. The Group had one of the largest cash machine networks of any leading banking group in the UK and, at 31 December 2008, personal customers of Lloyds TSB Bank and Lloyds TSB Scotland were able to withdraw cash and check balances through over 4,200 ATMs at branches and external locations around the UK.

Lloyds TSB Bank and Lloyds TSB Scotland offered a wide range of current accounts, including interest-bearing current accounts and a range of added-value accounts; savings accounts and retail investments; and personal loans.

The Group provided a range of card-based products and services, including credit and debit cards and card transaction processing services for retailers.

In 2008 C&G was UK Retail Banking's specialist residential mortgage arranger, offering a range of mortgage products to personal customers through its own branches and those of Lloyds TSB Bank in England and Wales, as well as through the telephone, internet and postal service, Mortgage Direct; mortgages were also offered through Lloyds TSB Scotland.

UK Wealth Management provided financial planning and advice for the Group's affluent customers, providing financial solutions across investments, retirement planning and income, trusts, tax and estate planning as well as share dealing.

	2008 £m	2007 £m
Net interest income	4,110	3,695
Other income	1,766	1,797
Total income	5,876	5,492
Operating expenses	(2,611)	(2,548)
Trading surplus	3,265	2,944
Impairment	(1,472)	(1,224)
Profit before tax	1,793	1,720
Cost:income ratio	44.4%	46.4%
Total assets (year end)	£127,502m	£115,012m

Profit before tax from UK Retail Banking increased by £73 million, or 4 per cent, to £1,793 million in 2008 compared to £1,720 million in 2007.

Net interest income was £415 million, or 11 per cent, higher at £4,110 million in 2008 compared with £3,695 million in 2007, reflecting both an increase in average interest-earning assets and an improvement in the net interest margin. Average interest-earning assets were £9,234 million, or 8 per cent, higher at £120,128 million in 2008 compared to £110,894 million in 2007 as a result of lending growth, particularly within the mortgage business. Average mortgage balances were £8,652 million higher in 2008. Gross new mortgage lending for the Group totalled £27,767 million, compared to £29,431 million in 2007; net new lending totalled £10,914 million, compared to £6,647 million in 2007, resulting in a market share of net new mortgage lending of 27.5 per cent, compared to 6.2 per cent in 2007. Average balances in respect of other personal lending were £20,138 million compared with £19,426 million in 2007. Average credit card balances in 2008 were 2 per cent lower at £6,477 million compared to £6,619 million in 2007, whilst balances on personal loans and overdrafts were 7 per cent higher at £13,661 million in 2008. Overall margins in UK Retail Banking improved by 9 basis points as a result of wider margins within the unsecured personal lending business and on new

mortgages.

Other income was £31 million, or 2 per cent, lower at £1,766 million compared to £1,797 million in 2007. Higher fees and commissions receivable as a result of growth in added-value current accounts and card services were more than offset by lower creditor insurance commissions and the impact of changes in product design leading to a greater proportion of earnings being recognised as net interest income rather than other income.

Operating expenses were £63 million, or 2 per cent, higher at £2,611 million in 2008 compared with £2,548 million in 2007. The Group had continued to benefit from the recent investment in reducing the levels of administration and processing work carried out in branches. This had enabled the Group to increase its focus on meeting the needs of its customers and had supported further improved productivity in the branch network sales effort. These initiatives supported a further improvement in the retail banking cost:income ratio to 44.4 per cent from 46.4 per cent in 2007.

The impairment charge on loans and advances of £1,472 million in 2008 was £248 million, or 20 per cent, higher than the £1,224 million impairment charge in 2007. The charge in respect of personal loans and overdrafts was £100 million, or 15 per cent, higher at £779 million compared to £679 million in 2007 and represented 5.73 per cent of average lending, compared to 5.32 per cent in 2007; and the charge in respect of card balances was £1 million lower at £526 million compared with £527 million in 2007. The impairment charge in Mortgages was £167 million, compared to £18 million in 2007, or 17 basis points of average mortgage lending. The most significant factors in the increase in the mortgage impairment charge during 2008 were the fall in the house price index and the deterioration in economic conditions in the UK.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**INSURANCE AND INVESTMENTS**

During 2008, Insurance and Investments offered life assurance, pensions and investment products, general insurance and fund management services.

In 2008, Scottish Widows was the Group's specialist provider of life assurance, pensions and investment products, which were distributed through Lloyds TSB Bank's branch network, through independent financial advisors and directly via the telephone and the internet. The Scottish Widows brand was the main brand for new sales of the Group's life, pensions, Open Ended Investment Companies (OEICs) and other long-term savings products.

Lloyds TSB General Insurance provided general insurance through retail branches of Lloyds TSB Bank and C&G, a direct telephone operation, the internet and through third party panel or other distribution channels. Lloyds TSB General Insurance was one of the leading distributors of home insurance in the UK.

Scottish Widows Investment Partnership managed funds for the Group's retail life, pensions and investment products. Clients also included corporate pension schemes, local authorities and other institutions in the UK and overseas.

	2008 £m	2007 £m
Net interest income	(62)	(106)
Other income	1,749	1,741
Total income	1,687	1,635
Insurance claims	(193)	(302)
Total income, net of insurance claims	1,494	1,333
Operating expenses	(591)	(611)
Trading surplus	903	722
Impairment	(2)	
Profit before tax, excluding insurance grossing	901	722
Insurance grossing adjustment <sup>1</sup>	10	26
<b>Profit before tax</b>	<b>911</b>	<b>748</b>

<sup>1</sup> The Insurance and Investment division's income statement includes income and expenditure which are attributable to the policyholders of the Group's long-term assurance funds. These items have no impact upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the Insurance and Investments segment, these items are shown net on a separate line in the segmental analysis above.

	2008 £m	2007 £m
<b>Analysis by area of business of profit before tax</b>		
Life, pensions and OEICs	635	597
General insurance	234	110
Scottish Widows Investment Partnership	42	41
<b>Profit before tax</b>	<b>911</b>	<b>748</b>

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Profit before tax from the Group's Insurance and Investments business was £163 million, or 22 per cent, higher at £911 million in 2008 compared to £748 million in 2007 for the reasons discussed below.

Net interest income improved by £44 million to a net expense of £62 million in 2008 compared to a net expense of £106 million in 2007.

Other income was £8 million higher at £1,749 million in 2008 compared to £1,741 million in 2007.

Other income from Life, pensions and OEICs was flat as growth in new business profit, reflecting sales growth in insurance-accounted products, was offset by reduced existing business profits principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets.

Other income from Scottish Widows Investment Partnership was £13 million lower; but other income from general insurance was £21 million, or 4 per cent, higher at £582 million in 2008 compared to £561 million in 2007. Insurance broking commissions receivable were £99 million, or 15 per cent, lower at £549 million in 2008 compared to £648 million in 2007; home insurance commissions were flat but creditor commissions fell in line with reduced new loan volumes. Underwriting income, net of reinsurance, was £21 million, or 4 per cent, higher at £612 million in 2008 compared to £591 million in 2007 and fees and commissions payable were £87 million, or 13 per cent, lower at £605 million in 2008 compared to £692 million in 2007.

Operating expenses were £20 million, or 3 per cent, lower at £591 million in 2008 compared to £611 million in 2007. A decrease in professional and other fees related to project work was partly offset by increased staff costs.

The performances of the life, pensions and OEICs business and the general insurance business are discussed separately below, on pages 46 and 47.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LIFE, PENSIONS AND OEICS

The table below shows the Present Value of New Business Premiums (PVNBP) which is the measure of new business premiums for the life and pensions business and OEIC sales that management monitors because it provides an indication of both the performance and the profitability of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums. There are three main distribution channels for the sale of the Group's life, pension and OEIC products and the tables below show the relative importance of each.

	2008 £m	2007 £m
<b>Present value of new business premiums (PVNBP)</b>		
Life and pensions:		
Protection	997	960
Savings and investments	437	913
Individual pensions	2,125	2,073
Corporate and other pensions	2,482	2,141
Retirement income	939	1,044
Managed fund business	217	486
Life and pensions	7,197	7,617
OEICs	2,897	2,807
<b>Life, pensions and OEICs</b>	<b>10,094</b>	<b>10,424</b>
Single premium business	7,346	8,375
Regular premium business	2,748	2,049
<b>Life, pensions and OEICs</b>	<b>10,094</b>	<b>10,424</b>
Bancassurance	4,247	4,096
Independent financial advisers	5,367	5,817
Direct	480	511
<b>Life, pensions and OEICs</b>	<b>10,094</b>	<b>10,424</b>

Overall life, pensions and OEICs sales were £330 million, or 3 per cent, lower at £10,094 million in 2008 compared to £10,424 million in 2007, for the following reasons.

Life and pension sales (including Managed fund business) were £420 million, or 6 per cent, lower at £7,197 million in 2008 compared with £7,617 million in 2007. Protection sales were £37 million, or 4 per cent, higher at £997 million compared to £960 million in 2007, but Savings and investment sales were £476 million lower at £437 million compared to £913 million in 2007, partly due to decreased Flexible Option Bond sales following changes in tax legislation which made such bonds less attractive to investors. Individual pension sales were £52 million higher at £2,125 million in 2008 compared to £2,073 million in 2007 as the negative impact of difficult market conditions were more than offset by the sales of the Retirement Account product. Corporate and other pension sales were £341 million higher at £2,482 million compared to £2,141 million in 2007 as continued product development has helped Scottish Widows to attract a number of large corporate pension schemes. Retirement income sales are £105 million lower at £939 million in 2008 compared to £1,044 million in 2007, as current market conditions have made annuity products unattractive; and Managed fund business sales were £269 million lower at £217 million compared to £486 million in 2008, again as a result of adverse market conditions.

OEICs sales increased by £90 million, or 3 per cent, to £2,897 million in 2008 compared to £2,807 million in 2007 as sales growth through the Wealth Management business has more than offset a decrease in sales elsewhere within the Bancassurance channel, as a result of a fall in consumer confidence in the investment market.

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By distribution channel, Bancassurance sales were £151 million, or 4 per cent, higher at £4,247 million in 2008 compared to £4,096 million in 2007 whereas sales via independent financial advisers were £450 million, or 8 per cent, lower at £5,367 million in 2008 compared to £5,817 million in 2007.

Profit before tax from life, pensions and OEICs was £38 million, or 6 per cent, higher at £635 million in 2008 compared to £597 million in 2007, as growth in new business profit, reflecting sales growth in insurance-accounted products, has been partly offset by reduced existing business profits principally reflecting the adverse effect of changes made to the economic assumptions used to calculate the value of in-force business included in the balance sheet and the impact of weaker investment markets.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GENERAL INSURANCE

The results of the general insurance business are set out below.

	2008 £m	2007 £m
Net interest income	6	5
Other income	582	561
<b>Total income</b>	<b>588</b>	<b>566</b>
Insurance claims	(193)	(302)
<b>Total income, net of insurance claims</b>	<b>395</b>	<b>264</b>
Operating expenses	(161)	(154)
<b>Profit before tax</b>	<b>234</b>	<b>110</b>
	2008 £m	2007 £m
Premium income from underwriting (net of reinsurance):		
Home	441	418
Creditor	163	164
Other	8	9
	612	591
Commissions from insurance broking:		
Creditor	428	510
Home	50	50
Other	71	88
	549	648

Profit before tax from the Group's general insurance operations was £124 million, or 113 per cent, higher at £234 million in 2008 compared to £110 million in 2007.

Net interest income was £1 million, or 20 per cent, higher at £6 million in 2008 compared to £5 million in 2007.

Other income was £21 million, or 4 per cent, higher at £582 million in 2008 compared to £561 million in 2007. Insurance broking commissions receivable were £99 million, or 15 per cent, lower at £549 million in 2008 compared to £648 million in 2007; home insurance commissions were flat but creditor commissions fell in line with reduced new loan volumes. Underwriting income, net of reinsurance, was £21 million, or 4 per cent, higher at £612 million in 2008 compared to £591 million in 2007; home insurance premiums were 6 per cent higher reflecting the success of the Home Solutions product. Fees and commissions payable were £87 million, or 13 per cent, lower at £605 million in 2008 compared to £692 million in 2007; this largely reflected reduced creditor insurance sales volumes.

Insurance claims expense was £109 million, or 36 per cent, lower at £193 million in 2008 compared to £302 million in 2007 largely as a result of the non-repetition of the £113 million increase in weather related claims in 2007, resulting from storms in January 2007 and severe flooding in June and July 2007 in the UK.

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Operating expenses were £7 million, or 5 per cent, higher at £161 million in 2008 compared to £154 million in 2007 reflecting increases in staff costs and other administration charges.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## WHOLESALE AND INTERNATIONAL BANKING

In 2008, Wholesale and International Banking provided banking and related services for major UK and multinational corporates and financial institutions, and small and medium-sized UK businesses. It also provided asset finance to personal and corporate customers, managed the Group's activities in financial markets through its treasury function and provided banking and financial services overseas.

Combining the respective strengths of some 3,000 employees, Corporate Markets played an integral role in leveraging and expanding the customer franchise and building deep, long-lasting relationships with around 26,000 corporate customers at 31 December 2008. Corporate Banking managed the Group's core corporate customer franchise, providing a relationship-based financial and advisory service to the corporate market place through dedicated regional teams throughout the UK and key strategic locations abroad, including New York. Customers had access to expert advice and a broad range of financial solutions. Products and Markets was where the specialist product capability resided for transactions undertaken by the corporate customers of the Group. It offered customers a comprehensive range of finance and capital solutions, and also provided tailored risk management solutions and structured solutions across all areas of risk, including foreign exchange, interest rates, credit, inflation and commodities on behalf of the Group.

At 31 December 2008, Commercial Banking served nearly one million customers across the UK from one-person start-ups to large, established enterprises. The business focused on providing banking facilities and solutions to customers with business turnover up to £15 million per annum, and additionally provided specialised working capital finance for its customers through its Commercial Finance subsidiary, and long-term finance to the agricultural sector through the Agricultural Mortgage Corporation.

The Group's asset finance businesses provided individuals and companies with specialist personal lending, store credit and finance through leasing, hire purchase and contract hire packages. Altogether, at 31 December 2008, Asset Finance had over 1.5 million individual customers and relationships with some 22,000 companies and small businesses.

The Group had continued to shape its international network to support its UK operations. Its overseas banking operations included offices in the UK, the Channel Islands, the Isle of Man, Dubai, Hong Kong, Spain, France, Switzerland, Luxembourg, Belgium, Netherlands, Monaco, Gibraltar, Cyprus, South Africa, Japan, Singapore, Malaysia, China and the US. The business provided a wide range of private and retail banking, wealth management and expatriate services to local residents, UK expatriates, foreign nationals and to other customers and also served the corporate and institutional markets in a number of these locations.

	2008 £m	2007 £m
Net interest income	3,303	2,380
Other income	829	1,644
Total income	4,132	4,024
Operating expenses	(2,350)	(2,152)
Trading surplus	1,782	1,872
Impairment	(1,508)	(572)
<b>Profit before tax</b>	<b>274</b>	<b>1,300</b>
Cost:income ratio	56.9%	53.5%
Total assets (year end)	£238,832m	£163,294m

In 2008 Wholesale and International Banking recorded a profit before tax of £274 million which was £1,026 million, or 79 per cent, lower than £1,300 million in 2007, for the following reasons.

Net interest income was £923 million, or 39 per cent, higher at £3,303 million compared to £2,380 million in 2007. This increase reflected growth in interest-earning assets in Corporate Markets, Commercial Banking and International Banking. Average interest-earning assets were £22,547 million, or 17 per cent, higher at £158,254 million. Excluding the fine margin reverse repurchase agreement balances from both years, the increase was £24,891 million. The net interest margin, again excluding the

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fine margin reverse repurchase agreement balances, increased by 27 basis points, as a widening of margins within Corporate Markets, in part as a result of changes in funding arrangements, and Asset Finance was partly offset by decreased margins in Commercial Banking, where growth has been in lower margin secured products.

Other income was £815 million, or 50 per cent, lower at £829 million compared to £1,644 million in 2007; the significant reduction in Corporate Markets other income (£936 million lower), primarily as a result of the recent market turmoil, was partially offset by increases in Commercial Banking (£34 million, or 8 per cent, higher), Asset Finance (£40 million, or 9 per cent, higher) and International Banking (£22 million, or 12 per cent, higher).

Operating expenses were £198 million, or 9 per cent, higher at £2,350 million in 2008 compared to £2,152 million in 2007. This increase reflects the continued investment in the Group's people and infrastructure, particularly within Corporate Markets.

The impairment charge in 2008 totalled £1,508 million, compared to £572 million in 2007, an increase of £936 million. The charge in respect of loans and receivables increased by £905 million, from £497 million in 2007 to £1,402 million in 2008 and the charge as a percentage of average lending was 1.33 per cent compared to 0.57 per cent in 2007. In Corporate Markets the charge was £774 million higher, at £939 million compared to £165 million in 2007; the significant increase reflects the economic slowdown in the UK and the impact of a number of high profile financial services company collapses. In Commercial Banking the charge was £89 million, or 90 per cent, higher, at £188 million; in Asset Finance the charge was £42 million, or 18 per cent, higher, at £270 million; and in International Banking there was a charge of £6 million compared with a release of £2 million in 2007. In addition, a charge of £100 million in 2008 (2007: £70 million) arose in respect of the impairment of available-for-sale financial assets.

At 31 December 2008, Lloyds Banking Group's Corporate Markets exposure to certain categories of assets the values of which had been affected by the ongoing capital markets uncertainties was as described below:

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Asset Backed Security CDOs (ABS CDOs) and monoline Credit Default Swap (CDS) exposure: Corporate Markets had no direct exposure to US sub-prime ABS and limited indirect exposure through ABS CDOs. During 2008, the market value of the Group's holdings in ABS CDOs reduced and, as a result, Corporate Markets took an income statement charge of £92 million. Corporate Markets had no exposure to mezzanine ABS CDOs. In addition, Corporate Markets had £1,867 million, compared to £1,861 million at 31 December 2007, of ABS CDOs which remained fully cash collateralised by major global financial institutions.

At 31 December 2008, Corporate Markets had fair value exposure to one monoline financial guarantor in the form of CDS protection bought against a £256 million collateralised loan obligation. The exposure on this CDS was £10 million, following a £28 million adverse credit valuation adjustment. A restructuring of the Group's other monoline hedged ABS CDO had eliminated any reliance on the financial guarantor and had resulted in a much improved risk profile on a reduced holding of £128 million included in loans and receivables. Credit valuation adjustments and restructuring costs related to the cancelled CDS in the amount of £275 million were recognised in the income statement.

Structured Investment Vehicles (SIV): During 2008 Corporate Markets wrote down the value of its SIV exposures by £95 million. Corporate Markets had no residual exposure to SIV Capital Notes. Additionally, at 31 December 2008 Corporate Markets had a commercial paper back up liquidity facility totalling £22 million, compared to £370 million at 31 December 2007.

Financial instruments held at fair value through profit or loss: During 2008, Corporate Markets also saw a reduction in profit before tax of £653 million (excluding the £303 million described above due to valuation and restructuring costs relating to CDS) as a result of the impact of mark-to-market adjustments in certain legacy trading portfolios, reflecting the marketwide repricing of liquidity and credit.

At 31 December 2008 the trading portfolio contained £33 million of indirect exposure to US sub-prime mortgages and ABS CDOs. This super senior exposure remained protected by note subordination.

Available-for-sale financial assets: At 31 December 2008, the Group's portfolio of available-for-sale financial assets totalled £55,707 million, compared to £20,196 million at 31 December 2007, of which £55,364 million, compared to £19,662 million at 31 December 2007, were held in Corporate Markets. This increase largely reflected the Group's decision to substantially increase, for liquidity purposes, its holdings of treasury and Government guaranteed securities over the HBOS acquisition period. The available-for-sale financial assets comprised £6,273 million ABS in Cancara, the Group's hybrid Asset-Backed Commercial Paper conduit, £2,917 million Student Loan ABS, predominantly guaranteed by the US Government, £11,747 million Government bonds and short-dated bank commercial paper, £29,142 million treasury bills and other eligible bills and £5,285 million major bank senior paper and high quality ABS. Temporary mark-to-market adjustments are required to be taken through reserves. During 2008, a net £2,023 million reserves adjustment, which had no impact on the Group's capital ratios, had been made to reflect a reduction in the value of available-for-sale financial assets.

Impairment of available-for-sale financial assets: Gross impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement during 2008 totalled £130 million, compared to £70 million during 2007, of which £100 million related to Corporate Markets, compared to £70 million during 2007.

Cancara: Total exposures in Cancara were £12,615 million at 31 December 2008, comprising £6,273 million of ABS in available-for-sale financial assets and £6,342 million in loans and advances to customers. Cancara is fully consolidated in the Group's accounts. At 31 December 2008, the ABS in Cancara were 91.8 per cent and 94.2 per cent Aaa/AAA rated by Moody's and Standard & Poor's respectively, and there was no exposure either directly or indirectly to sub-prime US mortgages within the ABS portfolio. All non AAA rated ABS had been funded by the Group. At 31 December 2008 loans and advances to customers included no US sub-prime mortgage exposure.

Leveraged finance underwriting commitments: At 31 December 2008, Corporate Markets' not yet syndicated leveraged loan underwriting commitments amounted to £931 million, compared to £756 million at 31 December 2007, of which £438 million were originated before the current market uncertainties. All of the underlying assets were performing satisfactorily.

The Group's exposures to categories of assets, the value of which has been affected by the ongoing capital markets uncertainties, increased significantly following the acquisition of HBOS.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CENTRAL GROUP ITEMS

	2008 <sup>1</sup> £m	2007 <sup>1</sup> £m
Net interest income	(293)	(368)
Other income	(203)	352
Total income	(496)	(16)
Operating expenses	(77)	(7)
Trading surplus	(573)	(23)
Impairment	(30)	
Share of results of joint ventures and associates	4	10
<b>Loss before tax</b>	<b>(599)</b>	<b>(13)</b>

1 Restated for IFRS 2 (Revised).

Central group items are comprised of three main elements:

1 The funding cost of acquisitions less earnings on capital:

interest costs on central balances, which principally arise from the cost of centrally funded acquisitions net of the proceeds of any subsequent disposals, together with the funding cost of dividend flows;

net interest margin cost resulting from central capital activities, primarily arising on the management of senior and subordinated debt and preference shares net of such cost allocated to the divisions; and

earnings allocated to the UK banking businesses on equity required to support their current activities offset by the income on actual equity held in those businesses.

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

3 Central costs and other unallocated items: these relate to the on-going costs of central group activities including those of group corporate treasury (including the central hedge function), internal group audit, group risk, group compliance, group finance and group IT and operations.

Loss before tax from Central group items was £599 million in 2008 compared to £13 million in 2007. Total income was a deficit of £496 million compared to a deficit of £16 million in 2007; income in 2008 was significantly affected by the impact of yield curve volatility on the fair value of derivatives entered into for risk management purposes, after taking into account the effect of hedge accounting adjustments. Operating expenses were £77 million, compared to £7 million in 2007, reflecting increased central costs that were not recharged to the divisions in connection with professional advice received during 2008 and other items; the charge for payments to the Lloyds TSB Foundations was £27 million compared to £37 million in 2007. An impairment charge of £30 million, compared to £nil in 2007, reflected the write-off of the Group's investment in Bradford & Bingley equity shares.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CONTINUING BUSINESSES BASIS SUMMARY 2008 COMPARED WITH 2007**

The continuing businesses segmental results for 2008 and 2007 are prepared in accordance with IFRS. However, the aggregated total of the continuing businesses segmental results constitutes a non-GAAP measure, as defined by the SEC.

Management used the aggregated total of the continuing businesses segmental results, a non-GAAP measure of performance, and believes that it provides important information for investors, because it provides a clearer representation of the Group's underlying business performance. Profit before tax is the comparable GAAP measure to profit before tax on a continuing businesses basis; a reconciliation of the Group's statutory income statement to its continuing businesses basis income statement is shown below. Readers should be aware that the continuing businesses basis excludes certain items, as indicated in the tables below, reflected in the Group's statutory results.

Set out below is a reconciliation from the Group's statutory results to the continuing businesses basis, together with a brief commentary.

	Removal of							
	Statutory <sup>1</sup> £m	Volatility £m	Provision for historic US dollar payments £m	Financial Services Compensation Scheme levy £m	Goodwill impairment £m	Continuing businesses <sup>1</sup> £m	Removal of insurance gross up £m	Continuing businesses excluding insurance gross up <sup>1</sup> £m
2008								
Net interest income	7,718	(9)				7,709	(651)	7,058
Other income	(709)	1,226				517	3,624	4,141
Total income	7,009	1,217				8,226	2,973	11,199
Insurance claims	2,859					2,859	(3,052)	(193)
Total income, net of insurance claims	9,868	1,217				11,085	(79)	11,006
Operating expenses	(6,100)		180	122	100	(5,698)	69	(5,629)
Trading surplus	3,768	1,217	180	122	100	5,387	(10)	5,377
Impairment	(3,012)					(3,012)		(3,012)
Share of results of joint ventures and associates	4					4		4
Profit before tax	760	1,217	180	122	100	2,379	(10)	2,369

1 Restated for IFRS 2 (Revised).

	Removal of							
	Statutory <sup>1</sup> £m	Volatility £m	Discontinued businesses £m	Profit on sale of businesses £m	Settlement of overdraft claims £m	Continuing businesses <sup>1</sup> £m	Removal of insurance gross up £m	Continuing businesses excluding insurance gross up <sup>1</sup> £m
2007								

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Net interest income	6,099	(7)	(70)			6,022	(421)	5,601
Other income	12,119	506	(858)			11,767	(6,233)	5,534
Total income	18,218	499	(928)			17,789	(6,654)	11,135
Insurance claims	(7,522)		605			(6,917)	6,615	(302)
Total income, net of insurance claims	10,696	499	(323)			10,872	(39)	10,833
Operating expenses	(5,568)		161		76	(5,331)	13	(5,318)
Trading surplus	5,128	499	(162)		76	5,541	(26)	5,515
Impairment	(1,796)					(1,796)		(1,796)
Share of results of joint ventures and associates	10					10		10
Profit on sale and closure of businesses	657			(657)				
Profit before tax	3,999	499	(162)	(657)	76	3,755	(26)	3,729

1 Restated for IFRS 2 (Revised).

Profit before tax on a continuing businesses basis decreased by £1,376 million, or 37 per cent, to £2,379 million in 2008 compared to £3,755 million in 2007; this deterioration in profit reflected a £990 million increase in the adverse impact of market dislocation and a significant increase in impairment losses.

Total income, excluding insurance gross up, was £64 million higher at £11,199 million in 2008 compared to £11,135 million in 2007. However, excluding the negative impact on income of the market dislocation of £925 million (2007: £188 million), total income, excluding insurance gross up, was £801 million, or 7 per cent, higher at £12,124 million in 2008 compared to £11,323 million in 2007.

This growth reflected increased income from both new and existing customers, with growth in both assets and liabilities leading to higher net interest income, as well as an increase in fee-related income.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Net interest income, excluding insurance grossing, increased by £1,457 million, or 26 per cent, to £7,058 million. During 2008, total assets increased by £82,687 million, or 23 per cent to £436,033 million, with a £30,530 million, or 15 per cent, increase in loans and advances to customers to £240,344 million compared to £209,814 million at 31 December 2007, reflecting customer lending growth in both corporate banking and mortgages. Customer deposits increased by £14,383 million, or 9 per cent, to £170,938 million compared to £156,555 million at 31 December 2007, supported by good growth in savings balances in the retail bank, where bank savings increased by 12 per cent and wealth management balances by 20 per cent.

The net interest margin was largely flat, as improved product margins were offset by an adverse mix effect. There were increased new business product margins in the mortgage and corporate businesses; however, higher growth in finer margin corporate and mortgage lending than in the wider margin unsecured consumer lending contributed to the negative mix effect which offset the increase in product margins.

Other income, excluding insurance grossing, decreased by £1,393 million, or 25 per cent, to £4,141 million, compared to £5,534 million in 2007, largely reflecting the impact of market dislocation. In the retail bank, higher fees and commissions receivable as a result of growth in added value current accounts and card services were offset by lower creditor insurance commissions and the impact of changes in product design leading to a greater proportion of earnings being recognised as net interest income rather than fee income. In addition, growth was achieved in fee-based product sales to commercial banking customers.

The Group continued to invest in improving processing efficiency, resulting in control over day-to-day operating costs. During 2008, operating expenses excluding the insurance grossing adjustment increased by £311 million, or 6 per cent, to £5,629 million compared to £5,318 million in 2007.

Impairment losses increased by £1,216 million, or 68 per cent, to £3,012 million in 2008 compared to £1,796 million in 2007. Excluding the impact of market dislocation of £345 million (2007: £92 million), impairment losses increased by £963 million, or 57 per cent, to £2,667 million in 2008 compared to £1,704 million in 2007.

In UK Retail Banking, impairment losses increased by £248 million, or 20 per cent, to £1,472 million, particularly reflecting the impact of lower house prices on the mortgage impairment charge. The Wholesale and International Banking charge for impairment losses increased significantly by £936 million to £1,508 million, including the £345 million impairment charge relating to the impact of market dislocation during 2008. The remaining charge reflected an increase in the level of impairments as a result of the economic slowdown in the UK and the impact of a number of high profile financial services company collapses.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2009 Average balance £m	2009 Interest income £m	2009 Yield %	2008 Average balance £m	2008 Interest income £m	2008 Yield %	2007 Average balance £m	2007 Interest income £m	2007 Yield %
<b>Assets</b>									
Loans and receivables:									
Loans and advances to banks	65,440	769	1.18	39,004	1,847	4.74	39,381	2,025	5.14
Loans and advances to customers	675,092	24,171	3.58	218,220	13,808	6.33	191,802	13,209	6.89
Debt securities	39,911	1,469	3.68	2,419	61	2.52			
Lease and hire purchase receivables	14,165	852	6.01	9,266	706	7.62	9,488	602	6.34
Available-for-sale financial assets	54,926	977	1.78	25,058	1,147	4.58	21,473	1,038	4.83
<b>Total interest-earning assets of banking book</b>	<b>849,534</b>	<b>28,238</b>	<b>3.32</b>	<b>293,967</b>	<b>17,569</b>	<b>5.98</b>	<b>262,144</b>	<b>16,874</b>	<b>6.44</b>
<b>Total interest-earning trading securities and other financial assets at fair value through profit or loss</b>	<b>59,849</b>	<b>2,224</b>	<b>3.72</b>	<b>24,292</b>	<b>1,577</b>	<b>6.49</b>	<b>28,524</b>	<b>1,542</b>	<b>5.41</b>
<b>Total interest-earning assets</b>	<b>909,383</b>	<b>30,462</b>	<b>3.35</b>	<b>318,259</b>	<b>19,146</b>	<b>6.02</b>	<b>290,668</b>	<b>18,416</b>	<b>6.34</b>
Allowance for impairment losses on loans and advances	(9,551)			(2,838)			(2,268)		
Non-interest earning assets	164,056			60,939			66,202		
<b>Total average assets and interest income</b>	<b>1,063,888</b>	<b>30,462</b>	<b>2.86</b>	<b>376,360</b>	<b>19,146</b>	<b>5.09</b>	<b>354,602</b>	<b>18,416</b>	<b>5.19</b>
	2009 Average interest earning assets £m	2009 Net interest income £m	2009 Net interest margin %	2008 Average interest earning assets £m	2008 Net interest income £m	2008 Net interest margin %	2007 Average interest earning assets £m	2007 Net interest income £m	2007 Net interest margin %
<b>Average interest-earning assets and net interest income:</b>									
Banking business	849,534	9,026	1.06	293,967	7,718	2.63	262,144	6,099	2.33
Trading securities and other financial assets at fair value through profit or loss	59,849	1,706	2.85	24,292	1,151	4.74	28,524	1,179	4.13
	<b>909,383</b>	<b>10,732</b>	<b>1.18</b>	<b>318,259</b>	<b>8,869</b>	<b>2.79</b>	<b>290,668</b>	<b>7,278</b>	<b>2.50</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2009 Average balance £m	2009 Interest expense £m	2009 Cost %	2008 Average balance £m	2008 Interest expense £m	2008 Cost %	2007 Average balance £m	2007 Interest expense £m	2007 Cost %
<b>Liabilities and shareholders funds</b>									
Deposits by banks	93,234	883	0.95	42,150	1,540	3.65	38,406	1,919	5.00
Liabilities to banks under sale and repurchase agreements	42,794	1,399	3.27	5,643	253	4.48	3,127	153	4.89
Customer deposits	357,323	4,410	1.23	151,013	4,932	3.27	142,048	5,085	3.58
Liabilities to customers under sale and repurchase agreements	41,890	256	0.61	106	3	2.83	95	2	2.11
Debt securities in issue	247,079	6,318	2.56	54,359	2,227	4.10	52,743	2,680	5.08
Other interest-bearing liabilities	10,865	1,621	14.92	4,239			4,551	195	4.28
Subordinated liabilities	43,033	4,325	10.05	15,400	896	5.82	13,126	741	5.65
<b>Total interest-bearing liabilities of banking book</b>	<b>836,218</b>	<b>19,212</b>	<b>2.30</b>	<b>272,910</b>	<b>9,851</b>	<b>3.61</b>	<b>254,096</b>	<b>10,775</b>	<b>4.24</b>
<b>Total interest-bearing liabilities of trading book</b>	<b>28,639</b>	<b>518</b>	<b>1.81</b>	<b>11,769</b>	<b>426</b>	<b>3.62</b>	<b>9,971</b>	<b>363</b>	<b>3.64</b>
<b>Total interest-bearing liabilities</b>	<b>864,857</b>	<b>19,730</b>	<b>2.28</b>	<b>284,679</b>	<b>10,277</b>	<b>3.61</b>	<b>264,067</b>	<b>11,138</b>	<b>4.22</b>
<b>Interest-free liabilities</b>									
Non-interest bearing customer accounts	6,902			3,793			3,899		
Other interest-free liabilities	158,881			76,584			74,628		
Minority interests and shareholders funds	33,248			11,304			12,008		
<b>Total average liabilities and interest expense</b>	<b>1,063,888</b>	<b>19,730</b>	<b>1.85</b>	<b>376,360</b>	<b>10,277</b>	<b>2.73</b>	<b>354,602</b>	<b>11,138</b>	<b>3.14</b>

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.

Average balances are based on daily averages for the principal areas of the Lloyds Banking Group's banking activities with monthly or less frequent averages used elsewhere. Management believes that the interest rate trends are substantially the same as they would be if all balances were averaged on the same basis.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

	Domestic			Foreign			Total		
	Average Balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
<b>Assets</b>									
Loans and receivables:									
Loans and advances to banks	57,500	594	1.03	7,940	175	2.20	65,440	769	1.18
Loans and advances to customers	619,856	22,092	3.56	55,236	2,079	3.76	675,092	24,171	3.58
Debt securities	38,189	1,439	3.77	1,722	30	1.74	39,911	1,469	3.68
Lease and hire purchase receivables	13,673	836	6.11	492	16	3.25	14,165	852	6.01
Available-for-sale financial assets	46,787	896	1.92	8,139	81	1.00	54,926	977	1.78
Total interest-earning assets of banking book	776,005	25,857	3.33	73,529	2,381	3.24	849,534	28,238	3.32
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,571	2,213	3.71	278	11	3.96	59,849	2,224	3.72
<b>Total interest-earning assets</b>	<b>835,576</b>	<b>28,070</b>	<b>3.36</b>	<b>73,807</b>	<b>2,392</b>	<b>3.24</b>	<b>909,383</b>	<b>30,462</b>	<b>3.35</b>
Allowance for impairment losses on loans and advances	(5,740)			(3,811)			(9,551)		
Non-interest earning assets	159,516			4,540			164,056		
<b>Total average assets and interest income</b>	<b>989,352</b>	<b>28,070</b>	<b>2.84</b>	<b>74,536</b>	<b>2,392</b>	<b>3.21</b>	<b>1,063,888</b>	<b>30,462</b>	<b>2.86</b>
<b>Percentage of assets applicable to foreign activities (%)</b>							7.01		

	Domestic			Foreign			Total		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
<b>Liabilities and shareholders funds</b>									
Deposits by banks	63,207	653	1.03	30,027	230	0.77	93,234	883	0.95
Liabilities to banks under sale and repurchase agreements	42,794	1,399	3.27				42,794	1,399	3.27
Customer deposits	349,709	4,255	1.22	7,614	155	2.04	357,323	4,410	1.23
Liabilities to customers under sale and repurchase agreements	41,827	256	0.61	63			41,890	256	0.61
Debt securities in issue	222,212	6,099	2.74	24,867	219	0.88	247,079	6,318	2.56
Other interest-bearing liabilities	10,865	1,621	14.92				10,865	1,621	14.92
Subordinated liabilities	42,183	4,276	10.14	850	49	5.76	43,033	4,325	10.05
Total interest-bearing liabilities of banking book	772,797	18,559	2.40	63,421	653	1.03	836,218	19,212	2.30
Total interest-bearing liabilities of trading book	28,639	518	1.81				28,639	518	1.81
<b>Total interest-bearing liabilities</b>	<b>801,436</b>	<b>19,077</b>	<b>2.38</b>	<b>63,421</b>	<b>653</b>	<b>1.03</b>	<b>864,857</b>	<b>19,730</b>	<b>2.28</b>
<b>Interest-free liabilities</b>	<b>6,253</b>			<b>649</b>			<b>6,902</b>		

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Non-interest bearing customer accounts									
Other interest-free liabilities	157,426			1,455			158,881		
Minority interests and shareholders funds	24,237			9,011			33,248		
<b>Total average liabilities and interest expense</b>	<b>989,352</b>	<b>19,077</b>	<b>1.93</b>	<b>74,536</b>	<b>653</b>	<b>0.88</b>	<b>1,063,888</b>	<b>19,730</b>	<b>1.85</b>
<b>Percentage of liabilities applicable to foreign activities (%)</b>							<b>6.36</b>		

## 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 2009 compared with 2008 and for 2008 compared with 2007. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2009 compared with 2008 Increase/(decrease)			2008 compared with 2007 Increase/(decrease)		
	Total change £m	Volume £m	Rate £m	Total change £m	Volume £m	Rate £m
<b>Interest receivable and similar income</b>						
Loans and receivables:						
Loans and advances to banks	(1,078)	311	(1,389)	(178)	(18)	(160)
Loans and advances to customers	10,363	16,358	(5,995)	599	1,672	(1,073)
Debt securities	1,408	1,380	28	61	61	
Lease and hire purchase receivables	146	295	(149)	104	(17)	121
Available-for-sale financial assets	(170)	531	(701)	109	164	(55)
Total banking book interest receivable and similar income	10,669	18,875	(8,206)	695	1,862	(1,167)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	647	1,321	(674)	35	(275)	310
<b>Total interest receivable and similar income</b>	<b>11,316</b>	<b>20,196</b>	<b>(8,880)</b>	<b>730</b>	<b>1,587</b>	<b>(857)</b>
<b>Interest payable</b>						
Deposits by banks	(657)	484	(1,141)	(379)	137	(516)
Liabilities to banks under sale and repurchase agreements	1,146	1,215	(69)	100	113	(13)
Customer deposits	(522)	2,546	(3,068)	(153)	293	(446)
Liabilities to customers under sale and repurchase agreements	253	255	(2)	1		1
Debt securities in issue	4,091	4,928	(837)	(453)	66	(519)
Other interest bearing liabilities	1,621	989	632	(195)		(195)
Subordinated liabilities	3,429	2,777	652	155	132	23
Total banking book interest payable	9,361	13,194	(3,833)	(924)	741	(1,665)
Total interest payable on trading and other liabilities at fair value through profit or loss	92	305	(213)	63	65	(2)
<b>Total interest payable</b>	<b>9,453</b>	<b>13,499</b>	<b>(4,046)</b>	<b>(861)</b>	<b>806</b>	<b>(1,667)</b>

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS  
RISK MANAGEMENT**

**AUDITED INFORMATION**

**THE GROUP'S APPROACH TO RISK**

The Group's approach to risk is founded on robust corporate governance practices and a risk management culture which guides the way all employees approach their work, the way they behave and the decisions they make. The board takes the lead by establishing the tone at the top and approving professional standards and corporate values for itself, senior management and other colleagues. The board ensures that senior management implements strategic policies and procedures designed to promote professional behaviour and integrity. The board also ensures that senior management implements risk policies and risk appetites that either limit, or where appropriate, prohibit activities, relationships, and situations that could diminish the quality of corporate governance. All colleagues including the group chief executive are assessed against a balanced scorecard that explicitly addresses their risk performance.

This board level engagement, coupled with the direct involvement of senior management in group-wide risk issues at group executive committee level, ensures that issues are escalated on a timely basis and appropriate remediation plans are put in place. The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by senior management. Key decisions are always taken by more than one person.

The group business risk committee and the group asset and liability committee are chaired by the group chief executive and include all members of the group executive committee. The aggregate group wide risk profile and portfolio appetite are discussed at these monthly meetings. The risk oversight committee, chaired by the deputy group chairman, comprises non-executive directors and oversees the Group's risk exposures. This second-line-of-defence committee is supported by the chief risk officer, who is independent of the front line business units, is a full member of the group executive committee and reports to the group chief executive. The chief risk officer regularly informs the risk oversight committee of the aggregate risk profile and has direct access to the deputy group chairman and the members of the risk oversight committee.

The Group has a conservative business model embodied by a risk culture founded on prudence and accountability, where everyone understands that they are accountable for the risks they take and that the needs of customers are paramount. The focus has been and remains on building and sustaining long-term relationships with customers, through good and bad economic times. The approach is supported by a through the cycle approach to risk with strong central control and monitoring.

**RISK AS A STRATEGIC DIFFERENTIATOR**

The maintenance of a strong control framework remains a priority for the new Lloyds Banking Group and is the foundation for the delivery of effective risk management. The Group optimises performance by allowing divisions and business units to operate within approved capital, liquidity and risk parameters and within the Group's policy framework. The Group's approach to risk management ensures that business units remain accountable for risk whilst realising individual strategies to meet business performance targets. The combination of divisional and group risk management maintains effective independent oversight.

The Group continues to enhance its capabilities by providing to the board both qualitative and quantitative data including stress testing analysis on risks associated with strategic objectives to facilitate more informed and effective decision making. The Group's ability to take risks which are well understood, consistent with its strategy and plans and which are appropriately remunerated, is a key driver of shareholder return.

As part of its integration initiative, the Group has been rolling out the methodology and financial control framework that was used by heritage Lloyds TSB; this includes compliance with the requirements of the US Sarbanes Oxley Act. This project is due to complete in time for reporting in February 2011.

Risk analysis and reporting capabilities support the identification of opportunities as well as risks and it provides an aggregate view of the overall risk portfolio. Risk mitigation strategies clearly aligned with responsibilities and timescales are monitored at group and divisional level.

Reflecting the importance the Group places on risk management, risk is included as one of the five principal criteria within the Group's balanced scorecard on which individual staff performance is judged. Business executives have specified risk management objectives, and incentive schemes take account of performance against these.

## STATE AID

The Group is subject to European state aid obligations as a result of the aid it received from HM Treasury. In November 2009 the European Commission, through its College of Commissioners, approved the Group's restructuring plan, which is designed to address any competition distortions arising from the benefits of state aid. The Group agreed with HM Treasury in the deed relating to its withdrawal from GAPS that it will comply with the terms of the European Commission's decision. This has placed a number of requirements on the Group including the disposal of certain portions of its business over the course of the next four years, including in particular the disposal of some parts of its retail banking business. This will require the Group to work closely with EU and UK authorities to demonstrate that it is complying with the terms of the European Commission's decision.

HM Treasury holds approximately 41.3 per cent of the Group's ordinary share capital. There is a risk that this shareholding could in future be used to seek to exercise influence over the affairs or strategic business plans of the Group, particularly if other Government priorities or HM Treasury's interests as a major shareholder in other financial institutions do not align with their interests purely as a shareholder in the Group.

United Kingdom Financial Investments has been appointed manager of HM Treasury's shareholding and the framework document between UKFI and HM Treasury states that UKFI will manage the UK financial institutions in which HM Treasury holds an interest on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (as defined therein). This document also makes it clear that such institutions will continue to be separate economic units with independent powers of decision and will continue to have their own independent boards and management teams, determining their own strategies and commercial policies including business plans and budgets.

In addition, the Group has made a number of undertakings to HM Treasury associated with the state aid it has received, including the provision of additional lending to certain mortgage and business sectors, and other matters relating for instance to corporate governance and staff remuneration. These commitments could limit the operational flexibility of the Group or lead HM Treasury to seek to influence the strategy of the Group in other ways.



**OPERATING AND FINANCIAL REVIEW AND PROSPECTS  
RISK GOVERNANCE****AUDITED INFORMATION**

The Group has rolled out the heritage Lloyds TSB approach to risk appetite, policies, delegations and risk committee structure and has continued to embed these across all risk disciplines and into the business. Having achieved alignment of all high level group principles and appetites on the date of acquisition, the Group has continued to embed these at all levels.

The risk governance structure is intended to strengthen risk evaluation and management, whilst also positioning the Group to manage the changing regulatory environment in an efficient and effective manner. The risk governance structure for Lloyds Banking Group is shown in the table on page 59.

**BOARD AND COMMITTEES**

The board, assisted by its key risk committees (risk oversight committee and group audit committee), approves the Group's overall risk management framework. The board also reviews the Group's aggregate risk exposures and concentrations of risk to seek to ensure that these are consistent with the board's appetite for risk. The role of the board, audit committee and risk oversight committee are shown in the corporate governance section on pages 123 to 128, and further key risk oversight roles are described below.

In particular, the **risk oversight committee**, which comprises non-executive directors, oversees the development, implementation and maintenance of the group's overall risk management framework and its risk appetite, strategy, principles and policies, to ensure they are in line with emerging regulatory, corporate governance and industry best practice. The risk oversight committee regularly reviews the Group's risk exposures across the primary risk drivers and the detailed risk types.

The **group executive committee** assisted by the group business risk committee and the group asset and liability committee, supports the group chief executive in ensuring the effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, whilst also reviewing the Group's aggregate risk exposures and concentrations of risk. The GEC's duties are described in greater detail on page 125.

The **group asset and liability committee** is responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility. The group asset and liability committee is supported by the **senior asset and liability committee**, which is responsible for the review of documentation relating to the management of assets and liabilities in the Group's balance sheet and the escalation of issues of group level significance to the group asset and liability committee.

The **group business risk committee** reviews and recommends the Group's risk appetite and risk management framework, high-level group policies and the allocation of risk appetite. The group business risk committee periodically reviews risk exposures and risk/reward returns and monitors the development, implementation and effectiveness of the Group's risk governance framework. Within the scope of its work the committee also considers reputational risk and any issues which could have a materially adverse impact on the Group.

The group business risk committee is supported by the following committees:

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

The **group credit risk committee**, which is responsible for the development and effectiveness of the Group's credit risk management framework, clear description of the Group's credit risk appetite, setting of high level Group credit policy, and compliance with regulatory credit requirements. On behalf of the group business risk committee, the group credit risk committee monitors and reviews the Group's aggregate credit risk exposures and concentrations of risk.

The **group model governance and approvals committee**, which is responsible for setting the control framework and standards for models across the Group, including establishing appropriate levels of delegated authority, the approval of models that are considered to be material to the Group (including credit risk rating systems), and the principles underlying the Group's economic capital framework.

The **group insurance risk committee**, which is responsible for the development and effectiveness of the Group's insurance risk management framework, clear articulation of the Group's insurance risk appetite, setting of high level insurance risk policy, and ensuring compliance with regulatory insurance requirements. On behalf of the group business risk committee, the group insurance risk committee monitors and reviews the Group's aggregate insurance risk exposures and provides proactive and robust challenge around insurance risk and business activities giving rise to insurance risk.

During the year, the Group has created **divisional financial control committees** to provide governance over financial statements. The meetings provide review and challenge as to the veracity of the results, press release and supporting analyst information addressing the processes that have been followed in drawing them up. Items of focus are key assumptions and areas of subjectivity in the results and ensuring proper remediation of control issues that impact internal controls over financial reporting, the Group's auditors also report findings from their audit work.

The group risk directors and divisional risk officers meet on a regular basis under the chairmanship of the chief risk officer to review and challenge the risk profile of the Group and seek to ensure that mitigating actions are appropriate. Aggregate risk reports are reviewed by this group before submission to group business risk committees and then to risk oversight committee.

Group executive directors have primary responsibility for measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group's high level policies and within the parameters set by the board, group executive committee and group risk. Compliance with policies and parameters is overseen by the risk oversight committee, the group business risk committee, the group asset and liability committee, group risk and the divisional risk officers.

## **RISK MANAGEMENT OVERSIGHT**

The chief risk officer oversees and promotes the development and implementation of a consistent group-wide risk management framework. The chief risk officer, supported by the group risk directors and the divisional risk officers, provides objective challenge to the Group's senior management. The group executive committee and the board receive regular briefings and guidance from the chief risk officer to ensure awareness of the overarching risk management framework and a clear understanding of their accountabilities for risk and internal control.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AUDITED INFORMATION

**RISK GOVERNANCE STRUCTURES**

Group risk directors who report directly to the chief risk officer, are allocated responsibility for certain specific risk types and are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the risk profile across the Group. Divisional risk officers have dual reporting lines to their own divisional executive and also to the chief risk officer and are responsible for the risk profile within their own divisions. This matrix approach enables the group executive committee members to fulfil their risk management accountabilities.

Divisional risk officers provide oversight of risk management activity for all risks within each of the Group's divisions. Reporting directly to the group executive directors responsible for the divisions and to the chief risk officer, their day-to-day contact with business management, business operations and risk initiatives seeks to provide an effective risk oversight mechanism.

The director of group audit provides independent assurance to the audit committee and the board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group audit is fully independent of group risk, seeking to ensure objective challenge to the effectiveness of the risk governance framework.

**RISK MANAGEMENT IN THE BUSINESS**

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

All business units, divisions and group functions complete a control self assessment annually (see page 127), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Managing directors of each business and each group executive committee member certify the accuracy of their assessment.

Risk management in the business forms part of a tiered risk management model, as shown above, with the divisional risk officers and group risk providing oversight and challenge, as described above, and the chief risk officer and group committees establishing the group-wide perspective.

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

**RISK MANAGEMENT FRAMEWORK****RISK MANAGEMENT FRAMEWORK**

The Group's risk management principles and risk management framework cover the full spectrum of risks that a group, which encompasses both banking and insurance businesses, would encounter.

The Group uses an enterprise-wide risk management framework for the identification, assessment, measurement and management of risk. It seeks to maximise value for shareholders over time by aligning risk management with the corporate strategy, assessing the impact of emerging risks from legislation, new technologies or the market, and developing risk tolerances and mitigating strategies. The framework seeks to: strengthen the Group's ability to identify and assess risks, aggregate group-wide risks and define the group risk appetite, develop solutions for reducing or transferring risk, and where appropriate, exploit risks to gain competitive advantage, thereby seeking to increase shareholder value. The principal elements of the risk management framework are shown in the table above. The framework above comprises 11 interdependent activities which map to the components of the internal control integrated framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

The framework is dynamic and allows for proportionate adjustment of policies and controls where business strategy and risk appetite is amended in response to changes in market conditions.

**The Lloyds Banking Group business strategy and objective** is used to determine the Group's high level risk principles and risk appetite measures and metrics for the primary risk drivers (see the table on page 63). The risk appetite is proposed by the group chief executive and reviewed by various governance bodies including the group executive committee and the risk oversight committee. Responsibility for the approval of risk appetite rests with the board. The approved high level appetite and limits are delegated to individual group executive committee members by the group chief executive.

The more detailed description of the risk principles and distribution of the risk appetite measures amongst the divisions and businesses are determined by the group chief executive, in consultation with the group business risk committee and the group asset and liability committee.

The risk principles are executed through the **policy framework and accountabilities**. These principles are supported by the policy levels below:

Principles – high level principles for the six primary risk drivers

High level group policy – policy statements for each of the main risk types aligned to the risk drivers

Detailed group policy – detailed policy that applies across the Group

Divisional policy – local policy that specifically applies to a division

Business unit policy – local policy that specifically applies to a business unit

Divisional and business unit policy is only produced by exception and is not necessary unless there is a specific area for which a particular division or business unit requires a greater level of detail than is appropriate for group level policy. The governance arrangements for development of, and compliance with, group, divisional and business unit policy and the associated accountabilities are clearly outlined to all colleagues. Colleagues are expected to be aware of policies and procedures which apply to them and their work and to observe the relevant policies and procedures. Line management in each business area has primary responsibility for ensuring that group policies and the relevant local policies and procedures are known and observed by all colleagues within that area.

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Group and divisional risk functions have responsibility for overseeing effective implementation of policy. Group audit provides independent assurance to the board about the effectiveness of the Group's control framework and adherence to policy. Policies are reviewed annually to ensure they remain fit for purpose.

Execution of the Group's risk management framework is dependent upon a clear and consistent **risk identification** using a common language to define risks and to categories them (see the table on page 63).

Proportionate **control activities** are in place to design mitigating controls, to transfer risk where appropriate and to seek to ensure executives are content with the residual level of risk accepted.

**Risk and control assessments** are undertaken to assess the effectiveness of current mitigations and whether risks taken are consistent with the Group's risk appetite (this includes the annual control self-assessment exercise).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

The impact of risks and issues (including financial, reputation and regulatory capital) are determined through effective **risk measurement** including modelling, stress testing and scenario analysis.

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

**Risk reporting** is standardised through the use of standard definitions to enable risk aggregation. Divisions monitor their risk levels against their risk appetite, seeking to ensure effective mitigating action is being taken where appropriate. Divisional risk reports are reviewed by each divisional executive committee to ensure that respective senior management are satisfied with the overall risk profile, risk accountabilities and progress on any necessary **action plans and tracking**. Reporting, including that of performance against relevant limits or policies, is in place to provide a level of detail appropriate to the exposures concerned and regular information is provided to group risk for review and aggregate reporting. Any significant issues identified in the **monitoring** process are appropriately reported, and an escalation process is in place to report significant losses to appropriate levels of management. Regular reports are prepared by group risk on risk exposures and material issues for the group asset and liability committee, group business risk committee, group executive committee, risk oversight committee and the board.

At group level, a consolidated risk report is produced which is reviewed and debated by the group business risk committee, group executive committee, audit committee, risk oversight committee and the board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The consolidated risk report provides a regular assessment of the aggregate residual risk for the primary risk drivers, comparing the assessment with the previous quarter and providing a forecast for the next 12 months.

### PRINCIPAL RISKS

At present the most significant risks faced by the Group, which are derived from the primary risk drivers detailed in the table on page 63, include:

#### Risk: Definition

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

#### Features

Arising in the Retail, Wholesale and Wealth and International divisions, reflecting the risks inherent in the Group's lending activities and in the Insurance division in respect of investment of own funds. Over the last two years the deteriorating economic outlook, both in the UK and overseas, brought about by the banking crisis has impacted the financial services industry resulting in further high profile losses and writedowns. The Group is impacted by the economic downturn and a further worsening of the business environment could adversely impact earnings.

This poses a major risk to the Group and its lending to:

Retail customers (including those in Wealth and International): where reducing affordability and/or asset values arising from a combination of house price falls, continuing high, or increasing levels of unemployment, consumer over-indebtedness, and rising interest rates impacts both secured and unsecured retail exposures.

Wholesale customers (including those in Wealth and International): where companies are facing increasingly difficult business conditions, resulting in corporate default levels rising and leading to increases in corporate impairment. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA, Australia and Spain. There are particular concentrations to: financial institutions, commercial real estate, and joint ventures, with high leverage and exposures through capital structure.

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The Group follows a through the economic cycle, relationship based, business model with risk management processes, appetites and experienced staff in place.

Legal and regulatory: The risk of regulatory action leading to fine and/or public censure and/or successful legal action being taken against the Group as a result of failure to meet one or more legal and/or regulatory requirements either in the UK or overseas.

The industry is currently subject to a wide range of international and UK consultations on proposals to change the regulatory requirements. For example the Basel Committee on Banking Supervision has issued proposals with respect to capital and liquidity requirements for banks ( Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring ) and draft proposals have also been issued for new capital requirements for insurers (Solvency II). In the UK we have seen the Turner review and more recently, proposals have been issued for governance, recovery and resolution ( Living Wills ) arrangements and also, potentially conduct of business requirements, which could have significant implications for past business as well as future product offerings for customers. There is a high level of uncertainty both as to the financial outcome in terms of specific requirements and the speed of implementation in the UK and internationally.

The Group is currently assessing the impacts of these regulatory proposals, and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2010. The Group currently meets and exceeds its regulatory capital requirements and expects to continue to do so. However, the FSA could impose more stringent capital and liquidity requirements, and/or introduce new ratios and/or change the manner in which it applies existing requirements to recapitalised banks, including those within the Group. Any one or combination of these events could result in the Group being forced to raise further capital or to divest assets.

The Group has made good preparations for the FSA s new liquidity regime (ILAS) and is ready to meet the reporting implications later in the year.

Lloyds Banking Group s policy is to maintain high levels of compliance with regulatory requirements and it will organise its business to maintain this level of compliance as the requirements become clearer, being mindful of maintaining an appropriate balance between risk and reward.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

## Risk: Definition

Liquidity and funding: Liquidity risk is defined as the risk that the Group has insufficient financial resources to meet its commitments as they fall due, or can only secure them at excessive cost.

Funding risk is defined as the risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.

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

## Features

Arising in the banking business of the Group and impacting the Retail, Wholesale and Wealth and International divisions reflecting the risk that the Group is unable to attract and retain either retail, wholesale or corporate deposits or issue debt securities. Like all major banks, the Group is dependent on confidence in the short and longer term wholesale funding markets; should the Group, due to exceptional circumstances, be unable to continue to source sustainable funding and provide liquidity when necessary, it could impact its ability to fund its financial obligations.

The key dependencies for successfully funding the Group's balance sheet include the continued functioning of the money and capital markets at their current levels; successful right sizing of the Group's balance sheet; the continuation of HM Treasury facilities in accordance with the terms agreed; limited further deterioration in the UK's and the Group's credit rating and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or UK Government support schemes. A return to the extreme market conditions of 2008 would place a strain on the Group's ability to meet its financial commitments.

Liquidity risk is managed within a board approved framework using a range of metrics to monitor the Group's Profile against its stated appetite and potential market conditions.

Customer treatment and how the Group manages its customer relationships affects all aspects of Lloyds Banking Group's operations and is closely aligned with achievement of Lloyds Banking Group's strategic aim to create deep long lasting relationships with its customers. There is currently a high level of scrutiny regarding the treatment of customers by financial institutions from the press, politicians and regulatory bodies.

The Office of Fair Trading's (OFT) investigation and legal test case in respect of unarranged overdraft charges on personal current accounts concluded in 2009, for further details see note 52 to the consolidated financial statements. The OFT is however continuing to discuss its concerns in relation to the personal current account market with the banks, consumer groups and other organisations under the auspices of its Market Study into personal current accounts. In October 2009, the OFT published voluntary initiatives agreed with the industry and consumer groups to improve transparency of the costs and benefits of personal current accounts and improvements to the switching process. The OFT aims to report on progress in respect of further changes it believes are required to make the market work in the best interest of bank customers by the end of March 2010.

The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place. Treating Customers Fairly remains the key principle underpinning the FSA's consumer protection objective. An additional challenge for Lloyds Banking Group is ensuring the fair treatment of customers during integration of the two heritage businesses. As a result the customer relationship management risks posed by integration are carefully considered through the integration governance process in place. If Lloyds Banking Group is unable to demonstrate the fair treatment of its customers there is the risk of increased complaints from customers, the potential for regulatory action (which could include reviews of past business and/or the payment of fines and compensation) and adverse media coverage (leading to reputational damage in the marketplace). The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers.



People: The risk of reduction in earnings and/or value, through financial or reputational loss, from failure to retain, train, reward, recruit and incentivise appropriately skilled staff, inappropriate staff behaviour or industrial action.

The delivery of Lloyds Banking Group's objectives is underpinned by the ability to attract, retain and develop the best talent in the industry. The challenges to the people agenda have never been greater with increased regulatory and public interest in remuneration practices, the effects of the Government shareholding and the impacts of integration. Lloyds Banking Group welcomes the regulation of remuneration provided there is an international consensus and will comply with the FSA Code. The Group has managed the initial stages of integration, working to establish control by defining and implementing the new organisational structures and continues to manage the relationship with colleagues during this period of change. The Group has policies, procedures and governance arrangements in place to ensure the effective management of people risk as the Group integrates and grows its business. The Group has published proposals to harmonise employee terms and conditions across the Group and is consulting with the various representative unions. The Group actively manages its relationships with unions, but is aware of the danger of industrial action, business disruption and reputational impact arising from union behaviour and communications. People risk is closely monitored as a key risk indicator, as well as being subject to oversight by the board.

Integration: The risk that Lloyds Banking Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc.

The integration of the two legacy organisations presents one of the largest integration challenges that has been seen in the UK financial services industry. There is a risk that the Group may fail to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from the acquisition of HBOS plc by Lloyds TSB Group plc, or may incur unanticipated costs and losses associated as a result. As a consequence, the Group results may suffer as a result of operational, financial management and other integration risks. The risk of failure to deliver synergy benefits or to meet publicly stated targets could potentially result in a loss of shareholder or market confidence with negative perceptions of the Group's integration strategy. As the Group goes through the integration process there is a danger of losing key staff potentially impacting upon integration plans.

The Group has created an integration execution board, chaired by the group operations director, to oversee the integration process. The Group is now one year into the integration programme and has a fully developed and functioning governance framework to manage these risks, with clear understanding of the dependencies and phased deliverables through to 2012. The programme is ahead of plan.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

### RISK DRIVERS

#### RISK DRIVERS

The Group's risk language is designed to capture the Group's primary risk drivers. A description of each primary risk driver, including definition, appetite, control and exposures, is included below. These are further sub divided into 29 more granular risk types to enable more detailed review and facilitate appropriate reporting and monitoring, as set out in the table above.

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

### BUSINESS RISK

#### DEFINITION

Business risk is defined as the risk that the Group's earnings are adversely impacted by a sub optimal business strategy or the sub optimal implementation of the strategy. In assessing business risk, consideration is given to internal and external factors.

#### RISK APPETITE

Business risk appetite is encapsulated in the Group's budget and medium-term plan, which are sanctioned by the board on an annual basis. Divisions and business units plans are aligned to the Group's overall business risk appetite.

#### EXPOSURES

The Group's portfolio of businesses exposes it to a number of internal and external factors:

internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and

external factors: economic, technological, political, social and ethical, environmental, legal and regulatory, market expectations, reputation and competitive behaviour.

#### MEASUREMENT

An annual business planning process is conducted at group, divisional and business unit level which includes a quantitative and qualitative assessment of the risks that could impact the Group's plans. Within the planning round, the Group conducts both scenario analysis and stress tests to assess risks to future earning streams. Stress testing and scenario analysis are fully embedded in the Group's risk management practice. The Group assesses a wide array of scenarios including economic recessions, regulatory action and scenarios specific to the operations of each part of the business.

#### MITIGATION

As part of the annual business planning process, the Group develops a set of management actions to prevent or mitigate the impact on earnings in the event that business risks materialise. Additionally, business risk monitoring, through regular reports and oversight, results in corrective actions to plans and reductions in exposures where necessary.

Revenue and capital investment decisions require additional formal assessment and approval. Formal risk assessment is conducted as part of the financial approval process. Significant mergers and acquisitions by business units require specific approval by the board. In addition to the standard due diligence conducted during a merger or acquisition, group risk conducts,

where appropriate, an independent risk assessment of the target company.

#### **MONITORING**

The Group's strategy is reviewed and approved by the board. Reputational risk is covered at a number of levels throughout the organisation, which includes the group executive committee and the group business risk committee. Regular reports are provided to the group executive committee and the board on the progress of the Group's key strategies and plans. Group risk conducts oversight to seek to ensure that business plans remain consistent with the Group's strategy.

#### **APPROACH**

The Group has adapted the heritage Lloyds TSB business risk approach which includes stress testing the medium term plan to changes in economic assumptions. The output of this stress testing is used to determine investment decisions.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS CREDIT RISK

## AUDITED INFORMATION

### DEFINITION

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

### RISK APPETITE

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

This statement of the Group's overall appetite for credit risk is reviewed and approved annually by the board. With the support of the group credit risk committee and group business risk committee, the group chief executive allocates this risk appetite across the Group. Individual members of the group executive committee ensure that credit risk appetite is further delegated to an appropriate level within their areas of responsibility.

### EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out in note 54 to the consolidated financial statements. Credit risk exposures are categorised as retail arising in the Retail and Wealth and International Divisions and wholesale arising in the Wholesale and Wealth and International Divisions.

In terms of loans and advances, credit risk arises both from amounts lent and commitments to extend credit to a customer as required. These commitments can take the form of loans and overdrafts, or credit instruments such as guarantees and standby, documentary and commercial letters of credit. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled and the credit worthiness of customers is monitored frequently. In addition, most wholesale commitments to extend credit are contingent upon customers maintaining specific credit standards, which are regularly monitored.

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 18 to the consolidated financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2009. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 54 on page F-103.

Credit risk exposures in the insurance businesses arise primarily from holding investments and from exposure to reinsurers. A significant proportion of the investments are held in unit linked and with profit funds where the shareholder risk is limited, subject to any guarantees given.

### MEASUREMENT

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

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios and a growing number of wholesale lending portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where

appropriate, with external data and subject matter expert judgement. Each rating model is subject to a rigorous validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. All material rating models are authorised by the group model governance committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between classifications if the assessment of the obligor probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale. (Note 54 on page F-104 provides an analysis of the portfolio).

The rating systems described above assess probability of default, exposure at default and loss given default, in order to derive an expected loss. In contrast, impairment allowances are recognised for financial reporting purposes only for losses that have been incurred at the balance sheet date based on objective evidence of impairment (see note 2(H) to the consolidated financial statements on page F-14). Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the expected loss models that are used for internal operational management and banking regulation purposes.

## **MITIGATION**

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

## **INTERNAL CONTROL**

**Credit principles and policy:** group risk sets out the Group credit principles and policy according to which credit risk is managed, which in turn is the basis for divisional and business unit credit policy. Principles and policy are reviewed regularly and any changes are subject to a review and approval process. Divisional and business unit policy includes lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.

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

**Credit scoring:** In its principal retail portfolios, the Group uses statistically-based decisioning techniques (primarily credit scoring). Divisional risk departments review scorecard effectiveness and approve changes, with material changes being subject to group risk approval.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

**Individual credit assessment and sanction:** Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as that for assets intended to be held over the period to maturity.

**Controls over rating systems:** The Group has established an independent team in group risk that sets common minimum standards, designed to challenge the discriminatory powers of systems, accuracy of calibration and seeks to ensure consistency over time and across obligors. Internal rating systems are developed and implemented by independent risk functions either in the business units or divisions with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the respective internal rating systems, supported and challenged by specialist functions in their respective division.

**Cross-border and cross-currency exposures:** Country limits are authorised by the Country Limits Panel taking into account economic and political factors.

**Concentration risk:** Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to the Group's risk appetite and restricts exposure to certain high risk and more vulnerable sectors and segments. Note 20 to the consolidated financial statements provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. The Group's large exposures are reported in accordance with regulatory reporting requirements.

**Stress testing and scenario analysis:** The credit portfolio is also subjected to stress-testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group wide level, at divisional and business unit level and by rating model and portfolio, for example, for a specific industry sector.

**Specialist expertise:** Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector-specific expertise; and legal services applicable to the particular market place and product range offered by the business.

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

**Risk assurance and oversight:** Divisional and group level oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators. Risk assurance teams are engaged where appropriate to conduct further credit reviews if a need for closer scrutiny is identified.

## COLLATERAL

The principal collateral types for loans and advances are:

mortgages over residential and commercial real estate;

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

charges over financial instruments such as debt securities and equities; and

guarantees received from third parties.

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

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Collateral or other security is also not usually obtained for credit risk exposures on derivative instruments, except where the Group requires margin deposits from counterparties.

It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of the customer, at the time of borrowing. Collateral is reviewed on a regular basis in accordance with business unit credit policy, which will vary according to the type of lending and collateral involved. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as impairment indicators are identified for the relevant individual loans and advances.

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

#### MASTER NETTING AGREEMENTS

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

#### OTHER CREDIT RISK TRANSFERS

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS MONITORING

## AUDITED INFORMATION

Portfolio monitoring and reporting: In conjunction with group risk, businesses and divisions identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Group risk in turn produces an aggregated review of credit risk throughout the Group, including reports on significant credit exposures, which are presented to both the group credit risk committee and to the group business risk committee.

The performance of all rating models is comprehensively monitored on a regular basis, to seek to ensure that models continue to provide optimum risk differentiation capability, the generated ratings remain as accurate and robust as possible and the models assign appropriate risk estimates to grades/pools. All models are monitored against a series of agreed key performance indicators. In the event that monthly monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated to the group model governance committee.

### APPROACH

The Group has largely adopted the heritage Lloyds TSB credit risk approach, including governance structure, sanctioning processes and risk appetite controls and framework. Integrated, prudent through the cycle credit policies and procedures have mostly all been established and implemented across the Group, supported by robust early warning indicators and triggers.

Following a prioritised appointment process an integrated credit risk management structure is in place throughout the Group, using the most experienced and skilled resources from both heritages. Substantial work has been undertaken to analyse portfolios and where necessary the Group has taken actions to manage effectively its exposure through the economic downturn. These actions have included revised credit criteria for key products and a withdrawal from those business sectors that are outside of the Group's risk appetite.

The Group has formed a group level Credit Risk Assurance function with experienced credit professionals from both heritages. Together with Divisional Risk senior management, this team has carried out an independent risk-based review of the high risk wholesale and retail books. Nearly £150 billion of high risk wholesale assets, primarily HBOS commercial real estate and corporate exposures, have been reviewed by the team. This has required a detailed file by file review of the original credit application, subsequent management papers and an understanding of the supporting collateral. In addition, portfolio level analysis and investigation, together with statistically robust sampling of accounts, have been carried out for over £300 billion of retail assets. These comprehensive reviews have greatly enhanced the Group's knowledge and understanding of the legacy portfolios and have enabled the Group to assess and manage these exposures confidently and effectively.

To support corporate customers that encounter difficulties during the current economic downturn the Group has continued to expand its dedicated Business Support Unit (BSU) model. Teams have been strengthened in both Wholesale and Wealth and International to deal with the rise in work loads experienced during the year as the recessionary conditions took hold both in the UK and overseas. In Wholesale three teams have been created to cover Corporate Real Estate, Corporate and Commercial, and Specialist Finance customers experiencing difficulties. In Wealth and International teams have been created in Ireland and Australia. Under this model, relationship management passes early and fully to BSU; because the BSU specialists receive the customers at an earlier stage in the process they have more time to develop effective solutions. The strategy is to work alongside management teams and key stakeholders to turn around businesses in distress and re-establish these as viable entities. Where a turnaround is not feasible, exposure is minimised through a combination of appropriate asset sales, restructuring and work out strategies.

To support UK Retail customers who are encountering financial difficulties the Group has launched a cross-channel support programme. Lloyds TSB branches and telephony units have at least one trained Financial Health Specialist providing customers with budgeting and money management advice. In the Group's Halifax and Bank of Scotland businesses, customers have a dedicated telephone support line with trained specialists able to guide them through any financial difficulties. Support is also available for all customers online, and via a specially developed support brochure. 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 where they have multiple credit facilities that require restructuring.



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Within Collections and Recoveries 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 Group has strengthened resources in Collections and Recoveries to help customers in distress by offering advice and access to a wider range of options such as short-term repayment plans or the government backed Homeowners Mortgage Support and Mortgage Rescue schemes. A core element of our relationship management approach is to contact customers showing signs of financial distress, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears. This year, nearly a quarter of a million customers have been contacted who were not yet in arrears.

The Group follows a through the economic cycle, relationship-based, business model with robust risk management processes, appropriate appetites and experienced staff in place. These robust policies and procedures define chosen target market and risk acceptance criteria. These have been, and will continue to be, tightened and fine tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LOAN PORTFOLIO

## ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

The following table analyses loans to banks and customers by category of loan at 31 December for each of the five years listed.

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Loans and advances to banks	<b>35,510</b>	38,868	34,845	40,639	31,656
Loans and advances to customers:					
Mortgages	<b>362,667</b>	114,643	102,739	95,601	88,895
Other personal lending	<b>42,958</b>	25,318	22,988	23,025	23,280
Agriculture, forestry and fishing	<b>5,130</b>	3,969	3,226	2,905	2,451
Energy and water supply	<b>3,031</b>	2,598	2,102	2,024	1,592
Manufacturing	<b>14,912</b>	12,057	8,385	7,513	7,923
Construction	<b>10,830</b>	3,016	2,871	2,332	2,222
Transport, distribution and hotels	<b>31,820</b>	14,664	11,573	10,490	9,465
Postal and telecommunications	<b>1,662</b>	1,060	946	831	546
Financial, business and other services	<b>66,923</b>	33,319	29,707	22,999	21,261
Property companies	<b>83,820</b>	23,318	17,576	12,896	8,713
Lease financing	<b>9,307</b>	4,546	4,686	4,802	5,815
Hire purchase	<b>8,710</b>	5,295	5,423	5,060	4,853
<b>Total loans</b>	<b>677,280</b>	282,671	247,067	231,117	208,672
Allowance for impairment losses	<b>(14,950)</b>	(3,594)	(2,408)	(2,194)	(2,073)
<b>Total loans and advances net of allowance for impairment losses</b>	<b>662,330</b>	279,077	244,659	228,923	206,599

The analysis of loans and advances as at 31 December 2009 between domestic and international offices is as follows:

	Domestic £m	Foreign £m	Total £m
Loans and advances to banks	<b>29,475</b>	<b>6,035</b>	<b>35,510</b>
Loans and advances to customers:			
Mortgages	<b>344,151</b>	<b>18,516</b>	<b>362,667</b>
Other personal lending	<b>40,790</b>	<b>2,168</b>	<b>42,958</b>
Agriculture, forestry and fishing	<b>4,829</b>	<b>301</b>	<b>5,130</b>
Energy and water supply	<b>1,141</b>	<b>1,890</b>	<b>3,031</b>
Manufacturing	<b>11,480</b>	<b>3,432</b>	<b>14,912</b>
Construction	<b>6,554</b>	<b>4,276</b>	<b>10,830</b>
Transport, distribution and hotels	<b>22,713</b>	<b>9,107</b>	<b>31,820</b>
Postal and telecommunications	<b>973</b>	<b>689</b>	<b>1,662</b>
Financial, business and other services	<b>58,132</b>	<b>8,791</b>	<b>66,923</b>
Property companies	<b>64,069</b>	<b>19,751</b>	<b>83,820</b>
Lease financing	<b>8,426</b>	<b>881</b>	<b>9,307</b>
Hire purchase	<b>7,671</b>	<b>1,039</b>	<b>8,710</b>
<b>Total loans</b>	<b>600,404</b>	<b>76,876</b>	<b>677,280</b>
Allowance for impairment losses	<b>(9,995)</b>	<b>(4,955)</b>	<b>(14,950)</b>
<b>Total loans and advances net of allowance for impairment losses</b>	<b>590,409</b>	<b>71,921</b>	<b>662,330</b>



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SUMMARY OF LOAN LOSS EXPERIENCE

The following table analyses the movements in the allowance for impairment losses on loans and advances to banks and customers for each of the five years listed.

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
<b>Balance at beginning of year before transition to IAS 39</b>					1,663
Adjustment to reflect transition to IAS 39 on 1 January 2005					256
<b>Balance at beginning of year after transition to IAS 39</b>	<b>3,594</b>	2,408	2,194	2,073	1,919
<b>Exchange and other adjustments</b>	<b>112</b>	43	2	(13)	1
<b>Reclassifications</b>					43
<b>Acquisition and disposal of businesses and portfolios</b>				(27)	(27)
<b>Advances written off:</b>					
Loans and advances to customers:					
Mortgages	(77)	(23)	(25)	(9)	(6)
Other personal lending	(3,063)	(1,206)	(1,256)	(1,195)	(904)
Agriculture, forestry and fishing	(5)	(2)	(1)	(1)	(1)
Energy and water supply	(28)	(24)	(11)	(17)	(20)
Manufacturing	(148)	(34)	(13)	(24)	(27)
Construction	(336)	(11)	(4)	(7)	(8)
Transport, distribution and hotels	(80)	(50)	(24)	(50)	(37)
Postal and telecommunications	(9)				
Financial, business and other services	(308)	(169)	(95)	(142)	(151)
Property companies	(51)	(6)		(4)	
Lease financing	(26)	(2)	(26)	(1)	(5)
Hire purchase	(69)	(59)	(87)	(39)	(77)
Loans and advances to banks					
<b>Total advances written off</b>	<b>(4,200)</b>	(1,586)	(1,542)	(1,489)	(1,236)
<b>Recoveries of advances written off:</b>					
Loans and advances to customers:					
Mortgages	1	1	2	2	2
Other personal lending	107	102	121	158	125
Energy and water supply				1	2
Manufacturing			1	3	4
Construction				1	1
Transport, distribution and hotels		1	1	4	5
Financial, business and other services	2	3	3	12	14
Hire purchase		5	9	9	5
<b>Total recoveries of advances written off</b>	<b>110</b>	112	137	190	158
<b>Total net advances written off</b>	<b>(4,090)</b>	(1,474)	(1,405)	(1,299)	(1,078)
	68				

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
<b>Effect of unwinding of discount recognised through interest income</b>	<b>(446)</b>	<b>(102)</b>	<b>(104)</b>	<b>(100)</b>	<b>(87)</b>
<b>Allowances for impairment losses charged against income for the year:</b>					
Loans and advances to customers:					
Mortgages	368	171	18	12	18
Other personal lending	3,779	1,455	1,313	1,349	1,192
Agriculture, forestry and fishing	29	2	4	1	
Energy and water supply	55	35	18	4	2
Manufacturing	737	122	19	12	(1)
Construction	842	61	8	5	(3)
Transport, distribution and hotels	1,783	66	39	29	20
Postal and telecommunications	14				
Financial, business and other services	2,193	491	151	53	7
Property companies	5,528	73	1		
Lease financing	241	1	35	4	(3)
Hire purchase	214	107	116	91	70
Loans and advances to banks	(3)	135	(1)		
<b>Total allowances for impairment losses charged against income for the year</b>	<b>15,780</b>	<b>2,719</b>	<b>1,721</b>	<b>1,560</b>	<b>1,302</b>
<b>Total balance at end of year</b>	<b>14,950</b>	<b>3,594</b>	<b>2,408</b>	<b>2,194</b>	<b>2,073</b>
<b>Ratio of net write-offs during the year to average loans outstanding during the year</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>0.7%</b>	<b>0.6%</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the year ended 31 December 2009 between domestic and international offices is as follows:

	Domestic £m	Foreign £m	Total £m
<b>Balance at beginning of year</b>	<b>3,575</b>	<b>19</b>	<b>3,594</b>
<b>Exchange and other adjustments</b>	<b>171</b>	<b>(59)</b>	<b>112</b>
<b>Advances written off:</b>			
Loans and advances to customers:			
Mortgages	(77)		(77)
Other personal lending	(3,062)	(1)	(3,063)
Agriculture, forestry and fishing	(5)		(5)
Energy and water supply	(28)		(28)
Manufacturing	(147)	(1)	(148)
Construction	(336)		(336)
Transport, distribution and hotels	(80)		(80)
Postal and telecommunications	(9)		(9)
Financial, business and other services	(308)		(308)
Property companies	(51)		(51)
Lease financing	(25)	(1)	(26)
Hire purchase	(69)		(69)
Loans and advances to banks			
<b>Total advances written off</b>	<b>(4,197)</b>	<b>(3)</b>	<b>(4,200)</b>
<b>Recoveries of advances written off:</b>			
Loans and advances to customers:			
Mortgages	1		1
Other personal lending	107		107
Agriculture, forestry and fishing			
Energy and water supply			
Manufacturing			
Construction			
Transport, distribution and hotels			
Postal and telecommunications			
Financial, business and other services	1	1	2
Hire purchase			
<b>Total recoveries of advances written off</b>	<b>109</b>	<b>1</b>	<b>110</b>
<b>Total net advances written off</b>	<b>(4,088)</b>	<b>(2)</b>	<b>(4,090)</b>

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	Domestic £m	Foreign £m	Total £m
<b>Effect of unwinding of discount recognised through interest income</b>	<b>(446)</b>		<b>(446)</b>
Allowances for impairment losses charged against income for the year:			
Loans and advances to customers:			
Mortgages	120	248	368
Other personal lending	3,659	120	3,779
Agriculture, forestry and fishing	2	27	29
Energy and water supply	24	31	55
Manufacturing	544	193	737
Construction	533	309	842
Transport, distribution and hotels	507	1,276	1,783
Postal and telecommunications	9	5	14
Financial, business and other services	1,840	353	2,193
Property companies	3,325	2,203	5,528
Lease financing	88	153	241
Hire purchase	135	79	214
Loans and advances to banks	(3)		(3)
<b>Total allowances for impairment losses charged against income for the year</b>	<b>10,783</b>	<b>4,997</b>	<b>15,780</b>
<b>Total balance at end of year</b>	<b>9,995</b>	<b>4,955</b>	<b>14,950</b>

The following table analyses the coverage of the allowance for loan losses by category of loans.

	2009 Allowance £m	2009 Percentage of loans in each category to total loans %	2008 Allowance £m	2008 Percentage of loans in each category to total loans %	2007 Allowance £m	2007 Percentage of loans in each category to total loans %	2006 Allowance £m	2006 Percentage of loans in each category to total loans %	2005 Allowance £m	2005 Percentage of loans in each category to total loans %
<b>Balance at year end applicable to:</b>										
Loans and advances to banks	149	5.2	135	13.8		14.1	1	17.6	1	15.2
Loans and advances to customers:										
Mortgages	489	53.6	186	40.5	37	41.5	42	41.3	36	42.5
Other personal lending	2,884	6.3	2,047	9.0	1,795	9.3	1,720	9.9	1,533	11.2
Agriculture, forestry and fishing	33	0.8	5	1.4	5	1.3	2	1.3	2	1.2
Energy and water supply	70	0.4	33	0.9	22	0.9	14	0.9	32	0.8
Manufacturing	699	2.2	119	4.3	29	3.4	25	3.3	33	3.8
Construction	527	1.6	60	1.1	10	1.2	6	1.0	8	1.1
Transport, distribution and hotels	1,621	4.7	75	5.2	58	4.7	45	4.5	64	4.5
Postal and telecommunications	5	0.2		0.4		0.4		0.4		0.3
Financial, business and other services	2,388	9.9	596	11.7	232	12.0	166	9.9	250	10.1
Property companies	5,504	12.4	70	8.2	4	7.1	5	5.6	11	4.2
Lease financing	224	1.4	15	1.6	16	1.9	7	2.1	4	2.8

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Hire purchase	357	1.3	253	1.9	200	2.2	161	2.2	99	2.3
<b>Total balance at year end</b>	<b>14,950</b>	<b>100.0</b>	3,594	100.0	2,408	100.0	2,194	100.0	2,073	100.0

71

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The analysis of the coverage of the allowance for loan losses at 31 December 2009 between domestic and international offices is as follows:

	Domestic		Foreign		Total	
	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %	Allowance £m	Percentage of loans in each category to total loans %
<b>Balance at year end applicable to:</b>						
Loans and advances to banks	149	4.9		7.9	149	5.2
Loans and advances to customers:						
Mortgages	243	57.2	246	24.0	489	53.6
Other personal lending	2,767	6.8	117	2.8	2,884	6.3
Agriculture, forestry and fishing	6	0.8	27	0.4	33	0.8
Energy and water supply	42	0.2	28	2.5	70	0.4
Manufacturing	504	1.9	195	4.5	699	2.2
Construction	217	1.1	310	5.6	527	1.6
Transport, distribution and hotels	396	3.8	1,225	11.8	1,621	4.7
Postal and telecommunications		0.2	5	0.9	5	0.2
Financial, business and other services	2,012	9.7	376	11.4	2,388	9.9
Property companies	3,306	10.7	2,198	25.7	5,504	12.4
Lease financing	72	1.4	152	1.1	224	1.4
Hire purchase	281	1.3	76	1.4	357	1.3
<b>Total</b>	<b>9,995</b>	<b>100.0</b>	<b>4,955</b>	<b>100.0</b>	<b>14,950</b>	<b>100.0</b>

## RISK ELEMENTS IN THE LOAN PORTFOLIO

The Group's credit risk elements analysed by categories reflecting US lending and accounting practices, which differ from those employed in the UK, are detailed below:

## NON-PERFORMING LENDING

In the US, it is the normal practice to stop accruing interest when payments are 90 days or more past due or when recovery of both principal and interest is doubtful. When the loans are transferred to non-accrual status, accrued interest is reversed from income and no further interest is recognised until it becomes probable that the principal will be repaid in full. Loans on which interest has been accrued but suspended would be included in risk elements as loans accounted for on a non-accrual basis.

In the US non-performing loans and advances are typically written off more quickly than in the UK. Consequently a UK bank may appear to have a higher level of non-performing loans and advances than a comparable US bank although the reported income may be similar in both the US and the UK.

## 2005

In 2005, the Group adopted IAS 39, which requires that interest is accrued and recognised on all outstanding loans. The interest recognised is based on the net carrying value of the loan and is, therefore, less than that that would be recognised on a similar performing loan. Accordingly, it is no longer possible to classify non-performing lending as being accounted for on a non-accruals basis. A provision is established if there is objective evidence that impairment has occurred and the carrying value of the loan exceeds the present value of its estimated future cash flows discounted at the loan's original effective interest rate.

As a result of the changes, the Group analysed its 2005 non-performing lending between impaired loans with a provision and impaired loans contractually past due 90 days or more without a provision.

	2005 £m
Impaired lending against which provisions are held	4,122
Loans contractually past due 90 days or more as to principal or interest, but against which no provisions have been made	1,210
<b>Total non-performing lending*</b>	<b>5,332</b>

\* There were no troubled debt restructurings in 2005.

**2006 AND LATER YEARS**

In 2007, the Group adopted IFRS 7, which requires more detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, for 2006 and later years, 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

	Loans and advances to customers					Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	
<b>31 December 2009</b>						
Neither past due nor impaired	35,333	347,292	48,429	185,872	581,593	19,082
Past due but not impaired		12,587	1,873	5,118	19,578	
Impaired no provision required		2,034	449	6,603	9,086	
provision held	153	5,918	5,902	37,927	49,747	
Gross	35,486	367,831	56,653	235,520	660,004	19,082
<b>31 December 2008</b>						
Neither past due nor impaired	38,716	110,148	33,571	86,707	230,426	608
Past due but not impaired	17	3,134	1,146	555	4,835	
Impaired no provision required		479	150	1,253	1,882	
provision held	135	882	4,327	1,451	6,660	
Gross	38,868	114,643	39,194	89,966	243,803	608
<b>31 December 2007</b>						
Neither past due nor impaired	34,845	99,828	29,850	73,475	203,153	1,189
Past due but not impaired		2,153	966	639	3,758	
Impaired no provision required		415	100	293	808	
provision held		343	3,600	560	4,503	
Gross	34,845	102,739	34,516	74,967	212,222	1,189
<b>31 December 2006</b>						
Neither past due nor impaired	40,638	92,873	29,364	60,005	182,242	835
Past due but not impaired		1,943	1,005	374	3,322	
Impaired no provision required		658	92	158	908	
provision held	1	127	3,580	299	4,006	
Gross	40,639	95,601	34,041	60,836	190,478	835

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The loans that are past due but not impaired are further analysed in the table below according to the number of days that have elapsed since the last payment was due from the borrower.

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail mortgages £m	Retail other £m	Wholesale £m		
<b>31 December 2009</b>						
0-30 days		6,018	1,316	2,347	9,681	
30-60 days		2,649	376	825	3,850	
60-90 days		1,702	74	825	2,601	
90-180 days		2,216	48	560	2,824	
Over 180 days		2	59	561	622	
Total		12,587	1,873	5,118	19,578	
<b>31 December 2008</b>						
0-30 days		1,527	853	289	2,669	
30-60 days		633	259	90	982	
60-90 days	17	424	32	70	526	
90-180 days		549	2	77	628	
Over 180 days		1		29	30	
Total	17	3,134	1,146	555	4,835	
<b>31 December 2007</b>						
0-30 days		1,123	781	266	2,170	
30-60 days		445	155	107	707	
60-90 days		260	29	129	418	
90-180 days		325	1	67	393	
Over 180 days				70	70	
Total		2,153	966	639	3,758	
<b>31 December 2006</b>						
0-30 days		1,104	797	156	2,057	
30-60 days		341	182	60	583	
60-90 days		216	26	38	280	
90-180 days		280		70	350	
Over 180 days		2		50	52	
Total		1,943	1,005	374	3,322	

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

**POTENTIAL PROBLEM LOANS**

Potential problem loans are loans where known information about possible credit problems causes management to have concern as to the borrower's ability to comply with the present loan repayment terms.

**2005**

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There were no similar disclosure requirements in the UK for the year ended 31 December 2005.

The following table discloses for 2005 lendings which were current as to payment of interest and principal but where concerns existed about the ability of the borrowers to comply with loan repayment terms in the near future:

	2005 £m
Potential problem lending	1,800

The figures shown for potential problem lending are not indicative of the losses that might arise should the credit quality of this lending deteriorate since they do not take into account security held.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2006 AND LATER YEARS

IFRS 7 requires, for 2006 and later years, 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.

	Loans and advances to customers					Loans and advances designated at fair value through profit or loss £m
	Loans and advances to banks £m	Retail mortgages £m	Retail other £m	Wholesale £m	Total £m	
<b>31 December 2009</b>						
Good quality	34,434	335,482	30,743	61,810		18,702
Satisfactory quality	135	9,614	12,654	59,752		267
Lower quality	15	746	1,480	45,986		90
Below standard, but not impaired	749	1,450	3,552	18,324		23
Total	35,333	347,292	48,429	185,872	581,593	19,082
<b>31 December 2008</b>						
Good quality	38,283	109,815	21,373	49,349		129
Satisfactory quality	215	264	9,192	31,042		411
Lower quality	204		900	5,831		56
Below standard, but not impaired	14	69	2,106	485		12
Total	38,716	110,148	33,571	86,707	230,426	608
<b>31 December 2007</b>						
Good quality	34,647	99,407	18,157	46,240		191
Satisfactory quality	190	378	8,964	25,013		670
Lower quality	7	1	665	2,034		327
Below standard, but not impaired	1	42	2,064	188		1
Total	34,845	99,828	29,850	73,475	203,153	1,189
<b>31 December 2006</b>						
Good quality	40,418	92,472	16,940	35,659		513
Satisfactory quality	201	359	9,667	21,797		314
Lower quality	17		663	2,249		3
Below standard, but not impaired	2	42	2,094	300		5
Total	40,638	92,873	29,364	60,005	182,242	835

For further details see page F-104.

INTEREST FOREGONE ON NON-PERFORMING LENDING

The table below summarises the interest foregone on impaired lending.

2009  
£m

Interest income that would have been recognised under original contract terms	<b>1,830</b>
Interest income included in profit	<b>(971)</b>
Interest foregone	<b>859</b>

**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 can be discontinued at the end of the first year.

As noted above, the Group adopted IFRS 7 in 2007; IFRS 7 requires the disclosure of loans that were renegotiated and that would otherwise have been past due or impaired (2009: £3,919 million; 2008: £144 million; 2007: £579 million; 2006: £342 million); see also page F-106.

**FORBEARANCE**

Forbearance or repayment arrangements allow a mortgage customer to repay a monthly amount which is lower than their contractual monthly payment for a short period. This period is usually for no more than 12 months and is negotiated with the customer by the mortgage collectors. During the period of forbearance, there is no clearing down of arrears such that unless the customer is paying more than their contractual minimum payment, arrears balances will remain. When customers come to the end of their arrangement period they will continue to be managed as a mainstream collections case and if unable to recover then will move toward possession.

Customers can have their arrears balance recapitalised once they have demonstrated they can pay the original contractual minimum payment, but are unable to clear their arrears. This is usually demonstrated by the customer making six consecutive contractual monthly payments. Customers are

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

not however able to recapitalise more than twice in a five year period. Recapitalised mortgages will return to the non-impaired book and will be managed in accordance with the recapitalised terms of the mortgage.

**ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES**

In most circumstances in the US, title to property securing residential real estate transfers to the lender upon foreclosure. The loan is written off and the property acquired in this way is reported in a separate balance sheet category with any recoveries recorded as an offset to the provision for loan losses recorded in the year. Upon sale of the acquired property, gains or losses are recorded in the income statement as a gain or loss on acquired property.

In the UK, although a bank is entitled to enforce a first charge on a property held as security, it typically does so only to the extent of enforcing its power of sale. In accordance with IFRS and industry practice, Lloyds Banking Group usually takes control of a property held as collateral on a loan at repossession without transfer of title. Loans subject to repossession continue to be reported as loans in the balance sheet. Any gains or losses on sale of the acquired property are recorded within the provision for loan losses during the reporting period.

The difference in practices has no effect on net income reported in the UK compared to that reported in the US but it does result in a difference in classification of losses and recoveries in the income statement. It also has the effect of causing UK banks to report an increased level of non-performing loans compared with US banks.

In certain circumstances the Group takes physical possession of assets held as collateral against wholesale lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

**CROSS BORDER OUTSTANDINGS**

The business of Lloyds Banking Group involves significant exposures in non-local currencies. These cross border outstandings comprise loans (including accrued interest), acceptances, interest-bearing deposits with other banks, other interest-bearing investments and any other monetary assets which are denominated in non-local currency. The following table analyses, by type of borrower, foreign outstandings which individually represent in excess of 1 per cent of Lloyds Banking Group's total assets.

	% of assets	Total £m	Governments and official institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m
<b>As at 31 December 2009:</b>					
<b>United States of America</b>	<b>1.9</b>	<b>19,033</b>	<b>3,266</b>	<b>2,548</b>	<b>13,219</b>
<b>France</b>	<b>1.4</b>	<b>14,126</b>	<b>768</b>	<b>2,932</b>	<b>10,426</b>
<b>As at 31 December 2008:</b>					
United States of America	2.0	8,928	253	1,843	6,832
France	1.1	4,735	69	2,904	1,762
Netherlands	1.0	4,449	4	1,658	2,787
<b>As at 31 December 2007:</b>					
Netherlands	1.8	6,245	1	3,806	2,438
United States of America	1.3	4,520	38	1,098	3,384

As at 31 December 2009, United States of America had commitments of £491 million, and France had commitments of £624 million.

As at 31 December 2009, there were no countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets.

As at 31 December 2008, the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £8,130 million in total, were Belgium and Germany.



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As at 31 December 2007, the countries with cross border outstandings of between 0.75 per cent and 1 per cent of assets, amounting to £8,505 million in total, were Germany, Republic of Ireland and Belgium.

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS**  
**MARKET RISK**

**AUDITED INFORMATION**

**DEFINITION**

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

**RISK APPETITE**

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

This statement of the Group's overall appetite for market risk is reviewed and approved annually by the board. With the support of the group asset and liability committee, the group chief executive allocates this risk appetite across the Group. Individual members of the group executive committee ensure that market risk appetite is further delegated to an appropriate level within their areas of responsibility.

**EXPOSURES**

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset.

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

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

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

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

With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.

Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in-Force Business (ViF) see note 28 to the consolidated financial statements.)

For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.

Surplus assets are held primarily in four portfolios: (a) in the long term funds of Scottish Widows plc, Clerical Medical Investment Group Limited and their subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 41 to the consolidated financial statements.

## MEASUREMENT

The primary market risk measure used within the Group is the Value at Risk (VaR) methodology, which incorporates the volatility of relevant market prices and the correlation of their movements. This is used for determining the Group's overall market risk appetite and for the high level allocation of risk appetite across the Group.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures.

## BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS

Based on the commonly used 95 per cent confidence level, assuming positions are held overnight and using observation periods of the preceding 300 business days, the VaR for the years ended 31 December 2009 and 2008 based on the Group's global trading positions was as detailed in the table Banking Trading Assets and Other Treasury Positions on page 78.

The risk of loss measured by the VaR model is the potential loss in earnings given the confidence level and assumptions noted above. The total and average trading VaR does not assume any diversification benefit across the four risk types, with the exception of the 2008 HBOS comparatives. VaR is a statistical measure and the trading book exposures for the two independently managed heritage banks arose from different management strategies and were measured against differing risk appetites. Separate disclosures have therefore been made for each heritage trading book for 2008 as this is considered to be a more informative approach. The 2008 HBOS comparatives have also been converted from 99 per cent 1-day to 95 per cent 1-day VaR numbers. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported as a whole. The Group internally uses VaR as the primary measure for all treasury positions arising from short term market facing activity, whether trading or banking book. Therefore the numbers below will include some risks which are also included in Banking non-trading, primarily those relating to the funding of lending activities.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

**BANKING TRADING ASSETS AND OTHER TREASURY POSITIONS**

Lloyds Banking Group	31 December 2009			
	Close £m	Average <sup>1</sup> £m	Maximum <sup>1</sup> £m	Minimum <sup>1</sup> £m
Interest rate risk	12.0	20.2	31.4	11.8
Foreign exchange risk	1.1	1.7	9.3	0.2
Equity risk	1.8	1.4	3.3	0.0
Credit spread risk	16.7	17.4	21.0	13.6
<b>Total VaR</b>	<b>31.6</b>	<b>40.7</b>	<b>53.3</b>	<b>31.6</b>
 Lloyds TSB	 31 December 2008			
	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	6.7	3.4	14.7	1.0
Foreign exchange risk	3.0	1.2	4.1	0.1
Equity risk	0.0	0.3	2.7	0.0
Credit spread risk	8.0	4.9	8.1	4.1
<b>Total VaR</b>	<b>17.7</b>	<b>9.8</b>	<b>25.0</b>	<b>5.4</b>
 HBOS (unaudited)	 31 December 2008			
	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	5.9	3.9	6.4	2.0
Foreign exchange risk	4.3	5.8	11.4	0.9
Equity risk	0.1	0.1	0.8	0.0
Credit spread risk		Suspended		
<b>Total VaR</b>	<b>5.9</b>	<b>8.5</b>	<b>12.8</b>	<b>3.5</b>

<sup>1</sup> For this table the average, minimum and maximum positions reflect the period from 19 January 2009 to 31 December 2009.

**BANKING NON-TRADING**

Market risk in non-trading books consists almost entirely of exposure to changes in interest rates. This is the potential impact on earnings and value that could occur when, if rates fall, liabilities cannot be re-priced as quickly or by as much as assets; or when, if rates rise, assets cannot be re-priced as quickly or by as much as liabilities.

Risk exposure is monitored monthly using, primarily, market value sensitivity. This methodology considers all re-pricing mismatches in the current balance sheet and calculates the change in market value that would result from a set of defined interest rate shocks. Where re-pricing maturity is based on assumptions about customer behaviour these assumptions are also reviewed monthly.

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A limit structure exists to ensure that risks stemming from residual and temporary positions or from changes in assumptions about customer behaviour remain within the Group's risk appetite.

The following table shows, split by material currency, Lloyds Banking Group sensitivities as at 31 December 2009 to an immediate up and down 25 basis points change to all interest rates.

### BANKING NON-TRADING

	2009		2008 (unaudited)	
	Up 25bps £m	Down 25bps £m	Up 25bps £m	Down 25bps £m
Sterling	66.6	(66.4)	(132.5)	135.1
US Dollar	(5.5)	5.6	(15.5)	15.6
Euro	4.4	(4.4)	(0.4)	0.4
Australian Dollar	2.2	(2.3)	0.0	0.0
Other	(0.2)	0.2	0.2	(0.3)
	<b>67.5</b>	<b>(67.3)</b>	<b>(148.2)</b>	<b>150.8</b>

Base case market value is calculated on the basis of the Lloyds Banking Group current balance sheet with re-pricing dates adjusted according to behavioural assumptions. The above sensitivities show how this projected market value would change in response to an immediate parallel shift to all relevant interest rates market and administered.

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio.

The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

### PENSION SCHEMES

Management of the assets of the Group's defined benefit pension schemes is the responsibility of the Scheme Trustees, who also appoint the Scheme Actuaries to perform the triennial valuations. The Group monitors its pensions exposure holistically using a variety of metrics including accounting and economic deficits and contribution rates. These and other measures are regularly reviewed by the Pensions Strategy Committee and used in discussions with the Trustees, through whom any risk management and mitigation activity must be conducted.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS  
INSURANCE PORTFOLIOS

## AUDITED INFORMATION

The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2009 and 2008. The 2008 comparatives are based on a post acquisition basis assuming the legacy businesses were combined at the year end and are unaudited. During 2009, the credit spread sensitivity was changed from a 25 basis point increase to a 30 per cent widening of the spread between corporate bonds and the swap curve, including an allowance for the assumed change in the illiquidity premium. Therefore no 2008 comparative is available. Foreign exchange risk arises predominantly from overseas holdings of equities. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently it is not tracked on a daily basis.

## INSURANCE PORTFOLIOS

As at 31 December

	2009 £m	2008 (unaudited) £m
Equity risk (impact of 10% fall pre-tax)	<b>(383.6)</b>	(429.4)
Interest rate risk (impact of 25 basis point reduction pre-tax)	<b>64.0</b>	59.7
Credit spread risk (impact of 30% widening)	<b>(156.4)</b>	n/a

## MITIGATION

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

## BANKING NON-TRADING ACTIVITIES

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

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled.

## INSURANCE ACTIVITIES

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

## MONITORING

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

## BANKING ACTIVITIES

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Trading is restricted to a number of specialist centres, the most important centre being the treasury and trading business in London. These centres also manage market risk in the wholesale non-trading portfolios, both in the UK and internationally. The level of exposure is strictly controlled and monitored within approved limits. Active management of the wholesale portfolios is necessary to meet customer requirements and changing market circumstances.

Market risk in the Group's retail portfolios and in the Group's capital and funding activities is managed within limits defined in the detailed Group policy for interest rate risk in the banking book, which is reviewed and approved annually.

### INSURANCE ACTIVITIES

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to the Group's overall risk appetite and regularly reviewed by the group asset and liability committee:

The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.

The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.

Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

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

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS**  
**INSURANCE RISK**

**AUDITED INFORMATION**

**DEFINITION**

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

**RISK APPETITE**

Insurance risk appetite is defined with regard to the quantum and composition of insurance risk that exists currently in the Group and the direction in which the Group wishes to manage this. It takes account of the need for each entity in the Group to maintain solvency in excess of the minimum level required by the entity's jurisdictional legal or regulatory requirements.

The Group's overall appetite for insurance risk is reviewed and approved annually by the board.

**EXPOSURES**

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

**MEASUREMENT**

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

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate, for example those set out in note 37 to the consolidated financial statements.

**MITIGATION**

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level committees/boards. For the life assurance businesses the key control bodies are the board of Scottish Widows Group Limited and the board of HBOS Financial Services Limited with the more significant risks also being subject to approval by the group executive committee and/or Lloyds Banking Group board. For the general insurance businesses the key control bodies are the boards of the legal entities including Lloyds TSB General Insurance Limited, St. Andrew's Insurance plc and the Irish subsidiaries, with the more significant risks again being subject to group executive committee and/or Lloyds Banking Group board approval. All Group staff pension schemes issues are covered by the group asset and liability committee and the group business risk committee.

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

Insurance risk is primarily controlled via the following processes:

Underwriting (the process to ensure that new insurance proposals are properly assessed)

Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)

Claims management



Product design

Policy wording

Product management

The use of reinsurance or other risk mitigation techniques.

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

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

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

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

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

#### **MONITORING**

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

Insurance risk exposures are reported and monitored regularly by the group executive committee.

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS**  
**OPERATIONAL RISK**

**AUDITED INFORMATION**

**DEFINITION**

The risk of reductions in earnings and/or value, through financial or reputational loss, from inadequate or failed internal processes and systems, operational inefficiencies, or from people related or external events.

There are a number of categories of operational risk:

**LEGAL AND REGULATORY RISK**

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

**CUSTOMER TREATMENT RISK**

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

**PEOPLE RISK**

The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate colleague actions and behaviour, industrial action, legal action in relation to people, or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

**INTEGRATION RISK**

The risk that Lloyds Banking Group fails to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or incurs unanticipated costs and losses associated with, the acquisition of HBOS plc.

**BUSINESS PROCESS RISK**

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from inadequate or failed internal processes and systems, people-related events and deficiencies in the performance of external suppliers/service providers.

**FINANCIAL CRIME RISK**

The risk of reductions in earnings and/or value, through financial or reputational loss, associated with financial crime and failure to comply with related legal and regulatory obligations (which includes compliance with economic sanctions). These losses may include censure, fines or the cost of litigation.

**SECURITY RISK**

The risk of reductions in earnings and/or value, through financial or reputational loss, resulting from theft of or damage to the Group's assets, the loss, corruption, misuse or theft of the Group's information assets or threats or actual harm to the Group's people. This also includes risks relating to terrorist acts, other acts of war, geopolitical, pandemic or other such events.

**CHANGE RISK**

The risk of reductions in earnings and/or value, through financial or reputational loss, from change initiatives failing to deliver to requirements, budget or timescale, failing to implement change effectively or failing to realise desired benefits.

## GOVERNANCE RISK

The risk of reductions in earnings and/or value, through financial or reputational loss, from poor corporate governance at group, divisional or business unit level. Corporate governance in this context embraces the structures, systems and processes that provide direction, control and accountability for the enterprise.

## RISK APPETITE

The Group has developed an impact on earnings approach to operational risk appetite. This involves looking at how much the Group could lose due to operational risk losses at various levels of certainty.

In setting operational risk appetite, the Group looks at both impact on solvency and the Group's reputation.

For legal and regulatory risk the Group has minimal risk appetite for non-compliance with mandatory requirements and seeks to operate to high ethical standards. The Group encourages and maintains an appropriately balanced legal and regulatory compliance culture and promotes policies and procedures to enable businesses and their staff to operate in accordance with the laws, regulations and voluntary codes which impact on the Group and its activities.

## EXPOSURES

The main sources of operational risk within the Group relate to the rate and scale of change arising from the Group's current integration programme, particularly in respect of people and business processes, and the legal and regulatory environment in which financial firms operate both in the UK and overseas.

Legal and regulatory exposure is driven by the significant volume of current legislation and regulation with which the Group has to comply, along with new legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. Following the financial crisis, the pace and extent of regulatory reform proposals both in the UK and internationally have increased significantly, and can be expected to remain at high levels. Future changes in regulation, fiscal or other policies are unpredictable and beyond the control of the Group, but could for instance affect the Group's future business strategy, structure or approach to funding. Further uncertainties arise where regulations are principles-based without the regulator defining supporting minimum standards either for the benefit of the consumer or firms. This gives rise to both the risk of retrospection from any one regulator and also to the risk of differing interpretation by individual regulators.

For legal and regulatory issues there are significant reputational impacts associated with potential censure which drive the Group's stance on appetites referred to above. There are clear accountabilities and processes in place for reviewing new and changing requirements. Each division and significant business areas have a nominated individual with compliance oversight responsibility under FSA rules. The role of such individuals is to

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

advise and assist management to ensure that each business has a control structure which creates awareness of the rules and regulations, to which the Group is subject, and to monitor and report on adherence to these rules and regulations.

Lloyds Banking Group welcomes the regulation of remuneration provided there is international consensus and we will comply with the FSA code.

### MEASUREMENT

Both Lloyds TSB and HBOS had operational risk management and measurement frameworks that had been granted, by the FSA, Advanced Measurement Approach (AMA) Waivers, enabling the use of an internal model for the calculation of regulatory capital.

Throughout 2009, both frameworks have continued to operate, whilst a single integrated framework has been in the course of development. The integrated framework and capital model will be rolled out during 2010 and it is anticipated that the Group will seek a variation from the FSA to operate under a single AMA waiver.

The Lloyds TSB Group capital model calculations are driven by actual loss data (internal and external) and forward looking scenarios which value potential future risk events. External industry-wide data is collected to help with validating scenarios.

The HBOS capital model calculations are driven by risk and control assessments, validated by scenarios and internal and external loss events.

### MITIGATION

Both Lloyds TSB and HBOS's operational risk management frameworks consist of the following key components:

- Identification and categorisation of the key operational risks facing a business area.

- Risk assessment, including impact assessment of financial and non-financial impacts (e.g. reputational risk) for each of the key risks to which the business area is exposed.

- Control assessment, evaluating the effectiveness of the control framework covering each of the key risks to which the business area is exposed.

- Loss and incident management, capturing actions to manage any losses facing a business area.

- The development of Key Risk Indicators for management reporting.

- Oversight and assurance of the risk management framework in divisions and businesses.

- Scenarios for estimation of potential loss exposures for material risks.

The Group purchases insurance to mitigate certain operational risk events.

### MONITORING

Business unit risk exposure is aggregated at divisional level and reported to group risk where a group-wide report is prepared. The report is discussed at the monthly group compliance and operational risk committee. This committee can escalate matters to the chief risk officer, or higher committees if appropriate.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

The Group has adopted a formal approach to operational risk event escalation. This involves the identification of an event, an assessment of the materiality of the event in accordance with a risk event impact matrix and appropriate escalation.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS FINANCIAL SOUNDNESS

## AUDITED INFORMATION

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

### LIQUIDITY AND FUNDING RISK

#### DEFINITION

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

#### RISK APPETITE

Liquidity and funding risk appetite for the banking businesses is set by the board and reviewed on an annual basis. This statement of the Group's overall appetite for liquidity risk is reviewed and approved annually by the board. With the support of the group asset and liability committee, the group chief executive allocates this risk appetite across the Group. Individual members of the group executive committee ensure that liquidity risk appetite is further delegated to an appropriate level within their areas of responsibility. It is reported through various metrics that enable the Group to manage liquidity and funding constraints. The Group chief executive, assisted by the group asset and liability committee and its sub-committee the senior asset and liability committee, regularly reviews performance against risk appetite.

#### EXPOSURE

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

#### MEASUREMENT

A series of measures are used across the Group to monitor both short and long term liquidity including: ratios, cash outflow triggers, liquidity gaps, early warning indicators and stress test survival period triggers. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

Details of contractual maturities for assets and liabilities form an important source of information for the management of liquidity risk. Note 54(4) to the consolidated financial statements sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. This forms the foundation of the Group's liquidity controls.

#### MITIGATION

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

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

supplement its retail deposit base.

The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's banking businesses. The Group holds sizeable balances of high grade marketable debt securities which can be sold to provide, or used to secure, additional short term funding should the need arise from either market counterparties or central bank facilities (European Central Bank, Federal Reserve, Bank of England).

## **MONITORING**

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

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

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

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group has invested considerable resource to ensure that it will satisfy the governance, reporting and stress testing requirements of the FSA's new ILAS liquidity regime. This work will continue in 2010 as further parts of the ILAS regime take effect. The Group has noted the industry move towards strategic balance sheet measures of the funding profile and has started to monitor the market's net stable funding ratio and the FSA's structural funding ratio. The Group is aware that the regulatory liquidity landscape is subject to potential change. Specifically, in relation to the consultation papers issued by the Basel Committee on Banking Supervision ( Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring ) the Group is actively participating in the industry-wide consultation and calibration exercises taking place through 2010.

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

## APPROACH

The Group has adopted the heritage Lloyds TSB liquidity and funding approach which involves reduced risk appetite and increasing the diversity of funding sources, supported by extensive analysis of funding needs and strong governance. The Group expects to meet its funding requirements even in a stressed scenario.

## LIQUIDITY AND FUNDING MANAGEMENT IN 2009

To understand the trends in liquidity and funding the comparatives have been provided for 2008 for the combined businesses. Consequently, pages 84 to 87 covering liquidity and funding management in 2009 are unaudited.

During 2009, the Group has seen a stabilisation in the customer deposit base, in marked contrast to the volatility observed by parts of the heritage HBOS businesses in the second half of 2008. The customer loan/deposit ratio improved slightly to 169 per cent compared with 177 per cent at the previous year end. The challenge facing the Group over the medium term is to continue to access the term funding markets, and for the Group to continue to reduce its utilisation of government sponsored funding schemes. The combination of a clear focus on right-sizing the balance sheet, developing the Group's retail liability base, and strategically accessing the capital markets will enable the Group to continue to strengthen its funding base.

In keeping with the Group's strategy of right-sizing the balance sheet, total funding has reduced by £73 billion. During the year the Group has reduced its dependency on the repo market whilst also reducing its wholesale funding requirements. Additionally there has been a managed reduction in certain types of non-bank deposits, in particular certain aggressively priced corporate deposits which were sourced from HBOS customers during the crisis in the second half of 2008. Actions taken to right size the balance sheet have reduced the portion of the Group's funding that is derived from wholesale markets.

## GROUP BALANCE SHEET

As at 31 December	2009 £bn	2008 <sup>1</sup> £bn	2009 Change %
<b>Assets</b>			
Loans and advances to customers	627.0	677.2	(7.4)
Wholesale assets <sup>2</sup>	153.6	189.2	(18.8)
Banking assets	780.6	866.4	(9.9)
<b>Total assets</b>	<b>1,027.3</b>	1,126.7	(8.8)
<b>Liabilities</b>			
Non-bank deposits <sup>3</sup>	371.2	381.0	(2.6)
Wholesale funding	325.5	342.9	(5.1)
Repo <sup>4</sup>	63.1	116.9	(46.0)
Total equity	44.1	35.7	23.5
Total funding	803.9	876.5	(8.3)
<b>Total liabilities and shareholders' equity</b>	<b>1,027.3</b>	1,126.7	(8.8)

<sup>1</sup> Adjusted to reflect the completion of the assessment of the fair value of the identifiable net assets of the HBOS Group.



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<sup>2</sup> Wholesale assets comprise balances arising from banking businesses and include cash and balances at central banks, loans and advances to banks, debt securities and available-for-sale financial assets.

<sup>3</sup> Non-bank deposits comprise balances arising from banking businesses and consist of customer deposits.

<sup>4</sup> All of the Group's repurchase transactions are recorded as balance sheet liabilities within deposits.

The global upheaval in the financial markets that occurred during 2008 has abated during the latter part of 2009. The steps taken in 2008 by HM Treasury, through the introduction of the Government Credit Guarantee Scheme (CGS) for senior funding and other facilities including the Special Liquidity Scheme have together continued to provide assurance of liquidity support to the banking markets. Notwithstanding the improvement in market liquidity during 2009, the Group continues to be reliant upon these facilities in order to maintain its wholesale funding position. At 31 December 2009, the Group's overall support from government and central bank sponsored funding facilities totalled £157 billion, with a significant portion maturing over the course of the next two years. The Group's balance sheet reduction plans will avoid the necessity to refinance much of this funding.

The key dependencies on successfully funding the Group's balance sheet include the continued functioning of the money and capital markets at their current levels; successful rightsizing of the Group's balance sheet; the continuation of HM Treasury facilities in accordance with the terms agreed; limited further deterioration in the UK's and the Group's credit rating and no significant or sudden withdrawal of deposits resulting in increased reliance on money markets or UK Government support schemes. A return to the extreme market conditions of 2008 would place a strain on the Group's ability to meet its financial commitments.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## GROUP RETAIL AND WHOLESALE FUNDING MIX

Wholesale funding has been analysed between that monitored by the London Treasury and Trading operations and the Group's overseas Treasury operations. The wholesale funding shown excludes any repo activity.

The composition and quality of wholesale deposits are regularly reviewed by management and comprises deposits from corporates and government agencies that roll over on a regular basis and are reinvested.

## WHOLESALE FUNDING BY TYPE

As at 31 December	2009	2009	2008	2008
	£bn	%	£bn	%
Bank deposits	48.6	7.0	54.9	7.6
Debt securities in issue:				
Certificates of deposit	50.9	7.3	77.5	10.7
Medium term notes	89.7	12.9	63.5	8.8
Covered bonds	28.1	4.0	29.1	4.0
Commercial paper	35.0	5.0	28.9	4.0
Securitisation	35.8	5.1	43.6	6.0
	239.5	34.3	242.6	33.5
Subordinated debt	37.4	5.4	45.4	6.3
Total wholesale (excluding non-bank deposits)	325.5	46.7	342.9	47.4
Customer deposits	371.2	53.3	381.0	52.6
Total Group funding <sup>1</sup>	696.7	100.0	723.9	100.0

<sup>1</sup> Excludes repos and total equity.

## TERM FUNDING

The Group has been able to take advantage of the improved market sentiment, by extending the duration of its money market funding, and by successfully accessing the term debt markets in unguaranteed format and through the issuance of Permanent RMBS. The reduction in the volume of money market funding has contributed to an improvement in the Group's term funding ratio (wholesale funding with a remaining life of over one year) which has improved to 50 per cent at 31 December 2009 from 44 per cent at the previous year end. The Group's long term target for this ratio is 40 per cent, this seeks to ensure that maturing liabilities are spread over subsequent years.

Lloyds Banking Group has continued to extend the term of its wholesale funding. The following significant capital market transactions were undertaken in 2009:

£13.5 billion rights issue

5 billion public senior unguaranteed debt

£4 billion public RMBS

US\$2 billion tier 1 capital securities

Lloyds Banking Group will continue to access the term capital markets, and has already successfully executed benchmark transactions in January 2010:

US\$5 billion equivalent of public senior term funding

£2.5 billion equivalent of public RMBS

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The Group had limited access to the term capital markets for large periods of 2009 due to highly market sensitive on-going negotiations around the Government Asset Protection Scheme and market recapitalisation.

Total wholesale funding is analysed by residual maturity as follows:

### WHOLESALE FUNDING BY RESIDUAL MATURITY

<b>As at 31 December</b>	<b>2009</b>	<b>2009</b>	2008	2008
	<b>£bn</b>	<b>%</b>	£bn	%
Less than one year	<b>161.8</b>	<b>49.7</b>	192.3	56.1
One to two years	<b>48.8</b>	<b>15.0</b>	29.8	8.7
Two to five years	<b>68.7</b>	<b>21.1</b>	62.2	18.1
More than five years	<b>46.2</b>	<b>14.2</b>	58.6	17.1
Total wholesale funding	<b>325.5</b>	<b>100.0</b>	342.9	100.0

During the period the Group has changed the definition of wholesale to align with that used by other international market participants to include interbank deposits, debt securities in issue and subordinated debt within this category.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The table below illustrates the Group's holding of highly liquid unencumbered assets. This liquidity is available for deployment at immediate notice and is a key component of the Group's liquidity management process.

## ELIGIBLE COLLATERAL

As at 31 December	2009 £bn	2008 £bn
Primary liquidity <sup>1</sup>	88.4	46.2
Secondary liquidity <sup>2</sup>	62.4	58.3
	150.8	104.5

<sup>1</sup> Primary liquidity is defined as FSA eligible liquid assets (UK Gilts, US Treasuries, Euro AAA government debt, unencumbered cash balances held at central banks).

<sup>2</sup> Secondary liquidity comprises a diversified pool of highly rated unencumbered collateral (including retained issuance). The following tables reconcile figures reported on page 85 in the table Wholesale Funding by Type with those in the balance sheet.

## RECONCILIATION OF WHOLESALE FUNDING BY TYPE TO THE BALANCE SHEET

As at 31 December 2009	Included in funding analysis £bn	Repos and conduits £bn	Fair value and other accounting methods £bn	Balance sheet £bn
Bank deposits	48.6	27.6	6.3	82.5
Debt securities in issue	239.5		(6.0)	233.5
Subordinated debt	37.4		(2.7)	34.7
Total wholesale funding	325.5	27.6		
Customer deposits	371.2	35.5		406.7
	696.7	63.1		
As at 31 December 2008				
	Included in funding analysis £bn	Repos and conduits £bn	Fair value and other accounting methods £bn	Balance sheet £bn
Bank deposits	54.9	95.8	4.4	155.1
Debt securities in issue	242.6	3.0	4.1	249.7
Subordinated debt	45.4		(3.2)	42.2
Total wholesale funding	342.9	98.8		
Customer deposits	381.0	18.1	10.1	409.2
	723.9	116.9		

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CONTRACTUAL CASH OBLIGATIONS**

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2009.

	Within one year £m	One to three years £m	Three to five years £m	Over five years £m	Total £m
Enhanced capital notes				9,047	9,047
Long-term debt dated	702	2,538	3,095	9,619	15,954
Medium-term notes	18,327	57,589	5,090	8,030	89,036
Commercial paper	34,900				34,900
Covered bonds	5,605	2,275	7,937	11,494	27,311
Securitisation notes	934	4,949	371	31,303	37,557
Finance leases	1	2		13	16
Operating leases	392	662	551	1,817	3,422
Capital commitments	256	4			260
Other purchase obligations	758	873	491	129	2,251
	61,875	68,892	17,535	71,452	219,754

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 £500 million to these schemes in 2010.

At 31 December 2009, Lloyds Banking Group also had £9,726 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2009, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds TSB Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds TSB Bank and HBOS to pay dividends going forward, or for Lloyds TSB Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

**OFF-BALANCE SHEET ARRANGEMENTS**

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2009 is included in note 52 to the consolidated financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £18,021 million at 31 December 2009 (with £5,425 million expiring within one year; £1,996 million between one and three years; £8,398 million between three and five years; and £2,202 million over five years).

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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 2009, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicles, Cancara, Grampian and Landale. These are funded in the global asset-backed commercial paper market. The assets and obligations of these conduits are included in Lloyds Banking Group's consolidated balance sheet. Lloyds Banking Group provides short-term asset-backed commercial paper liquidity support facilities on commercial terms to the issuers of the commercial paper, for use in the event of a market disturbance should they be unable to roll over maturing commercial paper or obtain alternative sources of funding.

Details of securitisations and other special purpose entity arrangements entered into by the Group are provided in notes 21 and 22 to the consolidated financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

As indicated on page F-48, the Group's securitisations include a number of synthetic securitisation arrangements. Synthetic securitisations use credit default swaps to transfer the credit risk of the underlying assets to a third party without transferring the funding requirement. As the prices of the underlying assets fall, this creates a credit risk on the third party which typically is not collateralised. The total notional amount of credit default swaps used for synthetic securitisation transactions at 31 December 2009 was £1,308 million. The Group takes a credit valuation adjustment by reserving the current mark to market of the exposure multiplied by the credit default swap spread of the counterparty for the maturity of the exposure. At 31 December 2009, the maximum exposure to default by the underlying counterparty (which is equivalent to the fair value) was £66 million, net of the credit reserves. There have been no recent changes in the methodology for assessing credit valuation reserves on credit default swaps.

Within Lloyds Banking Group's insurance businesses, the principal sources of liquidity are premiums received from policyholders, charges levied upon policyholders, investment income and the proceeds from the sale and maturity of investments. The investment policies followed by Lloyds Banking Group's life assurance companies take account of anticipated cash flow requirements including by matching the cash inflows with projected liabilities where appropriate. Cash deposits and highly liquid government securities are available to provide liquidity to cover any higher than expected cash outflows.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS CAPITAL RISK

## AUDITED INFORMATION

### DEFINITION

Capital risk is defined as the risk that the Group has insufficient capital to provide a sufficient resource to absorb losses or that the capital structure is inefficient.

### RISK APPETITE

Capital risk appetite is set by the board and reported through various metrics that enable the Group to manage capital constraints and shareholder expectations. One of the key metrics is the Group's core tier 1 capital ratio for which the board has set a target of more than 7 per cent. The chief executive, assisted by the group asset and liability committee, regularly reviews performance against risk appetite. The board formally reviews capital risk on an annual basis.

### EXPOSURE

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

### MEASUREMENT

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

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities, for example the amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

The Capital Resources Requirement (CRR), is 8 per cent of risk weighted assets and represents the capital required under Pillar 1 of the Basel II framework. In addition, the FSA currently sets Individual Capital Guidance (ICG) for each UK bank calibrated by reference to the CRR, to address the requirements of pillar 2 of the Basel II framework.

A key input into the FSA's ICG setting process is each bank's Internal Capital Adequacy Assessment Process. The FSA's approach is to monitor the available capital resources in relation to the ICG requirement. The Group has been given an ICG by the FSA and the board has also agreed a formal buffer to be maintained in addition to this requirement. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

In addition to the minimum requirement for total capital, the FSA has made further statements to explain the approach it has taken to the capital framework. These include core tier 1 and tier 1 targets under stressed conditions.

The Group undertook an extensive series of stress analysis during the year to determine the adequacy of the Group's capital resources against the FSA minimum requirements.

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The Group is subject to extensive regulation and regulatory supervision in relation to the levels of capital in its business. Specifically in relation to the consultation papers issued by the Basel Committee on Banking Supervision 'Strengthening the resilience of the banking sector' the group is participating in the industry-wide consultation and calibration exercises taking place through 2010.

### **MITIGATION**

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

The Group is able to raise equity either via a rights issue, placing or an open offer. Placing and open offers were completed in January 2009 as part of the Group's participation in the recapitalisation of the banking sector and in June 2009 when the Group repaid preference shares which were issued to HM Treasury as part of GAPS, and a rights issue and liability management exercise was completed in December.

The Group is also able to raise Tier 2 capital by issuing subordinated liabilities. The cost and availability of subordinated liability finance are influenced by credit ratings of both the Group and the UK's sovereign rating. A reduction in these ratings could increase the interest rate payable and could reduce market access.

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

### **MONITORING**

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the group asset and liability committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight. Regular reporting of actual and projected ratios is made to the senior asset and liability committee and to the group asset and liability committee. As part of this reporting any guidance to the market is regularly reviewed.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

**CAPITAL RATIOS**

	2009 £m	2008 £m
<b>Core tier 1</b>		
Ordinary share capital and reserves	44,275	9,573
Regulatory post-retirement benefit adjustments	434	435
Available-for-sale revaluation reserve	914	2,982
Cash flow hedging reserve	305	15
Other items	231	(108)
	<b>46,159</b>	<b>12,897</b>
<b>Less deductions from core tier 1</b>		
Goodwill and other intangible assets	(5,779)	(2,256)
Other deductions	(445)	(1,099)
<b>Core tier 1 capital</b>	<b>39,935</b>	<b>9,542</b>
<b>Perpetual non-cumulative preference shares</b>		
Preference share capital	2,639	1,966
<b>Innovative tier 1 capital instruments</b>		
Preferred securities	4,956	3,169
Less: restriction in amount eligible		(976)
<b>Total tier 1 capital</b>	<b>47,530</b>	<b>13,701</b>
<b>Tier 2</b>		
Available-for-sale revaluation reserve in respect of equities	221	8
Undated subordinated debt	2,575	5,189
Innovative capital restricted from tier 1		976
Eligible provisions	2,694	21
Dated subordinated debt	20,068	5,091
<b>Deductions from tier 2</b>		
Other deductions	(445)	(1,099)
<b>Total tier 2 capital</b>	<b>25,113</b>	<b>10,186</b>
<b>Supervisory deductions</b>		
Unconsolidated investments life	(10,015)	(4,208)
Unconsolidated investments other	(1,551)	(550)
<b>Total supervisory deductions</b>	<b>(11,566)</b>	<b>(4,758)</b>
<b>Total capital resources</b>	<b>61,077</b>	<b>19,129</b>
<b>Risk-weighted assets (unaudited)</b>	<b>493,307</b>	<b>170,490</b>
<b>Ratios (unaudited)</b>		
<b>Core tier 1 ratio</b>	<b>8.1%</b>	<b>5.6%</b>

<b>Tier 1 capital ratio</b>	<b>9.6%</b>	8.0%
<b>Total capital ratio</b>	<b>12.4%</b>	11.2%

OPERATING AND FINANCIAL REVIEW AND PROSPECTS  
**TIER 1 CAPITAL**

AUDITED INFORMATION

Core tier 1 capital increased by £30.4 billion largely reflecting the issuance of share capital during the year and retained profits.

Tier 1 capital increased by £33.8 billion principally as a result of the increase in core tier 1 capital. The remainder of the increase reflects the inclusion of HBOS tier 1 instruments, an increase in innovative securities of £2 billion as part of a liability management exercise to exchange upper tier 2 debt and a further issuance of £1.2 billion innovative securities in December 2009. This increase is offset by the effects of the offer of enhanced capital notes during December 2009; as part of the Group's recapitalisation and exit from GAPS, certain preference shares and preferred securities were exchanged for enhanced capital notes included within tier 2 capital.

**MOVEMENTS IN CORE TIER 1 AND TIER 1 CAPITAL DURING THE YEAR**

	Core tier 1 £m	Tier 1 £m
<b>As at 31 December 2008</b>	9,542	13,701
Profit attributable to ordinary shareholders	<b>2,827</b>	<b>2,827</b>
Issue of ordinary shares	<b>29,139</b>	<b>29,139</b>
Recognition of HBOS tier 1 capital instruments		<b>5,653</b>
Movement in goodwill and other intangible assets	<b>(2,526)</b>	<b>(2,526)</b>
Movement in tier 1 securities relating to ECNs exchange offer		<b>(5,447)</b>
Innovative securities exchange		<b>1,959</b>
Innovative issuance		<b>1,235</b>
Other movements	<b>953</b>	<b>989</b>
<b>As at 31 December 2009</b>	<b>39,935</b>	<b>47,530</b>

**TIER 2 CAPITAL**

Tier 2 capital has increased in the period by £14.9 billion, largely due to the acquisition of HBOS. The liability management exercises undertaken reduced tier 2 capital and increased tier 1 capital. The enhanced capital notes exchange offer completed during 2009 resulted in the exchange of certain existing tier 1 and tier 2 securities for tier 2 notes valued at £7.2 billion for regulatory purposes. Under certain specified conditions, these securities would convert to ordinary share capital and increase core tier 1 capital.

**SUPERVISORY DEDUCTIONS**

Supervisory deductions mainly consist of investments in subsidiary undertakings that are not within the banking group for regulatory purposes. These investments are primarily the Scottish Widows and Clerical Medical life and pensions businesses.

**RISK WEIGHTED ASSETS** (unaudited)

The following table sets out the Group's risk weighted assets that primarily arise in its banking businesses.

**ANALYSIS OF RISK WEIGHTED ASSETS**

As at 31 December	2009 (unaudited) £bn	2008 (unaudited) £bn
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Credit risk	<b>452.1</b>	149.6
Operational risk	<b>25.3</b>	12.3
Market and counterparty risk	<b>15.9</b>	8.5
	<b>493.3</b>	170.4

**Divisional analysis**

Retail	<b>128.6</b>	49.7
Wholesale	<b>286.0</b>	106.8
Insurance	<b>1.1</b>	0.1
Wealth and International	<b>63.2</b>	11.0
Group Operations and Central items	<b>14.4</b>	2.8
	<b>493.3</b>	170.4

Risk-weighted assets increased by £322.9 billion to £493.3 billion, principally as a result of the acquisition of HBOS plc which had risk-weighted assets of £328.0 billion at 31 December 2008. Subsequent to the acquisition, deteriorating economic conditions have led to increased average risk weightings. This has been offset, primarily within Wholesale, by a reduction in exposures due to impairments and asset run-off, and movements due to currency retranslations.

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS** **AUDITED INFORMATION**  
**FINANCIAL AND PRUDENTIAL REGULATORY REPORTING, DISCLOSURE AND TAX RISK**

**DEFINITION**

The risk of reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over financial, prudential regulatory and tax reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose information about the Group on a timely basis.

**RISK APPETITE**

The risk appetite is set by the board and reviewed on an annual basis. It includes complying with disclosure requirements within prescribed timescales and avoiding the need for restatement of published financial and prudential regulatory reporting, publicly disclosed information or tax reporting.

**EXPOSURE**

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate books and records to support statutory, prudential and tax reporting, to prevent and detect financial reporting fraud and to manage the Group's tax position.

**MITIGATION**

The Group maintains a system of internal controls, which is designed to be consistently applied and enable the preparation and disclosure of financial reporting, prudential regulatory reporting and tax returns in accordance with International Financial Reporting Standards, statutory and regulatory requirements. The system of internal control is designed to ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities and that assets are safeguarded and liabilities are properly recorded.

**MONITORING**

The Group has in place a disclosure committee whose responsibility is to review all significant disclosures made by the Group and to assist the group chief executive and group finance director fulfil their responsibilities under the Listing Rules and regulations emanating from the US Sarbanes-Oxley Act of 2002. A programme of work is undertaken and is designed to support an annual assessment of the effectiveness of internal controls over financial reporting, in accordance with the requirements of section 404 of the US Sarbanes-Oxley Act. It also has in place an assurance mechanism over its prudential regulatory reporting; additionally, monitoring activities are designed to identify and maintain tax liabilities and to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

**LIFE INSURANCE BUSINESSES**

At 31 December 2009, the principal subsidiaries involved in the Group's life insurance operations were Scottish Widows plc (Scottish Widows) and Clerical Medical Investment Group Limited (Clerical Medical). These subsidiaries hold the only large with-profit funds managed by Lloyds Banking Group.

**BASIS OF DETERMINING REGULATORY CAPITAL OF THE LIFE INSURANCE BUSINESSES**

**AVAILABLE CAPITAL RESOURCES**

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

**Statutory basis.** Assets are generally valued on a basis consistent with that used for accounting purposes (with the exception that, in certain cases, the value attributed to assets is limited) and which follows a market value approach where possible. Liabilities are

calculated using a projection of future cash flows after making prudent assumptions about matters such as investment return, expenses and mortality. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets in accordance with the FSA rules. Other assumptions are based on recent actual experience, supplemented by industry information where appropriate. The assessment of liabilities does not include future bonuses for with-profits policies that are at the discretion of management, but does include a value for policyholder options likely to be exercised.

**Realistic basis.** The FSA requires each life insurance company which contains a with-profit fund in excess of £500 million to also carry out a realistic valuation of that fund. The Group has two such funds; one within Scottish Widows and one within Clerical Medical. The word realistic in this context reflects the terminology used for reporting to the FSA and is an assessment of the financial position of a with-profits fund calculated under a prescribed methodology.

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

The realistic valuation of liabilities is carried out using a stochastic simulation model which values liabilities on a basis consistent with tradable market option contracts (a market-consistent basis). The model takes account of policyholder behaviour on a best-estimate basis and includes an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities. Further details regarding the stochastic simulation model are given in the section entitled *Options and guarantees* on page 96.

## REGULATORY CAPITAL REQUIREMENTS

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

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

The determination of realistic liabilities of the with-profit funds includes the value of internal transfers expected to be made from each with-profit fund to the non-profit fund held within the same life insurance entity. These internal transfers include charges on policies where the associated costs are borne by the non-profit fund. The With-Profits Insurance Capital Component may be reduced by the value, calculated in the stress test scenario, of these internal transfers, but only to the extent that credit has not been taken for the value of these charges in deriving actuarial reserves for the relevant non-profit fund.

## CAPITAL STATEMENT

The following table provides more detail regarding the capital resources available to meet regulatory capital requirements in the life insurance businesses. The figures quoted are as disclosed in the Group's UK annual report and accounts and were based on management's expectations in advance of completion of the annual financial returns to the FSA; these annual financial returns have since been completed and submitted without material change to the numbers set out below. The figures allowed for a transfer of £261 million and an anticipated transfer of £147 million from long-term funds to the UK life shareholder funds as at 31 December 2009.

Following the acquisition of the life companies within HBOS plc, the format of the capital position statement has been revised to accommodate the reporting of all life assurance businesses within the Group.

## CAPITAL RESOURCES

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK non-profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
<b>As at 31 December 2009</b>						
Shareholders' funds:						
Held outside the long-term funds				1,048	651	1,699
Held within the long-term funds			8,011		405	8,416
Total shareholders' funds			8,011	1,048	1,056	10,115
Adjustments onto a regulatory basis:						
Unallocated surplus within insurance business	310	772				1,082
Value of in-force business			(5,513)		(793)	(6,306)
Other differences between IFRS and regulatory valuation of assets and liabilities			253	(154)	108	207
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(407)	(40)				(447)
Qualifying loan capital				1,165		1,165
Support arrangement assets	354		(354)			
<b>Available capital resources</b>	<b>257</b>	<b>732</b>	<b>2,397</b>	<b>2,059</b>	<b>371</b>	<b>5,816</b>

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	Scottish Widows With Profit Fund £m	UK non-profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
As at 31 December 2008 (statutory basis)					
Shareholders funds					
Held outside the long-term funds			865	2	867
Held within the long-term funds		3,762		13	3,775
Total shareholders funds		3,762	865	15	4,642
Adjustments onto a regulatory basis:					
Unallocated surplus within insurance business	293				293
Value of in-force business		(1,893)			(1,893)
Other differences between IFRS and regulatory valuation of assets and liabilities		25	(317)	(4)	(296)
Estimated share of realistic liabilities consistent with the FSA reporting treatment	(406)				(406)
Qualifying loan capital			604		604
Support arrangement assets	371	(371)			
<b>Available capital resources</b>	<b>258</b>	<b>1,523</b>	<b>1,152</b>	<b>11</b>	<b>2,944</b>

Available capital resources for with-profit funds are presented in the table on a realistic basis.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS FORMAL INTRA-GROUP CAPITAL ARRANGEMENTS

## AUDITED INFORMATION

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

### CONSTRAINTS OVER AVAILABLE CAPITAL RESOURCES

#### SCOTTISH WIDOWS

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

**Requirement to maintain a Support Account:** The Scheme requires the maintenance of a Support Account within the Non-Participating Fund. The quantum of the Support Account is calculated with reference to the value of assets backing current with-profits policies which also existed at the date of demutualisation and must be maintained until the value of these assets reaches a minimum level. Assets can only be transferred from the Non-Participating Fund if the value of the remaining assets in the fund exceeds the value of the Support Account. Scottish Widows has obtained from the FSA permission to include the value of the Support Account (or, if greater, the excess of realistic liabilities for business written before demutualisation over the relevant assets) in assessing the realistic value of assets available to the With Profit Fund. At 31 December 2009, the estimated value of surplus admissible assets in the Non-Participating Fund was £1,627 million (31 December 2008: £1,523 million) and the estimated value of the Support Account was £222 million (31 December 2008: £200 million).

**Further Support Account:** The Further Support Account is an extra tier of capital support for the with-profits policies in existence at the date of demutualisation. The Scheme requires that assets can only be transferred from the Non-Participating Fund if the economic value of the remaining assets in the fund exceeds the aggregate of the Support Account and Further Support Account. Unlike the Support Account test, the economic value used for this test includes both admissible assets and the present value of future profits of business written in the Non-Participating Fund or by any subsidiaries of that fund. The balance of the Further Support Account is expected to reduce to nil by the year 2030. At 31 December 2009, the estimated net economic value of the Non-Participating Fund and its subsidiaries for the purposes of this test was £3,823 million (31 December 2008: £3,605 million) and the estimated combined value of the Support Account and Further Support Account was £2,495 million (31 December 2008: £2,582 million).

**Other restrictions in the Non-Participating Fund:** In addition to the policies which existed at the date of demutualisation, the With Profit Fund includes policies which have been written since that date. As a result of statements made to policyholders that investment policy will usually be the same for both types of business, there is an implicit requirement to hold additional regulatory assets in respect of the business written after demutualisation. The estimated amount required to provide such support at 31 December 2009 is £132 million (31 December 2008: £171 million). Scottish Widows has obtained from the FSA permission to include the value of this support in assessing the realistic value of assets available to the With Profit Fund. There is a further test requiring that no amounts can be transferred from the Non-Participating Fund of Scottish Widows unless there are sufficient assets within the Long Term Fund to meet both policyholders' reasonable expectations in light of liabilities in force at a year end and the new business expected to be written over the following year.

#### CLERICAL MEDICAL

The surplus held in the Clerical Medical With Profit Fund can only be applied to meet the requirements of the fund itself or distributed accordingly to the prescribed rules of the fund. Shareholders are entitled to an amount not exceeding one ninth of the amount distributed to policyholders in the form of bonuses. The use of capital within the fund is also subject to the terms of the scheme of demutualisation effected in 1996 and the conditions contained in the Principles and Practices of Financial Management of the fund. Capital within the Clerical Medical Non-Profit Fund is available to meet the With Profit Fund requirements.

#### OTHER LIFE INSURANCE BUSINESSES

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Except as described above capital held in UK non-profit funds is potentially transferable to other parts of the Group, subject to meeting the regulatory requirements of these businesses. There are no prior arrangements in place to allow capital to move freely between life insurance entities or other parts of the Group.

Overseas life business includes several life companies outside the UK, including Germany and Ireland. In all cases the available capital resources are subject to local regulatory requirements, and transfer to other parts of the Group is subject to additional complexity surrounding the transfer of capital from one country to another.

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS  
MOVEMENTS IN REGULATORY CAPITAL**
**AUDITED INFORMATION**

The movements in the Group's available capital resources in the life business can be analysed as follows:

**MOVEMENTS IN AVAILABLE CAPITAL RESOURCES**

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK non-profit funds £m	UK life shareholder funds £m	Overseas life business £m	Total life business £m
As at 31 December 2008	258		1,523	1,152	11	2,944
Acquisition of life businesses		511	1,205	1,342	250	3,308
Changes in estimations and in demographic assumptions used to measure life assurance liabilities		19	(208)	43	36	(110)
Changes in regulatory requirements			(438)	(453)	(14)	(905)
Dividends and capital transfers			17			
Change in support arrangements	(17)					
New business and other factors	16	202	298	(25)	88	579
<b>As at 31 December 2009</b>	<b>257</b>	<b>732</b>	<b>2,397</b>	<b>2,059</b>	<b>371</b>	<b>5,816</b>

**WITH-PROFIT FUNDS**

Available capital in the Scottish Widows With Profit Fund has decreased from £258 million at 31 December 2008 to an estimated £257 million at 31 December 2009.

Available capital in the Clerical Medical With Profit Fund has increased from £511 million at acquisition to an estimated £732 million at 31 December 2009.

**UK NON-PROFIT FUNDS**

Available capital in the UK non-profit funds has increased from £1,523 million at 31 December 2008 to an estimated £2,397 million at 31 December 2009. The acquisition of Clerical Medical resulted in a £1,205 million increase. Further increases due to new business were offset by changes in assumptions and actual and proposed transfers to the UK life shareholders funds.

**UK LIFE SHAREHOLDER FUNDS**

Available capital in the UK life shareholder funds has increased from £1,152 million at 31 December 2008 to an estimated £2,059 million at 31 December 2009. The acquisition of Clerical Medical resulted in a £1,342 million increase. Redemption of subordinated debt (shown within dividends and capital transfers) has been partly offset by actual and proposed transfers from the long term funds.

**OVERSEAS LIFE BUSINESS**

The acquisition of Clerical Medical business resulted in a £250 million increase. Further increases were due to new business and changes in assumptions.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AUDITED INFORMATION

Analysis of policyholder liabilities reported in the balance sheet in respect of the Group's life insurance business is as follows. With-profit fund liabilities are valued in accordance with FRS 27.

## ANALYSIS OF POLICYHOLDER LIABILITIES

	Scottish Widows With Profit Fund £m	Clerical Medical With Profit Fund £m	UK non-profit funds £m	Overseas life business £m	Total life business £m
<b>As at 31 December 2009</b>					
With-profit fund liabilities	13,347	10,225	5		23,577
Unit-linked business (excluding that accounted for as non-participating investment contracts)			32,816	6,864	39,680
Other life insurance business			11,449	183	11,632
Insurance and participating investment contract liabilities	13,347	10,225	44,270	7,047	74,889
Non-participating investment contract liabilities			45,328	1,020	46,348
<b>Total policyholder liabilities</b>	<b>13,347</b>	<b>10,225</b>	<b>89,598</b>	<b>8,067</b>	<b>121,237</b>

	Scottish Widows With Profit Fund £m	UK non-profit funds £m	Total life business £m
<b>As at 31 December 2008</b>			
With-profit fund liabilities	13,293		13,293
Unit-linked business (excluding that accounted for as non-participating investment contracts)		11,480	11,480
Other life insurance business		8,364	8,364
Insurance and participating investment contract liabilities	13,293	19,844	33,137
Non-participating investment contract liabilities		14,243	14,243
<b>Total policyholder liabilities</b>	<b>13,293</b>	<b>34,087</b>	<b>47,380</b>

## CAPITAL SENSITIVITIES

## SHAREHOLDERS FUNDS

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

## WITH-PROFIT FUNDS

The with-profit realistic liabilities and the available capital for the with-profit funds are sensitive to both market conditions and changes to a number of non-economic assumptions that affect the valuation of the liabilities of the fund. The available capital resources (and capital requirements) are sensitive to the level of the stock market, with the position worsening at low stock market levels as a result of the guarantees to policyholders increasing in value. However, the exposure to guaranteed annuity options increases under rising stock market levels. An increase in the level of equity volatility implied by the market cost of equity put

options also increases the market consistent value of the options given to policyholders and worsens the capital position.

The most critical non-economic assumptions are the level of take-up of options inherent in the contracts (higher take-up rates are more onerous), mortality rates (lower mortality rates are generally more onerous) and lapses prior to dates at which a guarantee would apply (lower lapse rates are generally more onerous where guarantees are in the money). The sensitivity of the capital position and capital requirements of the with-profit funds is partly mitigated by the actions that can be taken by management.

#### **OTHER LONG-TERM FUNDS**

Outside the with-profit funds, assets backing actuarial reserves in respect of policyholder liabilities are invested so that the values of the assets and liabilities are broadly matched. The most critical non-economic assumptions are mortality rates in respect of annuity business written (lower mortality rates are more onerous). Reinsurance arrangements are in place to reduce the Group's exposure to deteriorating mortality rates in respect of life insurance contracts. In addition, poor cost control would gradually depreciate the available capital and lead to an increase in the valuation of the liabilities (through an increased allowance for future costs).

Assets held in excess of those backing actuarial reserves are invested across a range of investment categories including fixed interest securities, equities, properties and cash. The mix of investments is determined in line with the policy of Lloyds Banking Group to minimise the working capital (defined as available capital less minimum required capital) required to ensure all capital requirements continue to be met under a range of stress tests.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS OPTIONS AND GUARANTEES

## AUDITED INFORMATION

The Group has sold insurance products that contain options and guarantees, both within the with-profit funds and in other funds.

### OPTIONS AND GUARANTEES WITHIN THE WITH-PROFIT FUNDS

The most significant options and guarantees provided from within the with-profit funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up within the With Profit Fund of Scottish Widows called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2009 of £1.6 billion (2008: £2.0 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, under the realistic capital regime of the FSA, the liabilities of the with-profit funds are valued using a market-consistent stochastic simulation model. This model is used in order to place a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are:

Risk-free yield. The risk-free yield is defined as spot yields derived from the UK gilt yield curve.

Investment volatility. The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical observed volatility where it is not possible to observe meaningful prices. For example, as at 31 December 2009, the 10 year equity-implied at-the-money assumption was set at 26.6 per cent (31 December 2008: 34.6 per cent). The assumption for property volatility was 15 per cent (31 December 2008: 15 per cent). The volatility of interest rates has been calibrated to the implied volatility of swaptions which was broadly 15 per cent (31 December 2008: 16 per cent).

The model includes a matrix of the correlations between each of the underlying modelled asset types. The correlations used are consistent with long-term historical returns. The most significant non-economic assumptions included in the model are management actions (in respect of investment policy and bonus rates), guaranteed annuity option take-up rates and assumptions regarding persistency (both of which are based on recent actual experience and include an adjustment to reflect future uncertainties where the exercise of options by policyholders might increase liabilities), and assumptions regarding mortality (which are based on recent actual experience and industry tables).

### OPTIONS AND GUARANTEES OUTSIDE THE WITH-PROFIT FUNDS

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 £64 million (31 December 2008: £65 million) in respect of those guarantees. If future salary growth were 0.5 per cent per annum greater than assumed, the liability would increase by some £3 million. If yields were 0.5 per cent lower than assumed, the liability would increase by some £11 million.

## 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; and debt securities classified as loans and receivables**

The following table sets out the book values and valuations of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

	2009 Book value £m	2009 Valuation £m	2008 Book value £m	2008 Valuation £m	2007 Book value £m	2007 Valuation £m
<b>Trading securities and other financial assets at fair value through profit or loss</b>						
US treasury and US government agencies	482	482	258	258	38	38
Other government securities	19,479	19,479	7,106	7,106	4,872	4,872
Other public sector securities	706	706	18	18		
Bank and building society certificates of deposit	2,034	2,034	433	433	811	811
Mortgage-backed securities	520	520	369	369	157	157
Other asset-backed securities	2,890	2,890	1,342	1,342	1,927	1,927
Corporate and other debt securities	20,668	20,668	11,656	11,656	17,171	17,171
Equity shares	84,150	84,150	23,274	23,274	31,746	31,746
	<b>130,929</b>	<b>130,929</b>	44,456	44,456	56,722	56,722
<b>Available-for-sale financial assets</b>						
US treasury and US government agencies	2,898	2,898	358	358	319	319
Other government securities	5,771	5,771	510	510		
Other public sector securities	31	31	12	12	5	5
Bank and building society certificates of deposit	1,014	1,014	9,602	9,602	1,825	1,825
Mortgage-backed securities	4,781	4,781	5,700	5,700	6,050	6,050
Other asset-backed securities	7,640	7,640	8,092	8,092	4,071	4,071
Corporate and other debt securities	19,904	19,904	2,183	2,183	6,270	6,270
Equity shares	2,031	2,031	41	41	29	29
Treasury bills and other bills	2,532	2,532	29,209	29,209	1,627	1,627
	<b>46,602</b>	<b>46,602</b>	55,707	55,707	20,196	20,196
<b>Debt securities classified as loans and receivables</b>						
Mortgage-backed securities	13,322	12,799	478	402		
Other asset-backed securities	17,137	15,998	540	192		
Corporate and other debt securities	2,623	3,110	3,531	3,337		
	<b>33,082</b>	<b>31,907</b>	4,549	3,931		
Allowance for impairment losses	(430)		(133)			
	<b>32,652</b>	<b>31,907</b>	4,416	3,931		

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## 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 2009 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 %
<b>Trading securities and other financial assets at fair value through profit or loss</b>								
US treasury and US government agencies	82	2.5	207	3.2	93	4.2	100	5.2
Other government securities	3,123	1.2	4,097	3.0	3,917	3.6	8,342	3.8
Other public sector securities	28	6.4	213	4.2	116	5.2	349	5.0
Bank and building society certificates of deposit	2,034	0.1						
Mortgage-backed securities	15	4.4	20	4.6	52	5.0	433	5.4
Other asset-backed securities			130	5.7	271	6.2	2,489	3.8
Corporate and other debt securities	2,458	1.1	4,169	2.6	4,356	5.1	9,685	4.6
	7,740		8,836		8,805		21,398	
<b>Available-for-sale financial assets</b>								
US treasury and US government agencies	2	4.6	6	6.8	2,159	3.6	731	5.8
Other government securities	83	0.4	327	4.6	2,007	3.5	3,354	3.7
Other public sector securities	31	9.4						
Bank and building society certificates of deposit	983	0.7	31	0.3				
Mortgage-backed securities	386	0.7	3,419	2.3	841	3.2	135	3.3
Other asset-backed securities	705	0.8	3,236	1.4	3,570	1.4	129	2.4
Corporate and other debt securities	2,694	2.0	12,862	1.2	4,040	3.4	308	5.5
Treasury bills	2,531	0.2	1	1.5				
	7,415		19,882		12,617		4,657	
<b>Debt securities classified as loans and receivables</b>								
Mortgage-backed securities	15	1.8	403	1.2	1,582	1.1	11,322	0.9
Other asset-backed securities	27	0.1	2,747	0.8	4,710	0.7	9,653	0.7
Corporate and other debt securities	645	0.5	1,331	0.8	210	8.5	437	1.8
	687		4,481		6,502		21,412	

The Group's investment holdings at 31 December 2009 include £15,228 million due from the UK Government and its agencies.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AS AT 31 DECEMBER 2009**

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis as at 31 December 2009.

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
<b>Domestic</b>				
Loans and advances to banks	26,594	1,604	1,277	29,475
Loans and advances to customers:				
Mortgages	8,296	34,683	301,172	344,151
Other personal lending	22,359	13,686	4,745	40,790
Property companies	24,629	22,811	16,629	64,069
Financial, business and other services	25,632	20,873	11,627	58,132
Transport, distribution and hotels	10,726	7,474	4,513	22,713
Manufacturing	4,840	5,158	1,482	11,480
Other	11,874	9,563	8,157	29,594
<b>Total domestic</b>	<b>134,950</b>	<b>115,852</b>	<b>349,602</b>	<b>600,404</b>
Foreign	31,378	19,148	26,350	76,876
<b>Total loans</b>	<b>166,328</b>	<b>135,000</b>	<b>375,952</b>	<b>677,280</b>
Of which:				
Fixed interest rate	34,989	40,159	122,688	197,836
Variable interest rate	131,339	94,841	253,264	479,444

**DEPOSITS**

The following tables show the details of the Group's average customer deposits in each of the past three years.

	2009 Average balance £m	2009 Average rate %	2008 Average balance £m	2008 Average rate %	2007 Average balance £m	2007 Average rate %
Non-interest bearing demand deposits	6,902		3,793		3,899	
Interest-bearing demand deposits	89,603	0.43	47,985	1.28	46,124	1.80
Savings deposits	234,273	1.19	84,756	3.60	77,834	3.90
Time deposits	33,447	3.66	18,272	6.94	18,090	6.73
<b>Total average deposits</b>	<b>364,225</b>	<b>1.21</b>	<b>154,806</b>	<b>3.19</b>	<b>145,947</b>	<b>3.48</b>

The analysis of the Group's average customer deposits for 2009 between domestic and foreign offices is as follows:

Domestic	Foreign	Total
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	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
Non-interest bearing demand deposits	6,253		649		6,902	
Interest-bearing demand deposits	88,567	0.44	1,036	0.19	89,603	0.43
Savings deposits	229,234	1.19	5,039	1.33	234,273	1.19
Time deposits	31,908	3.56	1,539	5.59	33,447	3.66
<b>Total deposits</b>	<b>355,962</b>	<b>1.20</b>	<b>8,263</b>	<b>1.88</b>	<b>364,225</b>	<b>1.21</b>

99

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits as at 31 December 2009 individually in excess of US \$100,000 (or equivalent in another currency) by time remaining to maturity.

	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
<b>Domestic</b>					
Certificates of deposit	16,816	1,508	8,701	171	27,196
Time deposits	55,300	6,520	6,868	10,538	79,226
	72,116	8,028	15,569	10,709	106,422
<b>Foreign</b>					
Certificates of deposit and other time deposits	23,943	3,310	2,265	1,199	30,717
<b>Total</b>	<b>96,059</b>	<b>11,338</b>	<b>17,834</b>	<b>11,908</b>	<b>137,139</b>

## 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.

	2009 £m	2008 £m	2007 £m
<b>Liabilities in respect of securities sold under repurchase agreements</b>			
Balance at the year end	63,112	24,980	733
Average balance for the year	84,684	5,749	3,222
Maximum balance during the year	110,505	24,980	3,728
Average interest rate during the year	2.0%	4.4%	4.8%
Interest rate at the year end	0.5%	3.7%	5.2%
<b>Certificates of deposit issued</b>			
Balance at the year end	50,858	33,207	14,995
Average balance for the year	68,318	23,082	24,085
Maximum balance during the year	111,761	33,207	30,467
Average interest rate during the year	1.9%	4.1%	5.3%
Interest rate at the year end	0.8%	2.2%	5.6%
<b>Commercial paper</b>			
Balance at the year end	34,900	20,644	17,388
Average balance for the year	36,137	21,520	14,325
Maximum balance during the year	49,451	28,957	17,404
Average interest rate during the year	0.8%	3.5%	5.3%
Interest rate at the year end	0.8%	0.8%	2.3%

**Securitisation notes**

Balance at the year end	<b>37,557</b>	10,050	12,501
Average balance for the year	<b>43,869</b>	10,182	11,881
Maximum balance during the year	<b>49,766</b>	12,707	13,259
Average interest rate during the year	<b>1.7%</b>	4.1%	5.2%
Interest rate at the year end	<b>1.4%</b>	2.8%	5.2%

**Covered bonds**

Balance at the year end	<b>27,311</b>
Average balance for the year	<b>27,601</b>
Maximum balance during the year	<b>29,408</b>
Average interest rate during the year	<b>4.4%</b>
Interest rate at the year end	<b>4.2%</b>

## MANAGEMENT AND EMPLOYEES

### DIRECTORS AND SENIOR MANAGEMENT

The Group is led by the board comprising executive and non-executive directors with wide experience. The appointment of directors is considered by the nomination and governance committee and approved by the board and, following the provisions in the articles of association, they must stand for election by the shareholders at the first annual general meeting following their appointment and must retire, and may stand for re-election by the shareholders, at least every three years. Independent non-executive directors are appointed for three-year renewable terms, which may, in accordance with the articles of association, be terminated without notice or payment of compensation.

The board usually meets at least nine times a year. It has a programme designed to enable the directors regularly to review corporate strategy and the operations and results of the businesses and discharge their duties within a framework of prudent and effective controls relating to the assessing and managing of risk.

The roles of the chairman, the group chief executive and the board and its governance arrangements, including the schedule of matters specifically reserved to the board for decision, are reviewed annually. The matters reserved to the board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group's budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisation structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company's main professional advisers and their fees; and the appointment of senior executives within the organisation and related succession planning.

According to the articles of association, the business and affairs of the Company are managed by the directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All directors have access to the services of the company secretary, and independent professional advice is available to the directors at the Group's expense, where they judge it necessary to discharge their duties as directors.

During 2009, the board, supported by JCA Group, conducted a formal evaluation of the performance of the board, its committees and individual directors. Directors were invited to comment, through questionnaires and interviews, and JCA Group's report was subsequently reviewed and discussed by the board. Where areas for improvement were identified, action has been agreed.

The chairman's performance was evaluated by the non-executive directors, taking account of the views of executive directors. This appraisal was discussed at a meeting of the non-executive directors, led by the senior independent director, without the chairman being present.

The remuneration committee reviewed the performance of the chairman, the group chief executive and the other group executive directors, when considering their remuneration arrangements. The nomination and governance committee reviewed the performance of all the directors and the independence of non-executive directors. Like all board committees, the nomination and governance committee and remuneration committee report to the board on their deliberations, including the results of the performance and independence evaluations.

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 new directors, which is tailored to their specific requirements and includes visits to individual businesses and meetings with senior management. Major shareholders are also offered the opportunity to meet new non-executive directors. Additional training and updates on particular issues are arranged as appropriate.

The directors and senior management of Lloyds Banking Group plc are:

**SIR WINFRIED BISCHOFF ♦♦ +**

Chairman

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Joined the board and was appointed chairman on 15 September 2009. Previously chairman of Citigroup Inc. from December 2007 to February 2009. He joined J Henry Schroder & Co in January 1966 and became managing director of Schroders Asia in 1971, group chief executive of Schroders Plc in 1984 and chairman in 1995. Following the acquisition of Schroders' investment banking business by Citigroup in 2000 he became chairman of Citigroup Europe before being appointed acting chief executive officer of Citigroup in 2007 and subsequently as chairman in the same year. A non-executive director of Eli Lilly and Company, and The McGraw Hill Companies Inc. in the United States, and chairman of the UK Career Academy Foundation. A member of the Akbank International advisory board. Aged 69.

### **LORD LEITCH** ♦

Deputy Chairman and Independent Director

Joined the board in 2005 and was appointed deputy chairman in May 2009. Appointed chairman of Scottish Widows in 2007. Held a number of senior and general management appointments in Allied Dunbar, Eagle Star and Threadneedle Asset Management before the merger of Zurich Group and British American Tobacco's financial services businesses in 1998. Subsequently served as chairman and chief executive officer of Zurich Financial Services United Kingdom, Ireland, Southern Africa and Asia Pacific, until his retirement in 2004. Chairman of the Government's Review of Skills (published in December 2006) and deputy chairman of the Commonwealth Education Fund. Chairman of BUPA and Intrinsic Financial Services and a non-executive director of Paternoster. Former chairman of the National Employment Panel. Aged 62.

### **SIR JULIAN HORN-SMITH** ♦ +

Independent Director

Joined the board in 2005. Held a number of senior and general management appointments in Vodafone from 1984 to 2006 including a directorship of that company from 1996, group chief operating officer from 2001 and deputy chief executive officer from 2005. Previously held positions in Philips from 1978 to 1982 and Mars GB from 1982 to 1984. A non-executive director of De La Rue, Digicel Group and Emobile (Japan), a director of Sky Malta, a member of the Altimo International advisory board and a senior advisor to UBS and CVC Capital Partners in relation to the global telecommunications sector. Pro vice-chancellor of University of Bath. A former chairman of The Sage Group. Aged 61.

### **GLEN R MORENO** ♦ ++

Senior Independent Director

Chairman of Pearson, the media group, since October 2005. He is a director of Fidelity International, one of the world's largest fund management companies, and chairman of its audit committee. From 1987 to 1991 he was chief executive of Fidelity International. Until mid 2009, he was a non-executive director and senior independent director of Man Group, the FTSE 100 financial services group, and acting chairman of UKFI. He was a group executive at Citigroup; from 1969 to 1987 he held a number of senior positions at the bank in Europe and Asia. Aged 66.

## MANAGEMENT AND EMPLOYEES

### **DAVID L ROBERTS<sup>+</sup>**

Independent Director

Executive director, member of the group executive committee and chief executive, International Retail and Commercial Banking at Barclays until December 2006. He joined Barclays in 1983 and held various senior management positions, including chief executive, Personal Financial Services and chief executive, Business Banking. He was also a non-executive director of BAA until June 2006 and a non-executive director of Absa Group Limited, one of South Africa's largest financial services groups, until October 2006. From 2007 to 2009 he was also the chairman and chief executive of BAWAG P.S.K. AG, the second largest retail bank in Austria. He is currently a member of the strategy board for Henley Business School, non-executive chairman of The Mind Gym and a non-executive director of Champion Willcocks. Aged 47.

### **T TIMOTHY RYAN, JR<sup>+</sup>**

Independent Director

Joined the board on 1 March 2009. President and chief executive of the Securities Industry and Financial Markets Association. Held a number of senior appointments in JP Morgan Chase from 1993 to 2008 including vice chairman, financial institutions and governments, from 2005. A director of the US-Japan Foundation, Great-West Life Annuity Insurance Co. and Putnam Investments and a member of the Global Markets Advisory Committee for the National Intelligence Council. A former director in the Office of Thrift Supervision, US Department of the Treasury and Koram Bank and the International Foundation of Election Systems. Aged 64.

### **MARTIN A SCICLUNA<sup>◆\*\*+</sup>**

Independent Director

Joined the board in September 2008. Chairman of Deloitte UK from 1995 to 2007 and a member of the board from 1991 to 2007. Joined the firm in 1973 and was a partner from 1982 until he retired in 2008. A member of the board of directors of Deloitte Touche Tohmatsu from 1999 to 2007. Chairman of Great Portland Estates. A member of the council of Leeds University and a governor of Berkhamsted School. Aged 59.

### **ANTHONY WATSON CBE<sup>◆\*</sup>**

Independent Director

Joined the board on 2 April 2009. Previously chief executive of Hermes Pensions Management. Held a number of senior appointments in AMP Asset Management from 1991 to 1998. A non-executive director of Hammerson, Vodafone and Witan Investment Trust, a member of the Norges Bank Investment Management advisory board and chairman of Marks and Spencer Pension Trust, Asian Infrastructure Fund and Lincoln's Inn investment committee. A former chairman of MEPC and of the Strategic Investment Board (Northern Ireland) and a former member of the Financial Reporting Council. Aged 65.

### **J ERIC DANIELS**

Group Chief Executive

Joined the board in 2001 as group executive director, UK retail banking before his appointment as group chief executive in June 2003. Served with Citibank from 1975 and held a number of senior and general management appointments in the USA, South America and Europe before becoming chief operating officer of Citibank Consumer Bank in 1998. Following the Citibank/Travelers merger in 1998, he was chairman and chief executive officer of Travelers Life and Annuity until 2000. Chairman and chief executive officer of Zona Financiera from 2000 to 2001. A non-executive director of BT Group. Aged 58.

### **ARCHIE G KANE**

Group Executive Director Insurance (Board Representative for Scotland)

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Joined the group in 1986 and held a number of senior and general management appointments before being appointed to the board in 2000, as group executive director, IT and operations. Appointed group executive director, insurance and investments in October 2003. After some 10 years in the accountancy profession, joined General Telephone & Electronics Corporation in 1980, serving as finance director in the UK from 1983 to 1985. Chairman of the Association of British Insurers and a member of The Takeover Panel. Aged 57.

### **G TRUETT TATE**

Group Executive Director Wholesale

Joined the group in 2003 as managing director, corporate banking before being appointed to the board in 2004. Served with Citigroup from 1972 to 1999, where he held a number of senior and general management appointments in the USA, South America, Asia and Europe. He was president and chief executive officer of eCharge Corporation from 1999 to 2001 and co-founder and vice chairman of the board of Chase Cost Management Inc from 1996 to 2003. A non-executive director of BritishAmerican Business Inc. Chairman of Arora Holdings and a director of Business in the Community and a director and trustee of In Kind Direct. Aged 59.

### **TIM J W TOOKEY**

Group Finance Director

Joined the group in 2006 as deputy group finance director, before being appointed acting group finance director in April 2008. Appointed to the board in October 2008 as group finance director. Previously finance director for the UK and Europe at Prudential from 2002 to 2006 and group finance director of Heath Lambert Group from 1996 to 2002. Prior to that, he spent 11 years at KPMG. Aged 47.

### **HELEN A WEIR CBE**

Group Executive Director Retail

Joined the board in 2004 as group finance director. Appointed as group executive director, UK retail banking in April 2008. Group finance director of Kingfisher from 2000 to 2004. Previously finance director of B&Q, having joined that company in 1995 from McKinsey & Co where she was a senior manager. Began her career at Unilever. Member of the Financial Services Practitioner Panel and the Said Business School Advisory Board. Chair of the British Bankers Association Retail Committee. A former member of the Accounting Standards Board. Fellow of the Chartered Institute of Management Accountants. Aged 47.

\*Member of the audit committee \*\*Chairman of the audit committee ♦ Member of the nomination and governance committee ♦♦ Chairman of the nomination and governance committee Member of the remuneration committee Chairman of the remuneration committee + Member of the risk oversight committee ++ Chairman of the risk oversight committee



## MANAGEMENT AND EMPLOYEES

### EMPLOYEES

As at 31 December 2009, the Group employed 107,144 people (on a full-time equivalent basis), compared with 58,756 at 31 December 2008 as a result of the acquisition of HBOS. At 31 December 2009 101,696 employees were located in the UK, 3,582 in continental Europe, 652 in the Americas, and 1,214 in the rest of the world. At the same date, 51,926 people were employed in Retail, 17,489 in Wholesale, 9,989 in Wealth and International, 9,646 in Insurance, 16,037 in Group Operations, and 2,057 in other functions.

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

In the UK, the Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age, Stonewall and the Race for Opportunity. The Group's involvement with these organisations enables it to identify and implement best practice for its staff.

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

Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in the Group. Further details are given in *Compensation*.

The Group has a code of business conduct which applies to all employees. The code as amended from time to time is available to the public on the Company's website at [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

### MEETINGS WITH SHAREHOLDERS

In order to develop an understanding of the views of major shareholders, the board receives regular reports from the group finance director and the director of investor relations.

The chairman, the group chief executive and the group finance director also have meetings with representatives of major shareholders and the senior independent director also attends some of these meetings. In addition, all directors are invited to attend investment analysts' and stockbrokers' briefings on the financial results.

All shareholders are encouraged to attend and participate in the Group's annual general meeting.

## COMPENSATION

This is a report made by the board of Lloyds Banking Group plc, on the recommendation of the remuneration committee. It covers the current and proposed components of the remuneration policy and details the remuneration for each serving director during 2009.

### REMUNERATION DECISIONS FOR 2009/2010 KEY HIGHLIGHTS

In 2010, our remuneration package will continue to have the same main elements as for 2009:

Base salary

Annual incentive

Long-term incentive plan

In addition, executive directors participate in pension arrangements and receive benefits such as life assurance and medical insurance.

The following key decisions have been made for 2009/2010 remuneration:

2010 base salaries for executive directors will continue to be frozen at 2008 levels

At his own request the group chief executive waived his award under the annual incentive plan for 2009

Awards under the annual incentive plan for 2009 for executive directors amounted to between 150 per cent and 185 per cent of salary

All awards under the annual incentive plan are deferred into shares and subject to clawback, with any awards released in 2012

LTIP award below historic award levels at a maximum of 275 per cent of salary subject to stretching performance conditions based on EPS, economic profit and the achievement of stretching share price targets

Any shares vesting as a result of the element of the LTIP relating to the share price targets must be retained for a further two years post vesting

The approximate make-up of the main components of our new package for executive directors on an expected value basis is shown below:

(The split in the components in the above chart are for executive directors. Comparable numbers for the group chief executive are: long term incentive 40 per cent, short term incentive 32 per cent and salary 28 per cent)

The 2010 package is designed to encourage a long-term and risk-based focus:

Salary is a significant proportion of the total package, avoiding excessive leverage

All incentives will be paid on a deferred basis at the end of three years

Deferred annual incentive is subject to clawback; ie it is not released when information subsequently comes to light about the performance on which the incentive award is based, which had it been known prior to the determination of the awards would have affected the original award decision

A combination of financial and non-financial measures encourages a long-term focus

Economic profit, which is a risk-adjusted profit measure, is a core financial target used in both the annual incentive plan and the LTIP

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Shares resulting from the vesting of the share price performance part of the LTIP must be retained for a further two years post vesting

We believe that these arrangements are well aligned with the FASB's Code of Practice on Remuneration.

**104**

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## COMPENSATION

### GOVERNANCE AND RISK MANAGEMENT

An essential component of our approach to remuneration is the governance process that underpins it. This ensures that our policy is robustly applied and risk is managed appropriately.

The overarching purpose of the remuneration committee is to consider, agree and recommend to the board an overall remuneration policy and philosophy for the Group that is aligned to its long-term business strategy, its business objectives, its risk appetite and values, and recognizes the interests of relevant stakeholders. The remuneration policy and philosophy covers the whole Group, but the committee pays particular attention to the top management group and those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile. The committee's role is to ensure that these colleagues are provided with appropriate incentives to encourage them to enhance the performance of the Group and that they are rewarded for their individual contribution to the success of the organization, whilst ensuring that there is no reward for excessive risk taking.

The committee determines the pensions policy for all colleagues and advises on other major changes to employee benefits schemes. It also agrees the policy for authorising claims for expenses from the group chief executive and the chairman. It has delegated power for settling remuneration for the chairman, the group executive directors, the company secretary and any group employee whose salary exceeds a specified amount, currently £350,000, and/or whose short-term incentive opportunity exceeds £250,000.

The committee monitors the application of the authority delegated to the group executive committee and the divisional remuneration committees to ensure that policies and principles are being fairly and consistently applied. The committee liaises with the risk oversight committee and the risk function in relation to risk-adjusted performance measures.

All the independent non-executive directors are invited to attend meetings if they wish, and they receive the minutes and have the opportunity to comment and have their views taken into account before the committee's decisions are implemented.

The committee's terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

The committee met on 13 occasions during 2009, and the members were as follows:

Dr Wolfgang Berndt (chairman)

Sir Victor Blank (until 14 September 2009)

Sir Winfried Bischoff (from 15 September 2009)

Mr Philip Green (until 23 October 2009)

Sir Julian Horn-Smith

Lord Leitch (from 18 May 2009)

Sir David Manning (until 2 November 2009)

Ms Carolyn McCall (from 23 January 2009 until 31 December 2009)

The committee welcomed Lord Leitch and Ms Carolyn McCall to the committee and Sir Winfried Bischoff, on his appointment as chairman of the Group. We thank Sir Victor Blank, Mr Philip Green, Ms Carolyn McCall and Sir David Manning for their contributions to the committee during 2009 up until their departures from the Group.

We also thank all committee members for their commitment during the last year and attendance at the unprecedented number of meetings.

As at the date of this report, the members of the committee are Mr Watson (chairman), Sir Winfried Bischoff, Sir Julian Horn-Smith, Lord Leitch, Mr Moreno, Mr Roberts and Mr Ryan.

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The committee appoints independent consultants to provide advice on specific matters according to their particular expertise. Towers Perrin, Hewitt New Bridge Street and Kepler Associates were retained by the committee during 2009 to advise on various matters relating to executive remuneration. In addition, PricewaterhouseCoopers LLP (PwC) were also retained in 2009 specifically to complete the committee's project to review executive remuneration arrangements in light of the acquisition of HBOS, given their particular expertise in the remuneration aspects of transactions. This project had commenced in 2008. As PwC are also the auditors to Lloyds Banking Group and to mitigate any threat to audit independence, Kepler Associates continue to be retained as the remuneration committee's primary independent advisors, and were commissioned to provide comment on PwC's advice.

In addition to their advice on executive remuneration, during 2009 Towers Perrin also provided market remuneration data as well as other remuneration consulting services to the Group, Hewitt New Bridge Street provided pension consulting services.

During 2009, Alithos Limited continued to provide information on behalf of the committee for the testing of total shareholder return (TSR) (calculated by reference to both dividends and growth in share price) performance conditions for the Group's long-term incentive schemes.

Mr Daniels, Mrs Risley (Group Human Resources Director) and Ms Kemp (HR Director, Total Reward) provided guidance to the committee (other than for their own remuneration). Mrs Carol Sergeant (Chief Risk Officer) also attended the committee to advise on risk matters.

The remuneration committee ensures that appropriate remuneration and governance arrangements are in place throughout the organisation, with the Group functions providing an oversight role in the development of remuneration policy and practice below the senior executive population. During 2009 as part of the review of compliance with the new FSA Code of Practice on Remuneration and the developing governance environment, the committee reviewed and adopted new terms of reference. In addition divisional remuneration committees were established to ensure a strong oversight from the group remuneration committee into the divisions.

## COMPENSATION

The key developments in the committee's terms of reference are:

Extension of its direct responsibilities to include all those colleagues who perform significant influence functions for the Group and those who could have a material impact on the Group's risk profile;

Formalising the periodic review of the adequacy and effectiveness of the Group's remuneration policy;

Formalising annual reporting to the board on the substance of the Group's remuneration policy and propose any substantive changes. This report will be supported by independent commentary from the chief risk officer in the context of the Group's risk appetite and by positive assurance from each group executive director that all remuneration arrangements within their division/function reflect fully the Group's overall approach to remuneration; and

The chief risk officer will attend the remuneration committee for at least two meetings a year.

The role of the divisional remuneration committees is to ensure a strong oversight from the group remuneration committee into the divisions. Specifically:

The relevant group executive director will be accountable for the effective implementation of the remuneration policy in their division;

The divisional remuneration committee, which will have representation from both divisional and group reward and risk functions, will ensure that the policy is effectively and efficiently executed in the division;

Formal positive assurance (through annual reporting) as to how the remuneration policy is being applied across the group will be provided to the group remuneration committee from each divisional remuneration committee; and

The divisional remuneration committee will be responsible for ensuring the effective governance of divisional specific remuneration arrangements, especially the design and outcome of short-term incentive/bonus schemes.

We believe our approach is well aligned with the FSA Code of Practice on Remuneration but we will continue to work with the FSA to ensure ongoing compliance and implement changes as appropriate.

## DIRECTORS REMUNERATION POLICY

The Group's remuneration policy supports our business strategy, which is based on building long-term relationships with our customers and employees, and managing the financial consequences of our business decisions across the entire economic cycle. The policy is to position base salaries to reflect the relevant market median and the total package is designed to enable upper quartile performance to be rewarded with upper quartile remuneration levels. Overall the policy is designed to ensure that cost effective packages are provided which attract and retain executive directors and senior management of the highest caliber and motivate them to perform to the highest standards. At the same time, the objective is to align individual rewards with the Group's performance, the interests of its shareholders, and a prudent approach to risk management. In this way we balance the requirements of our various stakeholders: customers, shareholders, employees, and regulators. We believe that this approach is in line with the Association of British Insurers best practice code on remuneration as well as the FSA Code of Practice on Remuneration, as the policy seeks to reward long-term value creation whilst not encouraging excessive risk taking.

We summarise below how each of these policy objectives is met by our remuneration packages.

Policy objective	How achieved
Building long-term relationships	We build relationships with our customers and people rather than viewing them as counterparties in a money-making transaction and are in the process of extending this philosophy across the integrated Group. This means that working for the Lloyds Banking Group should be about more than pay. While our relationship with our people means that we will pay them fairly and competitively, our pay is positioned conservatively against the market and we will not seek to be among the highest payers in the sector. In setting pay for executive directors, we take account of the terms and conditions applying to other

employees of the Group.

Our incentive measures are not just financial. Half of the annual incentive for executives is linked to a scorecard including how they perform against targets that measure how satisfied our customers are, and the extent to which our employees feel engaged with and committed to working for the Lloyds Banking Group, both of which are important foundations of a relationship-based strategy.

Managing the financial consequences of our business through the economic cycle

Economic profit is a key measure by which we manage our business. This measure takes into account the level of capital required to generate profits as well as the risks taken. The same level of profit generated at lower risk results in higher economic profit. Economic profit also measures risk based on an assessment of how business will perform through the economic cycle.

Therefore, for example, in good times, when default rates on loans are low, we adjust the economic profit measure downwards based on a higher average expected default experience over the economic cycle. This encourages us to avoid business and funding strategies that are only profitable during boom times but turn bad in a recession. Economic profit plays a prominent role in our incentive plans for executives, a role which was further enhanced in 2009, with its inclusion in the long-term incentive plan performance measures.

## COMPENSATION

Policy objective	How achieved
Aligning individual rewards with Group performance and shareholders	<p>The majority of our executives' pay is linked to stretching performance targets through annual and long-term incentives. Performance measures on the annual incentive are directly aligned to the Group's financial and non-financial performance.</p> <p>Executives are aligned with shareholders through the long-term incentive plan, which pays out based on performance against Group targets over a three year period, and which is paid in shares to further improve alignment with shareholders.</p> <p>This objective of aligning the interests of executives with those of shareholders throughout the economic cycle can be seen through the vesting outcomes of awards made to executives under the LTIP plans. In 2009, historic LTIP and option plans from 1999, 2005 and 2006 lapsed as their performance conditions were not met. The same outcome is envisaged for the 2007 LTIP with a performance period ending in 2010.</p> <p>Executives are required to build up a holding in Lloyds Banking Group shares of value equal to 1.5 times salary for executive directors (2 times salary for the group chief executive). They are expected to retain 100 per cent of the net-of-tax proceeds of the 2009 LTIP until they reach this target. In addition they are required to retain any shares vesting from the share price performance element of the 2010 LTIP for a further two years post vesting.</p> <p>Finally, we operate tough contract provisions whereby no executive has an entitlement to more than 12 months' notice, compensation on termination is limited to basic salary, and any compensation is paid monthly over 12 months and is mitigated if the executive gets another job. This approach avoids the risk of payment for failure. These requirements are among the toughest in the FTSE 100.</p>
A prudent approach to risk management	<p>Economic profit measures profit relative to the risk taken to generate that profit. Its use in our incentive plans therefore encourages executives to take a prudent approach to risk.</p> <p>We also have non-financial measures of performance against risk objectives in the plan for executives, which enables a more rounded assessment of risk-taking behavior.</p> <p>For the 2009 annual incentive we increased the alignment to long-term prudent risk management by deferring all of the award. For executive directors any cash incentive earned will be deferred 100 per cent into shares and paid out in 2012. If the performance that led to the incentive is found to be unsustainable during the deferral period, then some or all of the award may be forfeited.</p> <p>We pay competitively but not excessively. Our prudent approach to positioning compensation means that we reduce the incentives to take excessive risk for personal gain. This means that we do not attract employees with an extreme appetite for risk.</p> <p>We have a robust governance framework with an independent remuneration committee reviewing all compensation decisions. This approach to governance and review is cascaded through the organisation.</p>
Cost effective packages to attract and retain executives	<p>We aim to ensure that the totality of remuneration for executive directors is competitive against our benchmark groups. These groups are other major UK banks, and also the top 20 companies in the FTSE 100, reflecting practices in comparably sized large UK companies across all sectors. We aim to be competitively but conservatively positioned against the market.</p> <p>We aim to choose incentive plan targets that are directly linked to the business strategy and priorities. This not only ensures alignment with company performance, but also means that the targets are meaningful to executives and therefore motivating. This ensures that</p>



incentive packages are valued by executives and are cost effective.

## REMUNERATION FOR 2010

The remuneration committee undertook an extensive review of executive remuneration during late 2008 and into 2009 in light of the HBOS acquisition. That review in conjunction with detailed consultation with shareholders led to the remuneration decisions for 2009. The committee continued to review remuneration during 2009 in light of the FSA Code of Practice on Remuneration, the outcomes of the G20 meeting in September 2009 and Sir David Walker's review of corporate governance in UK banks and other financial industry entities. This ongoing review process has found that the structure of the remuneration package, in particular the focus on risk through the long-term incentive plan measures and balanced scorecard, was well aligned with emergent best practice in the sector.

The review process has highlighted the concern on how to maintain an appropriately competitive incentive for the senior executives of the Group, following the significant reduction in incentive levels in 2009, whilst recognizing the sensitivity of the operating environment and the fact that the Group was loss making on a combined businesses basis in 2009. Following consultation with shareholders, the remuneration committee is proposing a package for 2010 that is closely based on the structure and principles of 2009, but with an additional LTIP performance measure based on the achievement of stretching share price targets. With the addition of this performance measure, the maximum LTIP award for 2010 will be 275 per cent of salary, still 100 per cent of salary lower than the 2008 maximum level. To achieve maximum vesting of this award, not only will stretching EPS and economic profit targets need to be achieved but also stretching share price targets.

## COMPENSATION

### SUMMARY OF REMUNERATION ELEMENTS

The key remuneration elements for 2010 are summarised below. Each individual element is then described in more detail in the subsequent sub-sections.

Element	Level/design for 2010	Key purpose
Base salary	Base pay should be set competitively relative to FTSE 20 and banking sector competitors  In light of circumstances, no increase for 2010 and base salaries held at same level as for 2008	Meet essential commitments of executive Retention
Annual incentive	200 per cent of salary maximum (225 per cent for group chief executive), as for 2009  Based 50 per cent on Group financial targets relating to profit before tax and economic profit  Based 50 per cent on balanced scorecard covering, customers, people, risk and build franchise  Subject to deferral and clawback	Alignment with Group performance  Alignment with sound risk management  Motivation of executives
Long-term incentive plan	275 per cent of salary maximum, split as follows:  100 per cent on earnings per share  100 per cent on economic profit  75 per cent on absolute share price growth  Any shares vesting from the absolute share price growth element retained for a further 2 years post vesting	Motivation and retention of executives  Alignment with sound risk management  Alignment with long-term shareholder interests
Pension	A mixture of final salary and defined contribution pension arrangements  From April 2012, executive directors with final salary pensions will move to a defined contribution pension arrangement, with no compensation	Enable executives to build long-term retirement savings  Retention

### GENERAL CONSIDERATIONS

When deciding the approach to take for remuneration in 2010, the remuneration committee considered a range of factors. The environment for remuneration in the banking sector remains very sensitive and the committee is aware of this. Consistent with best practice, shareholders were fully consulted during the process and their views have been taken into account in the decisions the committee has made. At the same time, the ongoing challenges of the HBOS integration to create the UK's leading consumer bank were also considered by the committee as is the need to retain and motivate the management team to build on the outstanding start made to this process in 2009.

### BASE SALARY

Basic salaries are reviewed annually, usually in December, taking into account individual performance and market information (which is provided by Towers Perrin and supplemented with information from Kepler Associates as appropriate) and then adjusted from 1 January of the following year. The remuneration committee confirmed during the 2009 review that the FTSE 20 was the most appropriate comparator group to use to benchmark overall competitiveness of the remuneration package whilst taking

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particular account of the remuneration practice of our direct competitors, namely the major UK banks. The FTSE 20 is regarded as providing a realistic and relevant comparison in terms of company size and complexity, as well as being a key market for talent.

However, in recognition of the current operating environment base salaries for 2010 remain unchanged from the salaries set for 2008. Base salary increases for other employees across the Group will remain in line with any market movement, but will, in general be significantly lower than in previous years.

Name	J E Daniels	A G Kane	G T Tate	T J W Tookey	H A Weir
As at 1 January 2010	£1,035,000	£590,000	£640,000	£600,000	£625,000

**108**

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## COMPENSATION

### ANNUAL INCENTIVE PLAN

The combination of financial and non-financial measures, which support our prudent approach to managing risk, are retained in the annual incentive plan, whilst the operation of the plan is enhanced in order to increase the alignment between risk and reward still further. The committee recognises the challenges of setting robust targets in the current operating environment. Furthermore, the committee will review the performance against the targets for the 2010 annual incentive plan at the end of the year, taking into account the overall operating performance of the business in determining how much of any bonus will be paid out. The committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if they deemed this appropriate.

Consistent with the aim of ensuring that short-term financial results are only achievable sustainably, the committee has decided that the incentive will be deferred and released in tranches over a three year period. The deferred incentive will be subject to 100 per cent clawback if the performance that generated the incentive is found to be unsustainable.

The maximum annual incentive opportunity remains unchanged at 200 per cent (225 per cent for the group chief executive) of base salary for the achievement of exceptional performance targets.

The remuneration committee believes that the structure of the incentive in particular the use of risk-adjusted and non-financial measures has been highly successful in promoting a long-term focus within the senior management team.

### LONG-TERM INCENTIVE AWARD

Given the extraordinary circumstances during 2008, the remuneration committee made a reduced maximum LTIP award of 200 per cent of salary in 2009, 175 per cent less than the maximum award for 2008. For 2010, the remuneration committee continues to believe that it is appropriate to make LTIP awards below the maximum levels that the plan allows (400 per cent) and less than the award levels for 2008 (maximum award 375 per cent). Notwithstanding the increased size and complexity of the Group since the HBOS acquisition and the concerns about retention and motivation, the committee believes that the current environment requires a demonstration of continued restraint in relation to remuneration. At the same time, the committee believes in the importance of aligning shareholder and executive motivation and therefore it has approved maximum awards for the group chief executive and executive directors for 2010 of 275 per cent of base salary of which 200 per cent of the award will be based on the same performance conditions as for 2009, namely EPS and economic profit, with the remaining 75 per cent based on the achievement of stretching share price targets.

### LONG-TERM INCENTIVE PERFORMANCE MEASURES

In continuing with the same financial performance measures as for 2009, the remuneration committee has continued to create a focus on long-term performance, taking appropriate account of risk.

Performance targets have been set by reference to analysts' expectations, internal business plans, competitive performance assessments and probability modelling. Stretch performance will be equated to the remuneration committee's assessment of an upper quartile performance level or greater. Shareholders have been consulted on the targets and the targets have been made more stretching as a consequence of those discussions.

The details of the targets for the proposed measures are set out below:

#### EARNINGS PER SHARE (APPLYING TO AWARD OF 100 PER CENT OF SALARY)

Earnings per share continues to be an important measure of our profitability and ability to generate cash. The committee has therefore decided to retain this well-recognised measure in our incentive system.

For the EPS element of the award, performance will be measured based on EPS growth over a three year period from the baseline EPS of 2009.

Vesting	EPS absolute
(%)	percentage

	improvement	
Threshold	25%	158%
Maximum	100%	180%

ECONOMIC PROFIT (APPLYING TO AWARD OF 100 PER CENT OF SALARY)

The use of economic profit has been very successful in introducing a long-term, risk-based approach to managing our business. Economic profit is calculated on a through-the-cycle basis, considering the impact of decisions over an entire economic cycle, encouraging prudent risk management of our portfolio.

For the economic profit element of the award, performance will be based on the compound annual growth rate (CAGR) from the 2009 base over a three year period.

	Vesting (%)	CAGR growth in EP
Threshold	25%	57% pa
Maximum	100%	77% pa

## COMPENSATION

### ABSOLUTE SHARE PRICE GROWTH (APPLYING TO AWARD OF 75 PER CENT OF SALARY)

The absolute share price element of the award will fully align shareholder and executives' interests during a period of share price recovery.

Performance will be measured based on the average absolute share price achieved during the 90 days at the end of the three year period.

	Vesting %	Absolute share price achieved
Threshold	0%	75p
Maximum	100%	114p

There will be an underpin to the absolute share price element of the award such that shares making up that element may only be released if both the EPS and the economic profit element have achieved a threshold level of vesting as above.

Any shares vesting as a result of this element of the 2010 award will be required to be held for a further two years post vesting.

Vesting between threshold and maximum will be on a straight line basis for all three elements.

### PENSION

As stated last year, in April 2012, all executive directors will transition to defined contribution pension arrangements with contributions of 25 per cent of base salary for the group chief executive and other executive directors, with no compensation for ceasing final salary accrual.

### OTHER SHARE PLANS

The executive directors are also eligible to participate in the Group's sharesave and shareplan schemes. These are all-employee share schemes.

### CHAIRMAN'S REMUNERATION

The chairman's remuneration comprises salary and benefits. He does not participate in the annual bonus and long-term incentive arrangements, nor is he entitled to pension benefits.

The chairman's salary was reviewed at the time of the appointment of Sir Winfried Bischoff in 2009. The review took into account the market information and also the significant amount of time the chairman would be expected to focus on the Group's activities particularly during the current period. The chairman was appointed on a salary of £700,000 per annum. His salary will next be reviewed at the end of 2010, with any adjustments effective 1 January 2011.

### INDEPENDENT NON-EXECUTIVE DIRECTORS' FEES

The fees of the independent non-executive directors are agreed by the board within a total amount determined by the shareholders. Directors may also receive fees, agreed by the board, for membership of board committees. The fees are designed to recognise the various responsibilities of a non-executive director's role and to attract individuals with relevant skills, knowledge and experience. The fees are neither performance related nor pensionable and are comparable with those paid by other companies. The annual fees from 1 January 2010 are unchanged and are listed below.

Board	£65,000
-------	---------

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Audit committee chairmanship	£50,000
Audit committee membership	£20,000
Nomination and governance committee membership	£5,000
Remuneration committee chairmanship	£30,000
Remuneration committee membership	£15,000
Risk oversight committee membership	£15,000

Independent non-executive directors who serve on the boards of subsidiary companies may also receive fees from the subsidiaries. The fees paid in 2009 to the current non-executive directors are shown in the table in the following section.

## COMPENSATION

### REMUNERATION FOR 2009

#### 2009 ANNUAL INCENTIVE SCHEME

The annual incentive scheme for executive directors is designed to reflect specific goals linked to the performance of the business.

Incentive awards for executive directors are based upon individual contribution and overall corporate results. Half of the incentive opportunity is driven by corporate performance based on the stretching target relating to profit before tax and economic profit. The level of achievement against the targets for profit before tax and economic profit that results in the lower payout will determine the extent to which the target has been met. The other half of the incentive opportunity is determined by divisional achievement driven through individual performance. Individual targets relevant to improving overall business performance are contained in a balanced scorecard and are grouped under the following headings:

Financial

Franchise growth

Customer service

Risk

People development

These targets are weighted differently for each of the executive directors, reflecting differing strategic priorities. The non-financial measures include key performance indicators relating to process efficiency, service quality and employee engagement.

The maximum annual incentive opportunity is 200 per cent (225 per cent for the group chief executive) of basic salary for the achievement of exceptional performance targets. The maximum payment under the corporate half of the annual incentive is only available if exceptional performance is achieved against the stretching corporate target. An amount equal to 50 per cent of this element of the incentive is available on the achievement of the stretching corporate target. Failure to achieve at least 90 per cent of the stretching target would result in no payment under the corporate half of the incentive.

In 2009, the Group delivered a resilient trading performance against the backdrop of a marked slow down in the UK economic environment and continued challenges in financial markets. This has been a year of substantial achievement with the creation of a sound platform for future growth of the combined franchise. Positive trends have been established in margins, costs and impairments. The interest margin improved in the second half of the year and is expected to increase in 2010, with further improvements expected in subsequent years. Costs fell by 5 per cent in the year as integration related savings have started to be realised, with £534 million of cost synergy savings in 2009. Impairments peaked in the first half of the year, falling off by 21 per cent in the second half. A similar rate of improvement is expected through 2010. The Group's funding and liquidity positions were also strengthened during the year.

A number of actions were taken during the year to create a robust capital position, including the £4 billion ordinary share placing and compensating open offer in June and the successful £22.5 billion equity raising at the end of the year.

Franchise growth has been strong in both Retail and Wholesale and there has been a 48 per cent improvement in cross sales income from the Lloyds TSB customers. There were strong levels of mortgage lending with over £34 billion of gross new lending. The Lloyds TSB conservative approach to risk management has been implemented across the Group. All new lending is within the Group's risk appetite. Our employee engagement index has remained high through the year and has performed well against the UK norm.

Additionally a number of significant activities were delivered on during 2009 which were not anticipated when the targets were set. These activities have contributed to placing the Group in the best position possible to grow and develop the combined franchise. They include the largest ever capital raising and the successful conclusion of negotiations with the European Commission on State Aid. These have all been achieved at the same time as delivering the business as usual agenda and the integration programme.

Any payments under the plan are deferred 100 per cent in shares until June 2012 and subject to claw back.



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The calculation of the annual incentive plan payments for executive directors, based on the achievement of performance against targets in respect of performance in 2009, has been independently checked. The bonuses awarded to directors are shown in the table below:

Name	A G Kane	G T Tate	T J W Tookey	H A Weir
Opportunity	200%	200%	200%	200%
Bonus awarded	£885,000	£1,120,000	£1,110,000	£1,062,000
% awarded	150	175	185	170

The group chief executive has chosen to waive any payment under the scheme for the second successive year.

## COMPENSATION

**2009 LONG-TERM INCENTIVE PLAN AWARDS**

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances, awards are made of 300 per cent of salary with the additional 100 per cent available for circumstances that the remuneration committee deems to be exceptional. In 2008, awards were made of 375 per cent of base salary to the chief executive and two of the executive directors for retention purposes, and in light of data reviewed by the committee which showed total remuneration to be behind median both for the FTSE 20 and the other major UK banks.

Further information viewed by the committee through 2008 continued to show that total remuneration for the executive directors was materially behind the median of our peer groups, even before allowing for the increased responsibilities of running the combined bank and the magnitude of the task of integrating the two businesses. However, due to the external environment and following extensive consultation with shareholders, the committee determined that for 2009 the grant level for executive directors should be set at 200 per cent of base salary, 175 per cent less than the maximum award for 2008.

Details of the plan, including the specific performance conditions, can be found on page 121.

**2009 NON-EXECUTIVE DIRECTORS FEES (£)**

	Lloyds Banking Group fees						
	Board	Audit committee	Remuneration committee	Nomination and governance committee	Risk oversight committee	SW Board Fees <sup>1</sup>	2009 Total
W C G Berndt	65,000		30,000	5,000			100,000
Ewan Brown (until 5 June 2009)	28,314	8,665			6,581		43,560
J P du Plessis (until 17 April 2009)	19,451	14,962		1,496	4,489		40,398
P N Green (until 23 October 2009)	52,936	16,288	12,216				81,440
Sir Julian Horn-Smith	65,000		15,000	5,000	15,000		100,000
Lord Leitch <sup>2</sup>	204,028	7,540		1,885	5,655	30,000	249,108
Sir David Manning (until 2 November 2009)	54,424		12,560	4,187	12,560		83,731
C J McCall (until 31 December 2009)	65,000		14,090				79,090
T T Ryan (from 1 March 2009)	54,167	16,667			12,500		83,334
M A Scicluna	65,000	41,136			15,000		121,136
Anthony Watson (from 2 April 2009)	48,504	13,095			9,821		71,420

<sup>1</sup> Scottish Widows Services Ltd.

<sup>2</sup> Lord Leitch was appointed deputy chairman on 17 May 2009 when his remuneration was consolidated into an annual fee of £300,000.

## COMPENSATION

## DILUTION LIMITS

The following charts illustrate the shares available for the Group's share schemes.

## PENSIONS

Executive directors are either entitled to participate in the Group's defined benefit pension schemes (based on salary and length of service, with a maximum pension of two thirds of final salary), or the Group's defined contribution scheme (under which their pension entitlement will be based upon both employer and employee contributions). The defined benefit schemes are closed to new entrants on recruitment.

Pension accruals under the defined benefits scheme for Messrs Daniels and Kane will continue until April 2012. Thereafter they will have the opportunity to either participate in a defined contribution scheme or to receive a cash supplement with no compensation for ceasing final salary accrual. There is no entitlement to an immediate and unreduced pension should their employment be terminated before the normal date of retirement.

## SERVICE AGREEMENTS

The Group's policy is for executive directors to have service agreements with notice periods of no more than one year. All current executive directors are entitled to receive 12 months' notice from the Group, but would be required to give six months' notice if they wished to leave. Executive directors normally retire at age 60. However, following the implementation of The Employment Equality (Age) Regulations 2006, they may now choose to delay their retirement until age 65.

It is the Group's policy that where compensation on early termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured, and that bonus payments should relate to the period of actual service, rather than the full notice period, and will be determined on the basis of performance.

Any entitlements under the pension scheme or equity plans will be in accordance with the scheme rules on leaving.

	Notice to be given by the Company	Date of service agreement/letter of appointment
Sir Winfried Bischoff	6 months	27 July 2009
J E Daniels	12 months	22 January 2009
A G Kane	12 months	23 January 2009
G T Tate	12 months	9 February 2009
T J W Tookey	12 months	26 January 2009
H A Weir	12 months	21 January 2009
<b>Former director who served during 2009</b>		
Sir Victor Blank	6 months	25 January 2006

Independent non-executive directors do not have service agreements and their appointment may be terminated, in accordance with the articles of association, at any time without compensation.

## COMPENSATION

### EXTERNAL APPOINTMENTS

The Group recognises that executive directors may be invited to become non-executive directors of other companies and that these appointments may broaden their knowledge and experience, to the benefit of the Group. Fees are normally retained by the individual directors as the post entails personal responsibility.

Executive directors are generally allowed to accept one non-executive directorship.

During 2009, Mr Daniels and Mrs Weir received fees of £75,000 and £30,208 respectively, which were retained by them, for serving as non-executive directors of other companies.

### PERFORMANCE GRAPH

The graph below illustrates the performance of the Group measured by TSR against a broad equity market index over the past five years. The Group has been a constituent of the FTSE 100 index throughout this five year period.

### TOTAL SHAREHOLDER RETURN FTSE 100 INDEX

## COMPENSATION

## AUDITED INFORMATION

**DIRECTORS EMOLUMENTS FOR 2009**

	Salaries/ fees £000	Other benefits		Performance- related payments £000 <sup>3</sup>	2009 Total £000	2008 Total £000
		Cash £000 <sup>1</sup>	Non-cash £000 <sup>2</sup>			
<b>Current directors who served during 2009</b>						
<b>Executive directors</b>						
J E Daniels	1,035	78	8		1,121	1,151
A G Kane	590	24	24	885	1,523	635
G T Tate	640	27	20	1,120	1,807	689
T J W Tookey	600	25	1	1,110	1,736	108
H A Weir	625	59	21	1,062	1,767	742
<b>Non-executive directors</b>						
Sir Winfried Bischoff (from 15 September 2009)	207	4			211	
W C G Berndt	100				100	100
Sir Julian Horn-Smith	100				100	100
Lord Leitch	249				249	165
T T Ryan (from 1 March 2009)	83				83	
M A Scicluna	121				121	33
Anthony Watson (from 2 April 2009)	71				71	
<b>Former directors who served during 2009</b>						
Sir Victor Blank <sup>4</sup> (until 14 September 2009)	640	5	38		683	669
Ewan Brown (until 5 June 2009)	44				44	122
J P du Plessis (until 17 April 2009)	40				40	119
P N Green (until 23 October 2009)	81				81	100
Sir David Manning (until 2 November 2009)	84				84	67
C J McCall (until 31 December 2009)	79				79	16
Others						807
	<b>5,389</b>	<b>222</b>	<b>112</b>	<b>4,177</b>	<b>9,900</b>	<b>5,623</b>

<sup>1</sup> The cash column under other benefits includes flexible benefits payments (4 per cent of basic salary), the tax planning allowance for Mr Daniels, payments to certain directors who elect to take cash rather than a company car under the car scheme and the cash balance of a pension allowance for Mrs Weir. Sir Winfried Bischoff has elected to take cash rather than a company car.

<sup>2</sup> The non cash column includes amounts relating to the use of a company car, use of a company driver and private medical insurance and the cost of home security in respect of Sir Victor Blank. It also includes the value of any matching shares which are received under the terms of Shareplan, through which employees have the opportunity to purchase shares up to a maximum of £125 per month and receive matching shares on a one for one basis up to a maximum value of £30 per month, rounded down to the nearest whole share.

<sup>3</sup> The group chief executive waived his entitlement to any bonus in respect of 2009 performance. There were no free shares awarded under Shareplan in respect of 2009.

<sup>4</sup> Sir Victor Blank donated his salary from 30 September 2009 until 31 December 2009, amounting to £160,000 to charity. The Group was obligated to pay Sir Victor Blank's remuneration in lieu of services rendered during 2010 of £53,333. This was also donated to charity.

**DIRECTORS PENSIONS**

The executive directors are currently members of one of the pension schemes provided by the Lloyds TSB Group with benefits either on a defined benefit or defined contribution basis. Those directors who joined the Lloyds TSB Group after 1 June 1989 and are members of a defined benefit scheme have pensions provided on salary in excess of the earnings cap through membership of or by an unfunded pension promise. Retirement pensions accrue at rates of between 1/60 and 1/30 of basic salary.

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For those directors who are members of a defined benefit pension scheme, pension will continue to accrue until 5 April 2012. On 6 April 2012, defined benefit pension accrual will cease and directors will be offered the option to participate in the defined contribution pension scheme in operation at that date. Alternatively, they may choose not to join the scheme and elect to receive a pension cash allowance.

Directors have a normal retirement age of 60. However, following the implementation of The Employment Equality (Age) Regulations 2006, they may now choose to delay their retirement until age 65. In the event of death in service, a lump sum of four times salary is payable plus, for members of a defined benefit scheme, a spouse's pension of two-thirds of the member's prospective pension. On death in retirement, a spouse's pension of two-thirds of the member's pension is payable. The defined benefit schemes are non-contributory. Members of defined contribution schemes are required to contribute.

**COMPENSATION  
DEFINED CONTRIBUTION SCHEME MEMBERS**
**AUDITED INFORMATION**

During the year to 31 December 2009 the employer has made the following contributions to the defined contribution scheme:

	<b>£000</b>
G T Tate	<b>159</b>
T J W Tookey	<b>147</b>
H A Weir	<b>122</b>

**DEFINED BENEFIT SCHEME MEMBERS**

	<b>Accrued pension at 31 December 2009 £000 (a)</b>	<b>Accrued pension at 31 December 2008 £000 (b)</b>	<b>Change in accrued pension £000 (a)-(b)</b>	<b>Transfer value at 31 December 2009 £000 (c)</b>	<b>Transfer value at 31 December 2008 £000 (d)</b>	<b>Change in transfer value £000 (c)-(d)</b>	<b>Additional pension earned to 31 December 2009 £000 (e)</b>	<b>Transfer value of the increase £000 (f)</b>
J E Daniels	192	175	17	3,844	3,263	581	8	169
A G Kane	357	342	15	6,889	6,146	743		

The disclosures in columns (a) to (d) are as required under section 421 of the Companies Act 2006.

Columns (a) and (b) represent the deferred pension to which the directors would have been entitled had they left the Group on 31 December 2009 and 2008, respectively.

Column (c) is the transfer value of the deferred pension in column (a) calculated as at 31 December 2009 based on factors supplied by the actuary of the relevant Lloyds TSB Group pension scheme. The basic method used to arrive at the factors has not changed during the year.

Column (d) is the equivalent transfer value, but calculated as at 31 December 2008 on the assumption that the director left service at that date.

Column (e) is the increase in pension built up during the year, recognising (i) the accrual rate for the additional service based on the pensionable salary in force at the year end, and (ii) where appropriate the effect of pay changes in real (inflation adjusted) terms on the pension already earned at the start of the year.

Column (f) is the capital value of the pension in column (e).

The disclosures in columns (e) and (f) are as required by the UK Listing Authority listing rules. The requirements of the listing rules differ from those of the Companies Act. The listing rules require the additional pension earned over the year to be calculated as the difference between the pension accrued at the end of the financial year and the pension accrued at the start of the financial year less the increase in the pension earned over the year solely due to inflation. The transfer value in column (f) can differ significantly from the change in transfer value as required by the Companies Act because the additional pension accrued over the year calculated in accordance with the listing rules makes allowance for inflation, and the change in the transfer value required by the Companies Act will be significantly influenced by changes in the assumptions underlying the transfer value calculation at the beginning and end of the financial year.

Members of the Lloyds TSB Group's pension schemes have the option to pay additional voluntary contributions: neither the contributions nor the resulting benefits are included in the above table.

Major changes to the legislation governing the provision of pensions in the UK (known as pension simplification) came into effect in April 2006. Benefits from an approved pension scheme will be limited to the Lifetime Allowance, currently £1.75 million which is

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equivalent to an annual pension of £87,500. Any benefit in excess of this amount will incur a tax charge for the individual. The Group has agreed that if an executive director has benefits in excess of the Lifetime Allowance they may cease to accrue benefits in the Scheme and receive a salary supplement as an alternative. This will not cost the Group more than the current arrangements. The Group will not compensate any individual in respect of any increased tax liability arising from pension simplification. To date, the executive directors affected have elected to continue to accrue benefits in the approved scheme.



## COMPENSATION

**DIRECTORS INTERESTS**

The interests, all beneficial, of those who were directors at 31 December 2009 in shares in Lloyds Banking Group were:

**NUMBER OF SHARES**

	At 1 January 2009 (or later date of appointment)	<b>At 31 December 2009</b>	At 25 February <sup>1</sup> 2010
<b>Executive directors</b>			
J E Daniels	423,018	<b>2,557,816</b>	2,558,383
A G Kane	204,061	<b>1,224,960</b>	1,225,527
G T Tate	75,072	<b>526,061</b>	526,629
T J W Tookey	2,493	<b>97,727</b>	98,294
H A Weir	61,822	<b>425,162</b>	425,729
<b>Non-executive directors</b>			
Sir Winfried Bischoff		<b>585,000</b>	
W C G Berndt	170,000	<b>948,429</b>	
Sir Julian Horn-Smith	5,000	<b>27,890</b>	
Lord Leitch	10,000	<b>55,787</b>	
T T Ryan		<b>63,451</b>	
M A Scicluna	10,000	<b>56,226</b>	
Anthony Watson	13,209	<b>51,357</b>	

<sup>1</sup> The changes in beneficial interests between 31 December 2009 and 25 February 2010 related to partnership and matching shares acquired under the Lloyds TSB Group Shareplan.

## COMPENSATION

## AUDITED INFORMATION

## INTERESTS IN SHARE OPTIONS

	At 1 January 2009	Granted during the year	Exercised during the year	Lapsed during the year	At 31 December 2009	Exercise price	Exercise periods		Notes
						From	To		
J E Daniels	131,484				<b>131,484</b>	419.25p	18/3/2007	17/3/2014	d, f
	430,547				<b>430,547</b>	474.25p	17/3/2008	16/3/2015	e, f
	6,906				<b>6,906</b>	139p	1/1/2012	30/6/2012	a, h
A G Kane	27,000			<b>27,000</b>		887.5p	4/3/2002	3/3/2009	b, g, i
	64,786			<b>64,786</b>		549.5p	6/3/2003	5/3/2010	c, g
	11,841			<b>11,841</b>		615.5p	8/8/2003	7/8/2010	c, g
	34,759			<b>34,759</b>		655p	6/3/2004	5/3/2011	c, g
	73,255			<b>73,255</b>		419.25p	18/3/2007	17/3/2014	d, f
	247,891			<b>247,891</b>		474.25p	17/3/2008	16/3/2015	e, f
	6,906			<b>6,906</b>		139p	1/1/2012	30/6/2012	a, h
G T Tate	64,400			<b>64,400</b>		419.25p	18/3/2007	17/3/2014	d, f
	27,357			<b>27,357</b>		403p	12/8/2007	11/8/2014	d, f
	247,891			<b>247,891</b>		474.25p	17/3/2008	16/3/2015	e, f
	6,906			<b>6,906</b>		139p	1/1/2012	30/6/2012	a, h
T J W Tookey	6,906			<b>6,906</b>		139p	1/1/2012	30/6/2012	a, h
H A Weir	77,868			<b>77,868</b>		424.75p	29/4/2007	28/4/2014	d, f
	247,891			<b>247,891</b>		474.25p	17/3/2008	16/3/2015	e, f
	6,906			<b>6,906</b>		139p	1/1/2012	30/6/2012	a, h
Other share plan									
T J W Tookey	35,305		<b>35,305</b>			(see page 122)	20/4/2009	19/10/2009	j
<b>Former director who served during 2009</b>									
Sir Victor Blank	6,906			<b>6,906</b>		139p	1/2/2010	31/7/2010	a, k

a Sharesave.

b Executive option granted between March 1999 and August 1999.

c Executive option granted between March 2000 and March 2001.

d Executive option granted between March 2004 and August 2004.

e Executive option granted from March 2005.

f Exercisable to the extent at which the performance condition vested.

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- g Not exercisable as the performance conditions had not been met.
- h Not exercisable as the option has not been held for the period required by the relevant scheme.
- i Option lapsed as not exercised by 10th anniversary of date of grant.
- j Mr Tookey exercised his option on 8 May 2009. Market price on day of exercise was 100.70p.
- k Exercisable only in the period shown.

Sir Victor Blank retired as chairman on 14 September 2009 but remained employed by the Group until 31 January 2010.

None of the other directors at 31 December 2009 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

The market price for a share in the Company at 1 January 2009 and 31 December 2009 was 126p and 50.69p, respectively. The range of prices between 1 January 2009 and 31 December 2009 was 40.30p to 140.70p.

The following table contains information on the performance conditions for executive options granted since 1999. The remuneration committee chose the relevant performance condition because it was felt to be challenging, aligned to shareholders' interests and appropriate at the time.

COMPENSATION

AUDITED INFORMATION

Options granted March 1999 August 1999	Performance conditions Growth in earnings per share which is equal to the aggregate percentage change in the retail price index plus two percentage points for each complete year of the relevant period plus a further condition that the Company's ranking based on TSR over the relevant period should be in the top 50 companies of the FTSE 100.
March 2000 March 2001	As the performance condition had not been met, the options lapsed in 2009. As for March 1999 August 1999 except that there must have been growth in the earnings per share equal to the change in the retail price index plus three percentage points for each complete year of the relevant period.
March 2004 August 2004	That the Company's ranking based on TSR over the relevant period against a comparator group (17 UK and international financial services companies including Lloyds Banking Group) must be at least ninth, when 14 per cent of the option will be exercisable. If the Company is ranked first in the group, then 100 per cent of the option will be exercisable and if ranked tenth or below the performance condition is not met.
March 2005 August 2005	Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 24 per cent for Mr Tate's March option and at 14 per cent for all other options granted to executive directors during 2004. That the Company's ranking based on TSR over the relevant period against a comparator group (15 companies including Lloyds Banking Group) must be at least eighth, when 30 per cent of the option will be exercisable. If the Company is ranked first to fourth position in the group, then 100 per cent of the option will be exercisable and if ranked ninth or below, the performance condition is not met.  Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted to executive directors.

**LLOYDS TSB PERFORMANCE SHARE PLAN**

Under the plan, executive directors were required to defer 50 per cent of their bonus awards in 2006 into shares in the Company, known as bonus shares. The number of bonus shares awarded was calculated after the deduction of income tax and national insurance from the deferred element of the bonus.

The bonus shares are held on behalf of the executive for a period of three years before release.

Executives received a further award of performance shares on the basis of two performance shares for each bonus share. The receipt of the performance shares is dependent on the satisfaction of a TSR performance condition measured over three financial years of the Company.

The following table details the number of bonus and performance shares released in respect of their 2005 bonus.

	Bonus shares			Performance shares			Award price
	At 31 December 2009	Released 20 March 2009	At 31 December 2009	At 31 December 2009	Lapsed 20 March 2009	At 31 December 2009	
J E Daniels	50,944	50,944		172,694	172,694		566.10p
A G Kane	20,531	20,531		69,598	69,598		566.10p
G T Tate	27,358	27,358		92,738	92,738		566.10p
H A Weir	20,062	20,062		68,008	68,008		566.10p

The following table contains information on the performance conditions for performance shares. The remuneration committee chose the relevant performance condition because it was felt to be challenging, aligned to shareholders' interests and appropriate at

the time.

Performance shares awarded  
March 2006

Performance conditions

That the Company's ranking based on TSR over the relevant period against a comparator group (15 companies including Lloyds Banking Group) must be at least eighth for any shares to be received. If ranked ninth or below no shares would be received. The maximum of two performance shares for each bonus share will be awarded only if the Company is first in the comparator group; one performance share will be awarded for each bonus share if the Company is placed fifth; and one performance share for every two bonus shares if the Company is placed eighth. Between first and fifth positions and fifth and eighth positions a sliding scale will apply.

Whilst income tax and national insurance was deducted from the deferred bonus before the conversion to bonus shares, where a match of performance shares is justified, these shares will be awarded as if income tax and national insurance had not been deducted. This maintains the original design of the plan prior to the issue of guidance from HM Revenue & Customs in December 2004.

The performance condition attached to the March 2006 award was not met, with Lloyds Banking Group ranked in ninth place. Bonus shares were released on 20 March 2009, at which time the performance shares lapsed.

**COMPENSATION  
LLOYDS TSB LONG-TERM INCENTIVE PLAN**
**AUDITED INFORMATION**

The following are conditional share awards available under the plan. Further information regarding this plan can be found on pages 121 and 122.

	At 1 January 2009	Awarded during the year	Adjusted number of shares	Lapsed during the year	At 31 December 2009	Year of vesting	Notes
J E Daniels	507,692			507,692		2009	
	534,322		165,403		699,725	2010	a
	838,735		259,637		1,098,372	2011	a
		1,143,014	353,829		1,496,843	2012	a, b
A G Kane		1,714,522	530,743		2,245,265	2012	a, b
	288,460			288,460		2009	
	306,122		94,762		400,884	2010	a
	413,309		127,943		541,252	2011	a
G T Tate		651,573	201,700		853,273	2012	a, b
		977,360	302,549		1,279,909	2012	a, b
	297,114			297,114		2009	
	333,951		103,377		437,328	2010	a
T J W Tookey	518,638		160,548		679,186	2011	a
		706,791	218,792		925,583	2012	a, b
		1,060,187	328,189		1,388,376	2012	a, b
	54,258			54,258		2009	
H A Weir	52,875		16,367		69,242	2010	a
	71,220		22,046		93,266	2011	a
		662,617	205,118		867,735	2012	a, b
		993,926	307,677		1,301,603	2012	a, b
H A Weir	288,460			288,460		2009	
	320,037		99,069		419,106	2010	a
	506,482		156,785		663,267	2011	a
		690,226	213,665		903,891	2012	a, b
	1,035,339	320,497		1,355,836	2012	a, b	

a Conditional awards of shares made under this plan were adjusted on 2 July 2009 as a result of the Placing and Compensatory Open Offer. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the capital raising event.

b Original award price 72.44p, award price post adjustment 55.31p.

COMPENSATION

AUDITED INFORMATION

The following table contains information on the performance conditions for awards made under the long-term incentive plan. The remuneration committee chose the relevant performance conditions because they were felt to be challenging, aligned to shareholders' interests and appropriate at the time.

<p>LTIP award May 2006</p>	<p>Performance conditions</p> <p>For 50 per cent of the award (the EPS Award) the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period must be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the retail price index over the same period. If it is less than 3 per cent per annum, the EPS Award will lapse. If the increase is more than 3 per cent but less than 6 per cent per annum, then the proportion of shares released will be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2006 and ended on 31 December 2008.</p> <p>For the other 50 per cent of the award (the TSR Award) it will be necessary for the Group's TSR to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award will vest where the Group's TSR is equal to median and vesting will occur on a straight line basis in between these points. Where the Group's TSR is below the median of the comparator group, the TSR Award will lapse. The relevant period commenced on 1 January 2006 and ended on 31 December 2008.</p>
<p>March 2007</p>	<p>When tested at the end of the relevant performance period, neither the EPS nor the TSR performance conditions were met and all awards made in 2006 lapsed.</p> <p>For 50 per cent of the award (the EPS Award) the performance condition was as described for May 2006 with the relevant performance period commencing on 1 January 2007 and ending on 31 December 2009.</p>
<p>March and April 2008</p>	<p>For the other 50 per cent of the award (the TSR Award) the performance condition was as described for May 2006 with the relevant performance period commencing on 8 March 2007 (the date of award) and ending on 7 March 2010.</p> <p>For 50 per cent of the award (the EPS Award) the performance condition was as described for May 2006 with the relevant performance period commencing on 1 January 2008 and ending on 31 December 2010.</p>
<p>April 2009</p>	<p>For the other 50 per cent of the award (the TSR Award) the performance condition was as described for May 2006 with the relevant performance period commencing on 6 March 2008 (the date of the March award) and ending on 5 March 2011.</p> <p>EPS: The release of 50 per cent of the shares will be dependent on the extent to which the growth in EPS achieves cumulative EPS targets over the three year period.</p> <p>Economic profit: The release of the remaining 50 per cent of shares will be dependent on the extent to which Lloyds Banking Group achieves cumulative Economic Profit targets over a three year period.</p> <p>The EPS and economic profit performance measures applying to this 2009 LTIP award were set on the basis that the Group would enter into GAPS. Now that the Group is not participating in GAPS, the remuneration committee has determined that these performance measures will be restated on a basis consistent with the EPS and economic profit measures used for the 2010 LTIP awards. This restatement will be undertaken in 2010.</p>

The current targets prior to restatement are:  
EPS

Vesting      Growth in EPS

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Threshold	25%	55%
Maximum	100%	81%
ECONOMIC PROFIT		
	Vesting	Absolute
Threshold	25%	100%
Maximum	100%	185%
	<b>121</b>	

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COMPENSATION

AUDITED INFORMATION

April 2009  
Integration award

Synergy Savings: The release of 50 per cent of the shares will be dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award will be broken down into three equally weighted annual tranches. Performance will be assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets have been achieved will determine the proportion of shares to be banked each year. Any release of shares will be subject to the remuneration committee judging the overall success of the delivery of the integration programme.

Integration Balanced Scorecard: The release of the remaining 50 per cent of the shares will be dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced Scorecard element will be broken down into three equally weighted tranches. The tranches will be crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

Performance against the first year of the award has been assessed and all targets have been met or exceeded.

Alithos Limited provided information for the testing of the TSR performance conditions for the Company's long-term incentive schemes. EPS is the Group's normalised earnings per share as shown in the Group's report and accounts, subject to such adjustments as the remuneration committee regards as necessary for consistency.

**OTHER SHARE PLAN**

**LLOYDS TSB GROUP EXECUTIVE SHARE PLAN 2003**

Mr Tookey was granted an option under this plan to acquire 35,305 ordinary shares in Lloyds Banking Group plc. The option was not subject to any performance condition but would normally have become exercisable only if he remained an employee, and had not given notice of resignation, as at 19 April 2009. As Mr Tookey remained an employee, the option vested on 19 April 2009, and was exercised on 8 May 2009.

In addition, on 26 March 2008 (prior to his appointment as an executive director), Mr Tookey was granted an award under the Lloyds TSB Executive Retention Plan 2006. The award is satisfied in cash only and, subject to continued employment, gives Mr Tookey the right to receive an amount equal to the value of 141,880 Lloyds Banking Group shares on the date of vesting. The award was adjusted on 2 July 2009 as a result of the placing and compensatory open offer. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the capital raising event. The award vests as to 50 per cent on 26 March 2011 and 50 per cent on 26 March 2013. Mr Tookey has agreed to reinvest the cash proceeds into Lloyds Banking Group shares. As an executive director, he is no longer eligible to be granted awards under this 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.

The register of directors' interests, which is open to inspection, contains full particulars of directors' shareholdings and options to acquire shares in Lloyds Banking Group.

## CORPORATE GOVERNANCE

### STATEMENT ON US CORPORATE GOVERNANCE STANDARDS

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's main listing is on the London Stock Exchange, it follows the principles contained in the combined code on corporate governance issued by the UK Financial Reporting Council. The Group has complied with the provisions of the code and has done so throughout 2009 regarding the provisions where the requirements are of a continuing nature. Key differences are set out below.

The nomination and governance committee sets the corporate governance principles applicable to the Company and conducts an annual evaluation of the performance of the board, its committees and its individual members.

The remuneration and nomination and governance committees comprise the chairman and six and five independent non-executive directors respectively.

### DIRECTORS CONFLICTS OF INTEREST

The board, as permitted by the Company's articles of association, has authorised all potential conflicts of interest declared by individual directors. Decisions regarding these conflicts of interest could only be taken by directors who had no interest in the matter. In taking the decision, the directors acted in a way they considered, in good faith, would be most likely to promote the Company's success. The directors had the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given will be reviewed at least every 15 months. No director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest.

### THE BOARD AND ITS COMMITTEES

At the year end, the board comprised the chairman, five executive directors and seven independent non-executive directors. Sir Winfried Bischoff succeeded Sir Victor Blank as chairman on 15 September 2009. Details of his selection and appointment process are set out on page 125.

The board considers that it is of an appropriate size to oversee the Group's businesses, with a suitable diversity of backgrounds and mix of experience and expertise to maximise its effectiveness. The composition of the board is kept under continuous review by the chairman, with the support of the nomination and governance committee, to ensure the right balance of skills and experience. All director appointments are subject to detailed due diligence which includes a robust search and selection process overseen by the nomination and governance committee. On 11 February 2010, the Company announced the appointments of Mr Moreno and Mr Roberts which took effect on 1 March 2010. Their details are included in the biographies on pages 101 and 102.

The chairman is responsible for leading the board and ensuring its effectiveness while the group chief executive manages the Group's business – these are distinct functions.

The chairman is responsible for the clarity and timeliness of information provided to the board and for facilitating the effective contribution of all directors and ensures that directors receive appropriate induction and ongoing training.

The chairman has a key role in the development (jointly with the group chief executive) of the Group's strategy, as well as oversight of strategy implementation and performance delivery. He ensures that there is a constructive, close working relationship with the group chief executive and the rest of the board.

### MEETINGS

Responding to the challenges faced by the Company, the board held 28 meetings during 2009. In addition there was regular contact with directors outside of these meetings. The time commitment demanded of directors, in particular, non-executive directors, was far in excess of that anticipated in the normal course of business. All directors showed themselves to be willing and able to devote the additional time required often at short notice and at unsocial hours.

### INDEPENDENCE

All the non-executive directors are considered by the board to be independent both in character and judgement and free of relationships or circumstances which could affect their judgement. Throughout the year at least half of the board comprised independent non-executive directors.

#### **INDUCTION AND TRAINING**

All new directors and committee members receive a full and tailored induction. The primary aim of the induction programme is to provide directors with a comprehensive introduction to the Group; its individual businesses; business models; strategy; and risks. This enables directors to make an early, informed and effective contribution to board debates, based on an understanding of the key challenges facing the Group, the Group's businesses, and the business model. The induction programme is supplemented by ongoing training and development.

The current induction and training programmes are being reviewed and enhanced to ensure that they meet the requirement for a substantive and personalised programme as recommended by the Walker review of corporate governance in UK banks and other financial industry entities published in November 2009.

## CORPORATE GOVERNANCE

### BOARD EVALUATION

In autumn 2009, the board, supported by JCA Group, conducted a rigorous process of evaluating its effectiveness, and the effectiveness of its principal committees. The process included confidential, unattributable, one-on-one interviews with every board member and with UKFI and the Group's external auditors. The review covered corporate governance, board effectiveness, strategy development, risk management and board and committee organisation, composition, operation and dynamics. In addition, although early in his tenure, the review also considered the performance of the chairman, including the effectiveness of his relationships with the group chief executive and other members of the board. The outcomes of the review were subsequently discussed by the board as a whole.

The review was conducted during a period of significant change for the board with several members leaving and a number of relatively new members.

The board members individually and collectively considered that the board is working as an effective whole. After the significant challenges faced by the Group and the board in 2009, the review highlighted the importance of returning to a more normal operating mode by focusing on delivering the integration, developing the future strategy, and reviewing the operations and risk management for the Group as a whole and within each of the key areas. In addition, the review encouraged continued vigorous debate in the board and committees and emphasised the importance of succession plans for the management team and non-executive directors. An action plan has been developed to ensure that the chief conclusions of the review are addressed in a timely manner. As part of this, it has been agreed that issues of risk, liquidity and funding should receive particularly high attention in 2010.

### ELECTION AND RE-ELECTION OF DIRECTORS

All directors are subject to election by shareholders at the first annual general meeting (AGM) following their appointment. Sir Winfried Bischoff, Mr Moreno and Mr Roberts stood for election at the AGM, held on 6 May 2010, and were duly elected.

The Company requires all directors to stand for re-election at intervals of no more than three years. At the 2010 AGM, Dr Berndt, Mr Daniels and Mrs Weir retired. Mr Daniels and Mrs Weir sought re-election by shareholders and were re-elected.

The chairman endorsed the effectiveness and commitment of all directors standing for election or re-election at the AGM, and the senior independent director gave a similar endorsement in respect of the chairman's election.

### COMPANY SECRETARY AND INDEPENDENT ADVICE

The company secretary, Mr Baines, is responsible for advising the board on corporate governance matters and, in conjunction with the chairman, for ensuring good information flows between the board, its committees, non-executive directors and senior executives. All directors have access to his advice and services. Additionally, if required in the furtherance of their duties, non-executive directors (along with any other members of the board's main committees) are entitled to seek independent, professional advice at the Company's expense.

### RELATIONS WITH SHAREHOLDERS

The investor relations team has primary, day-to-day responsibility for managing communications with institutional shareholders through a combination of briefings to analysts and institutional shareholders (both at the interim and year end results and throughout the year), site visits and individual discussions between institutional shareholders and board members and key senior executives. Regular dialogue with shareholders helps to ensure that the Company's strategy is understood and that any queries or other issues are addressed in a constructive way. In 2009, there has been extensive and regular engagement with institutional shareholders and UKFI, the body set up to manage the Government's investments in banks. The board receives weekly reports on market and investor sentiment and opinion which helps it develop a balanced understanding of the views of major shareholders.

The company secretary oversees communications with private shareholders. Shareholders are encouraged to attend and participate in the Group's AGM.

### AUDIT COMMITTEE

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The audit committee comprises Mr Scicluna (chairman), Lord Leitch, Mr Roberts, Mr Ryan and Mr Watson. All members of the audit committee are independent. The committee's terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com). The board of directors has determined that Mr. Scicluna is an audit committee financial expert (as defined in the rules promulgated under the U.S. Securities Exchange Act). Although Mr. Scicluna has been identified as an audit committee financial expert for the purposes of the SEC's rules, the committee members are selected with a view to the expertise and experience of the committee as a whole, and the committee reports to the board of directors as a single entity. The designation of a person as an audit committee financial expert does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation. Nor does the designation of a person as an audit committee financial expert affect the duties, obligations or liability of any other member of the audit committee or board of directors.

During the year, the audit committee received reports from, and held discussions with, management and the external auditors. In discharging its duties, the committee has approved the auditors' terms of engagement, including their remuneration and, in discussion with them, has assessed their independence and objectivity (more information about which is given in note 11 to the consolidated financial statements, in relation to the procedure for approving fees for audit and non-audit work) and recommended their re-appointment at the AGM. The committee also reviewed the financial statements published in the name of the board and the quality and acceptability of the related accounting policies, practices and financial reporting disclosures; the scope of the work of the group audit department, reports from that department and the adequacy of its resources; the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations (more information about which is given in the note about internal control on page 127); the results of the external audit and its cost effectiveness; and reports from the external auditors on audit planning and their findings on accounting and internal control systems. Procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and for staff to raise concerns in confidence have been established by the committee. The committee also had a meeting with the auditors, without executives present, and a meeting with the group audit director alone.

## CORPORATE GOVERNANCE

### CHAIRMAN'S COMMITTEE

The chairman's committee, comprising the chairman, deputy chairman, senior independent director and the group chief executive, meets to assist the chairman in ensuring the effectiveness and efficiency of board meetings. The committee exercises specific powers delegated to it by the board from time to time.

### NOMINATION AND GOVERNANCE COMMITTEE

To ensure that the Group's governance arrangements take due account of best practice developments, the nomination and governance committee has expanded its terms of reference to expressly include governance issues.

The nomination and governance committee is chaired by Sir Winfried Bischoff. Lord Leitch, Sir Julian Horn-Smith, Mr Moreno, Mr Scicluna and Mr Watson are members. The committee reviews the structure, size and composition of the board; oversees the selection process for prospective directors; makes recommendations to the board on potential appointments and re-appointments of directors at the end of their specified term; and considers board succession. Following expansion of its terms of reference, it also reviews the board's governance arrangements and oversees the Company's implementation of governance requirements eg under the Walker Review and Combined Code.

The committee is responsible for overseeing the process for appointments of new non-executive directors and making recommendations to the board. In 2009, two new non-executive director appointments were announced. A further two appointments were announced on 11 February 2010. All appointments are subject to a rigorous search and selection process.

In addition, on 26 July 2009, the appointment of Sir Winfried Bischoff as chairman of Lloyds Banking Group was recommended to, and approved by, the board, following the process set out below.

The committee's terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

### CHAIRMAN'S SUCCESSION

On 18 May 2009, following Sir Victor Blank's decision to step down from the board, a sub-committee of the nomination committee was established to oversee the chairman's succession. The committee was chaired by Sir Julian Horn-Smith. Membership was made up entirely of independent non-executive directors, namely Dr Berndt, Mr Green, Sir David Manning and Mr Watson. There was an open invitation to other non-executive directors to attend meetings. Ms McCall was a regular attendee; Mr Ryan and Mr Scicluna also attended a number of meetings. As deputy chairman, Lord Leitch was kept advised of developments and, towards the latter end of the process, was invited to join meetings. The committee was advised by the group human resources director and the head of secretariat. Sir Victor Blank did not participate in any part of the process.

Following a tender process, the committee appointed Jan Hall of JCA Group, as executive search advisor.

The sub-committee met 10 times. Activities included agreeing the role specification and selection criteria; reviewing applicant profiles and agreeing short lists; reviewing shareholder feedback and ultimately recommending the appointment of Sir Winfried Bischoff to the board. In conjunction with the remuneration committee, the committee also proposed the terms and conditions of appointment for the new chairman. Between meetings, there were regular updates on progress.

Short listed candidates were subject to an extensive interview process, initially by panels of committee members along with other directors. Ms McCall and Lord Leitch also participated in the interview process. All executive and non-executive directors were given the opportunity to meet the candidates prior to any decision being made. Detailed referencing and due diligence, both formal and informal, was also carried out. The appointment was subject to, and received, approval from the Financial Services Authority.

The views of institutional shareholders including UKFI were sought prior to any decision being made. Those shareholders consulted confirmed that they were satisfied that the search and selection process had been robust and extensive.

### REMUNERATION COMMITTEE

Information about the remuneration committee's membership and work is given in the directors' remuneration report on pages 105 and 106. Its terms of reference are available from the company secretary and are displayed on the Group's website, [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

#### **RISK OVERSIGHT COMMITTEE**

The risk oversight committee comprises Mr Moreno (chairman), Sir Winfried Bischoff, Sir Julian Horn-Smith, Mr Roberts, Mr Ryan and Mr Scicluna. There is a standing invitation for all other non-executive directors to attend meetings of the committee. The risk oversight committee's duties include overseeing the development, implementation and maintenance of the Group's overall risk management framework, and its risk appetite, strategy, principles and policies, to ensure they are in line with emerging regulatory, corporate governance and industry best practice. The committee also oversees the Group's risk exposures; facilitates the involvement of non-executive directors in risk issues and aids their understanding of these issues; oversees adherence to Group risk policies and standards and considers any material amendments to them; and reviews the work of the group risk function.

#### **GROUP EXECUTIVE COMMITTEE**

The group executive committee, comprising the group chief executive, all the group executive directors (as shown on page 102), together with the chief risk officer, the group human resources director and the director of group operations, meets to assist the group chief executive in performing his duties. Specifically, the committee considers the development and implementation of strategy, operational plans, policies and budgets; the monitoring of operating and financial performance; the assessment and control of risk; the prioritisation and allocation of resources; and the monitoring of competitive forces in each area of operation. The committee, assisted by its sub-committees, the group business risk and group asset and liability committees, also supports the group chief executive in endeavouring to ensure the development, implementation and effectiveness of the Group's risk management framework and the clear articulation of the Group's risk policies, and in reviewing the Group's aggregate risk exposures and concentrations of risk.

## CORPORATE GOVERNANCE

## ATTENDANCE AT MEETINGS

The attendance of directors at board meetings and at meetings of the audit, nomination and governance, remuneration and risk oversight committees during 2009 was as follows:

	Board meetings			Audit committee	Nomination and governance committee	Remuneration committee	Risk oversight committee
	Regular	Ad hoc	Total				
Number of meetings during the year	9	19	28	8	2	13	4
<b>Current directors who served during 2009</b>							
Dr W C G Berndt	9	15	24		2	13	
Sir Winfried Bischoff <sup>1</sup>	3	7	10			3 (max 3)	1 (max 1)
J E Daniels	9	19	28				
Sir Julian Horn-Smith	8	17	25		2	8	3
A G Kane	9	19	28				
Lord Leitch <sup>2</sup>	8	19	27	7	2	4 (max 5)	4
T T Ryan <sup>3</sup>	7	14	21	5 (max 5)			3 (max 3)
M A Scicluna	9	18	27	8			4
G T Tate	8	18	26				
T J W Tookey	9	19	28				2 (max 2)
A Watson <sup>4</sup>	7	11	18	3 (max 3)			
H A Weir	9	19	28				
<b>Former directors who served during 2009</b>							
Sir Victor Blank <sup>5</sup>	6	11	17			10 (max 10)	3 (max 3)
E Brown <sup>6</sup>	4	6	10	4 (max 5)			2 (max 2)
J P du Plessis <sup>7</sup>	2	6	8	3 (max 4)	1 (max 1)		1 (max 2)
P N Green <sup>8</sup>	7	10	17	6 (max 7)	1 (max 2)	7 (max 11)	
Sir David Manning <sup>9</sup>	7	15	22		1 (max 1)	12 (max 12)	4
C J McCall <sup>10</sup>	9	11	20			7 (max 12)	

<sup>1</sup> Appointed to the board, nomination and governance, remuneration and risk oversight committees on 15 September 2009.

<sup>2</sup> Appointed to the remuneration committee on 4 August 2009.

<sup>3</sup> Appointed to the board, audit and risk oversight committees on 1 March 2009.

<sup>4</sup> Appointed to the board on 2 April 2009. Appointed to the audit and risk oversight committees on 6 May 2009.

<sup>5</sup> Left the board on 15 September 2009.

<sup>6</sup> Left the board on 5 June 2009.



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- 7 Left the board on 17 April 2009.
- 8 Left the board on 23 October 2009.
- 9 Left the board on 2 November 2009.
- 10 Appointed to the remuneration committee on 23 January 2009. Left the board on 31 December 2009.

**126**

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## CORPORATE GOVERNANCE

### **COMPLIANCE WITH THE BRITISH BANKERS ASSOCIATION DRAFT CODE FOR FINANCIAL REPORTING DISCLOSURE**

In October 2009, the British Bankers Association published a draft Code for Financial Reporting Disclosure (the Disclosure Code). The draft Disclosure Code sets out five disclosure principles together with supporting guidance. The principles are that UK banks: commit to providing high quality, meaningful and decision-useful disclosures; commit to ongoing review of, and enhancement to, their financial instrument disclosures for key areas of interest; will assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; will seek to enhance the comparability of financial statement disclosures across the UK banking sector; and will clearly differentiate in their annual reports between information that is audited and information that is unaudited.

The Group and other major UK banks have voluntarily adopted the draft Disclosure Code in their 2009 financial statements. The Group's 2009 financial statements have therefore been prepared in compliance with the draft Disclosure Code's principles.

### **INTERNAL CONTROL**

The board of directors is responsible for the establishment and review of Lloyds Banking Group's system of internal control, which is designed to ensure effective and efficient operations, quality of internal and external reporting, internal control, and compliance with laws and regulations. It should be noted, however, that such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives. In establishing and reviewing the system of internal control, the directors have regard to the nature and extent of relevant risks, the likelihood of a loss being incurred and the costs of control. It follows, therefore, that the system of internal control can only provide reasonable but not absolute assurance against the risk of material loss.

The directors and senior management are committed to maintaining a control-conscious culture across all areas of operation. This is communicated to all employees by way of published policies and procedures and regular management briefings. A requirement to comply with internal control risk policies is a key component of individual staff objectives expressed in the balanced scorecard. Key business risks are identified, and these are controlled by means of procedures such as physical controls, credit, trading and other authorisation limits and segregation of duties. In addition, there is an annual control self assessment exercise whereby the key businesses and head office functions review specific controls and attest to the accuracy of their assessments. The assessment covers all enterprise-wide risk management categories and is in accordance with the principles of the Combined Code. As in previous years, this exercise was completed for the year ended 31 December 2009. All returns have been satisfactorily completed and appropriately certified.

The effectiveness of the internal control system is reviewed regularly by the board and the audit committee, which also receives reports of reviews undertaken around Lloyds Banking Group by group risk and group audit. The audit committee receives reports from the Company's auditors, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditors at least once a year without executives present, to ensure that there are no unresolved issues of concern.

### **DISCLOSURE CONTROLS AND PROCEDURES**

As of 31 December 2009, Lloyds Banking Group, under the supervision and with the participation of the Group's management, including the group chief executive and the group finance director, performed an evaluation of the effectiveness of the Group's disclosure controls and procedures. Based on this evaluation, the group chief executive and group finance director concluded that the Company's disclosure controls and procedures, as at 31 December 2009, 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**

Lloyds Banking Group was formed on 16 January 2009 following the acquisition of HBOS plc in a purchase business combination. Management has performed an evaluation of changes in the Lloyds Banking Group's internal control over financial reporting. This evaluation has not included an assessment of internal control over financial reporting relating to the HBOS businesses, except for controls over certain assets where the progress of integration with heritage Lloyds TSB assets has made it possible for these to be

included.

Based on this evaluation, management has concluded that there has been no change in the Lloyds Banking Group's internal control over financial reporting that occurred during the year ended 31 December 2009 that has materially affected, or is reasonably likely to materially affect, the Lloyds Banking Group's internal control over financial reporting.

As part of the Group's integration project a separate work stream has been created to assess the effectiveness of financial reporting controls. This workstream is a critical element of the overall integration programme, is sufficiently resourced and is on target to achieve required milestones. A complete assessment of the internal controls over financial reporting for Lloyds Banking Group, including HBOS, will be included in management's assessment as of 31 December 2010.

## CORPORATE GOVERNANCE

### 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 as at 31 December 2009 based on the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in its report *Internal Control - Integrated Framework*.

Management's assessment of and conclusion on the effectiveness of internal control over financial reporting does not include internal controls relating to the HBOS plc business which was acquired in a purchase business combination on 16 January 2009, except for controls over certain assets where the progress of integration with heritage Lloyds TSB assets has made it possible for these to be included. The HBOS plc business has been included in the consolidated financial statements of Lloyds Banking Group plc for the year ended 31 December 2009. The businesses which have not been included in management's assessment represented approximately 49 per cent of the Group's total income and 56 per cent of the Group's total assets for the year ended 31 December 2009.

Based on this assessment, management concluded that, as at 31 December 2009, 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 2009. This report appears on page F-2.

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### MAJOR SHAREHOLDERS

At 30 April 2010, notification had been received that The Solicitor for the Affairs of Her Majesty's Treasury had a direct interest of 41.26 per cent (27,608,563,642 ordinary shares) in the Company's issued share capital with rights to vote in all circumstances at general meetings. No other notification has been received that anyone has an interest of 3 per cent or more in the Company's issued ordinary share capital. Further information on The Solicitor for the Affairs of Her Majesty's Treasury's shareholding in the Company is provided in *Information about the Lloyds Banking Group's relationship with the UK Government and Business History and development of Lloyds Banking Group*.

All shareholders within a class of the Company's shares have the same voting rights.

### RELATED PARTY TRANSACTIONS

The Group, as at 31 December 2009, had related party transactions with 14 key management personnel. See note 47 to the consolidated financial statements. In addition, material contracts with HM Treasury are described in the *Information about the Lloyds Banking Group's relationship with the UK Government* section below.

Except as described in *Business Material contracts* and below under *Information about the Lloyds Banking Group's relationship with the UK Government*, there are no transactions to which the Group is a party involving the UK Government or any body controlled by the UK Government which are material to the Group or, to the Group's knowledge, to the UK Government or any UK Government controlled body, that were not made in the ordinary course of business, or that are unusual in their nature or conditions. However, considering the nature and scope of the bodies controlled by the UK Government, it may be difficult for the Group to know whether a transaction is material for such a body.

To the best of the Group's knowledge, any outstanding loans made by the Group to or for the benefit of the UK Government or any body controlled by the UK Government, were made (1) in the ordinary course of business, (2) on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, (3) did not involve more than the normal risk of collectability or present other unfavourable features, and (4) were made on arm's length basis.

### INFORMATION ABOUT THE LLOYDS BANKING GROUP'S RELATIONSHIP WITH THE UK GOVERNMENT

On 18 September 2008, with the support of the UK Government, the boards of the Company and HBOS announced that they had reached agreement on the terms of a recommended acquisition by the Company of HBOS. On 13 October 2008, in the context of further unprecedented turbulence in global financial markets and as part of a co-ordinated package of capital and funding measures for the UK banking sector implemented by HM Treasury, the boards of both the Company and HBOS announced that they intended to participate in the proposed UK Government funding package and that they had agreed to proceed with the acquisition on revised terms. In this context, a combined total of £17,000 million of new capital was raised, consisting of £4,500 million in ordinary shares and £1,000 million in preference shares (before costs and expenses) by the Company and £8,500 million by ordinary shares and £3,000 million in preference shares (before costs and expenses) by HBOS.

### 2008 PLACING AND OPEN OFFER AGREEMENT AND PREFERENCE SHARE SUBSCRIPTION AGREEMENT

Pursuant to a placing and open offer agreement with effect from 13 October 2008 entered into between the Company, HM Treasury and the joint sponsors and joint bookrunners named therein (the 2008 Placing and Open Offer Agreement), (i) the Company agreed to invite qualifying shareholders to apply to acquire open offer shares at an issue price of 173.3 pence per ordinary share by way of an open offer; (ii) the joint sponsors and joint bookrunners agreed to use reasonable endeavours to procure places to acquire open offer shares at not less than the issue price on the basis that the open offer shares placed were subject to clawback to the extent they were taken up by qualifying shareholders in the open offer; and (iii) HM Treasury agreed that, to the extent not placed or taken up under the open offer, HM Treasury would acquire the open offer shares at the issue price. The 2008 placing and open offer comprised a placing and open offer of 2,596,653,203 shares at the issue price. The 2008 placing and open offer was successfully completed in accordance with its terms; however, the Company gave certain customary representations and warranties and indemnities to each of HM Treasury, the joint sponsors and joint bookrunners under the 2008 Placing and Open Offer Agreement that are unlimited as to time and amount.

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The Company and HM Treasury also entered into a preference share subscription agreement, with effect from 13 October 2008, pursuant to which HM Treasury agreed to acquire, and the Company agreed to allot and issue, 1,000,000 new preference shares to HM Treasury for a total consideration of £1,000 million (before costs and expenses).

HBOS also entered into a placing and open offer agreement with effect from 13 October 2008 with HM Treasury and the joint sponsors and joint bookrunners named therein, on similar terms and for similar purposes as the Company's 2008 Placing and Open Offer Agreement and corresponding placing and open offer. A total of 7,482,394,366 HBOS open offer shares were offered at the issue price of 113.6 pence per share. In addition, HBOS entered into a preference share subscription agreement with HM Treasury with effect from 13 October 2008, pursuant to which HM Treasury agreed to acquire, and HBOS agreed to allot to HM Treasury, new HBOS preference shares for a total consideration of £3,000 million (before costs and expenses).

Pursuant to the placing and open offer, which was completed in January 2009 (and the concomitant placing and open offer by HBOS) and the acquisition of HBOS by the Company completed on 16 January 2009, the UK Government acquired 43.38 per cent of the Company's issued ordinary share capital. In addition, £3,000 million non-cumulative 12 per cent fixed to floating rate preference shares were issued by the Company to HM Treasury on 16 January 2009 in exchange for the £3,000 million preference shares which had been issued by HBOS plc to HM Treasury on 15 January 2009 (as referred to above).

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### 2009 PLACING AND OPEN OFFER AGREEMENT

In June 2009 the Company issued approximately 10,408 million new ordinary shares as part of a placing and compensatory open offer. HM Treasury subscribed for approximately 4,521 million of these new ordinary shares at a price of 38.43 pence per share. As placees were procured for all the new ordinary shares for which valid acceptances were not received under the placing and compensatory open offer, HM Treasury's shareholding remained at 43.4 per cent. The Company used the proceeds from this placing and compensatory open offer to redeem the £4,000 million preference shares issued by the Company to HM Treasury, described above, at 101 per cent of their issue price (in accordance with the terms agreed with HM Treasury) together with accrued dividends thereon.

In connection with the placing and compensatory open offer, a Placing and Open Offer Agreement dated 7 March 2009 (the 2009 Open Offer Agreement) was entered into between the Company and HM Treasury (as amended and restated on 20 March 2009 between the Company, HM Treasury, Citigroup Global Markets U.K. Equity Limited, J.P. Morgan Cazenove Limited and UBS Limited and further amended and restated between the same parties on 18 May 2009), pursuant to which (i) the Company agreed to invite qualifying shareholders to apply to subscribe for the new ordinary shares described above at an issue price of 38.43 pence per share by way of a compensatory open offer, (ii) the joint sponsors and joint bookrunners were appointed and agreed to use reasonable endeavours to procure placees to subscribe for the open offer shares not taken up under the compensatory open offer, and (iii) HM Treasury agreed that, to the extent not placed or taken up under the compensatory open offer and subject to the terms and conditions set out in the Open Offer Agreement, HM Treasury would subscribe for such open offer shares itself at the issue price.

In consideration of the provision of its services under the 2009 Open Offer Agreement, the Company agreed to pay to HM Treasury (i) a commission of 0.5 per cent of the aggregate value of the open offer shares at the issue price per open offer share payable on the earlier of admission to the Official List and to trading on the London Stock Exchange's main market and the second business day after the day on which the 2009 Open Offer Agreement is terminated, and (ii) a further commission of 1 per cent of the aggregate value of the open offer shares subscribed for by HM Treasury (or its nominee) or by placees (including, for the avoidance of doubt, HM Treasury) at the issue price per open offer share payable on such date.

The Company also agreed to pay to each of HM Treasury, the joint sponsors and joint bookrunners all legal and other costs and expenses (properly incurred in the case of the joint bookrunners), and those of HM Treasury's financial advisers incurred in connection with the placing and compensatory open offer, the redemption of the preference shares or any arrangements referred to in the 2009 Open Offer Agreement.

The Company also agreed to bear all costs and expenses relating to the placing and compensatory open offer and the preference share redemption, including (but not limited to) the fees and expenses of its professional advisers, the cost of preparation, advertising, printing and distribution of the prospectus document and all other documents connected with the placing and compensatory open offer and the preference share redemption, the listing fees of the FSA, any charges by CREST and the fees of the London Stock Exchange and Euronext. The costs and commissions incurred by the joint bookrunners in connection with the rump placing were deducted from the aggregate proceeds of the rump placing.

The Company gave certain representations and warranties and indemnities to each of HM Treasury, the joint sponsors and joint bookrunners under the 2009 Open Offer Agreement. The Company's liabilities thereunder are unlimited as to time and amount. HM Treasury is entitled to novate its rights under the agreement to any entity that is wholly-owned, directly or indirectly, by HM Treasury.

### REGISTRATION RIGHTS AGREEMENT

Pursuant to its obligations to HM Treasury under the open offer agreement entered into by the Company with effect from 13 October 2008, the Company entered into a Registration Rights Agreement with HM Treasury on 12 January 2009, granting customary demand and piggyback registration rights in the United States under the United States Securities Act of 1933, as amended to HM Treasury with respect to any ordinary shares of the Group held by HM Treasury (Registrable Securities). Pursuant to the Registration Rights Agreement, HM Treasury is permitted to transfer its registration rights to any of its wholly-owned, directly or indirectly, entities, as well as to any third party to whom it transfers not less than US\$500 million in Registrable Securities. In connection with any registered offering of ordinary shares by the Group under the Securities Act, any holders of Registrable Securities will have the right to participate in the offering, pursuant to customary piggyback registration rights, to the extent that such participation would not prevent successful completion of the offering. In addition, all holders of Registrable Securities have piggyback registration rights, on a pro rata basis, in any demand registration made by another holder pursuant to the Registration Rights Agreement.

The Registration Rights Agreement was amended with effect from 11 June 2009 to include as Registrable Securities (as defined in the Registration Rights Agreement) any new shares subscribed for under the 2009 Open Offer Agreement, any B shares and other securities in the Company called by HM Treasury to be issued by any person from time to time and securities issued by HM Treasury from time to time which are exchangeable for, convertible into, give rights over or are referable to any such securities.

#### **RESALE RIGHTS AGREEMENT**

Pursuant to its obligations to HM Treasury under the 2009 Open Offer Agreement, the Company entered into a Resale Rights Agreement with HM Treasury with effect from 11 June 2009, in which it agreed to provide its assistance to HM Treasury in connection with any proposed sale by HM Treasury of ordinary shares, B shares and other securities held by HM Treasury in the Company from time to time, by HM Treasury and of any securities of any description caused by HM Treasury to be issued by any person from time to time and which are exchangeable for, convertible into, give rights over or are referable to such ordinary shares or other securities issued by the Group, to be sold in such jurisdictions (other than the United States) and in such manner as HM Treasury may determine. Such assistance may include, the provision by the Company of assistance with due diligence and the preparation of marketing and such other documentation (including any offering memorandum, whether or not a prospectus) as HM Treasury may reasonably request.

#### **GOVERNMENT ASSET PROTECTION SCHEME**

The Company entered into a Pre-Accession Commitments Deed dated 7 March 2009 and a Lending Commitments Deed dated 6 March 2009 with HM Treasury, both relating to the Company's proposed participation in the Government Asset Protection Scheme (GAPS). As further detailed below, the Company subsequently withdrew from its proposed participation in GAPS.

#### **LENDING COMMITMENTS DEED**

On 6 March 2009, the Company entered into a deed poll in favour of certain UK Government departments under which it undertook to support lending to creditworthy borrowers in the UK in a commercial manner with effect from 1 March 2009. This lending commitment was a pre-requisite to the Group's proposed participation in the GAPS, the objective of which was to reinforce the stability of the UK financial system and support the recovery of the UK economy. A condition to the Group's proposed participation in the GAPS was the commitment by the Company to increase net



## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

lending by approximately £14,000 million in the twelve months commencing 1 March 2009 to support UK businesses (approximately £11,000 million) and homeowners (approximately £3,000 million), and to maintain in the twelve months commencing 1 March 2010 similar levels of lending as in the twelve months commencing 1 March 2009, subject to adjustment of the lending commitments by agreement with HM Treasury and the Department for Business, Enterprise and Regulatory Reform to reflect circumstances at the start of the twelve month period commencing 1 March 2010.

Under the GAPS Withdrawal Deed (detailed below), the Company has agreed to reaffirm the lending commitments which were originally given in the Lending Commitments Deed. On 23 March 2010, the Company entered into a deed poll in favour of the UK Government departments confirming its lending commitments for the 12 month period commencing 1 March 2010. The Company agreed subject to, amongst other things, sufficient customer demand, to provide gross new lending to UK businesses of £44,000 million and to adjust the undertakings given in connection with lending to homeowners for the 12 month period. This additional lending in 2009 and 2010 is expressed to be subject to the Group's prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group's standard credit and other acceptance criteria.

### HM TREASURY PRE-ACCESSION DEED

On 7 March 2009, the Company entered into a deed poll in favour of HM Treasury, pursuant to which the Company gave a series of undertakings in relation to the provision of information and the management of the proposed assets, commitments and exposures proposed to be included in the GAPS (the Proposed Assets) in the period to the Group's proposed accession to the GAPS.

The Company's obligations under the Pre-Accession Deed referred to above (other than its commitment to inform the UK Government of certain deleveraging activities) were terminated pursuant to the GAPS Withdrawal Deed.

### 2009 RIGHTS ISSUE

In connection with the rights issue announced in November 2009, the Company issued approximately 36,505 million new ordinary shares in respect of a rights issue as part of an alternative to the Group's proposed participation in GAPS (together with a liability management exercise). The Company entered into an Undertaking to Subscribe agreement with HM Treasury whereby HM Treasury undertook, amongst other things, to take up its rights to subscribe for all of the new shares to which it was entitled under the rights issue. HM Treasury subscribed for approximately 15,854 million new shares at a price of 37 pence per share. As subscribers were procured for all the new ordinary shares for which valid acceptances were not received under the rights issue, HM Treasury's shareholding again remained at 43.4 per cent.

### GAPS WITHDRAWAL DEED

Pursuant to the successful rights issue, the Company withdrew from its proposed participation in GAPS and on 3 November 2009, the Company entered into a GAPS Withdrawal Deed with HM Treasury (the GAPS Withdrawal Deed) pursuant to which, among other matters, the Company agreed to pay HM Treasury an amount of £2,500 million in recognition of the benefits to the Group's trading operations arising as a result of HM Treasury proposing to make GAPS available to the Group.

The GAPS Withdrawal Deed contained certain undertakings given by the Group to HM Treasury in connection with the state aid approval obtained from the European Commission and its withdrawal from GAPS. In particular, the Group is required to do all acts and things necessary to ensure the UK Government's compliance with its obligations under the European Commission decision approving state aid to the Group. This undertaking includes an obligation: (i) to comply with the restructuring measures that the Group has agreed to undertake; (ii) to comply with the terms of the restructuring plan accepted by the European Commission in connection with the approval of state aid to the Group; and (iii) to provide certain information to HM Treasury and do such acts as are necessary to enable compliance with the state aid approval to be monitored. The GAPS Withdrawal Deed also provides for the Group's restructuring obligations to be modified in certain limited circumstances (without prejudice to any challenge to such modifications). However, HM Treasury has undertaken that it will not, without the consent of the Company, agree modifications to the Group's undertakings with respect to state aid which are significantly more onerous to the Company than those granted in order to obtain the state aid approval.

If the European Commission adopts a decision that the United Kingdom must recover any state aid, the Group has undertaken to repay all such state aid (subject to the Group's right to challenge any such decision in the European courts).

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The GAPS Withdrawal Deed includes a number of other commitments given by the Company to HM Treasury. The Company has, among other things, acknowledged its commitment to the principle that, from 2010, it should be at the leading edge of implementing the G20 principles, the FSA Code on remuneration and any remuneration provisions accepted by the Government from the Walker Review, provided that this principle shall always be applied in such a way as to allow the Company to operate on a level playing field with its competitors. In addition, the Group has agreed with HM Treasury the specific deferral and clawback terms which will apply to any bonuses in respect of the 2009 performance year.

### STATE AID

As part of the European Commission's decision approving state aid to the Group, Lloyds Banking Group was required to work with HM Treasury to submit a restructuring plan to the European Commission in the context of a state aid review. The plan was required to contain measures to limit any competition distortions resulting from the state aid received by Lloyds Banking Group. The College of Commissioners announced its formal approval of Lloyds Banking Group's restructuring plan on 18 November 2009.

The restructuring plan consists of the following principal elements: (i) the disposal of a retail banking business with at least 600 branches, a 4.6 per cent share of the personal current accounts market in the UK and approximately 19 per cent of Lloyds Banking Group's mortgage assets; (ii) an asset reduction programme to achieve a £181 billion reduction in a specified pool of assets by 31 December 2014; and (iii) behavioural commitments, including commitments not to make certain acquisitions for approximately three to four years and not to make discretionary payments of coupons or to exercise voluntary call options on hybrid securities from 31 January 2010 until 31 January 2012, which will prevent Lloyds Banking Group from paying dividends on its ordinary shares for the same duration.

The business referred to in (i) above will need to be disposed of within four years and consists of the TSB brand, the branches, savings accounts and branch-based mortgages of Cheltenham & Gloucester, the branches and branch-based customers of Lloyds TSB Scotland and a related banking licence, additional Lloyds TSB branches in England and Wales, with branch-based customers, and Intelligent Finance. Lloyds Banking Group is unable at this time to identify with any precision the assets and liabilities that will be divested, and associated income and expenses, until nearer the date of a sale.

### HMT UNDERTAKING TO SUBSCRIBE

Under the HMT Undertaking to Subscribe, HM Treasury irrevocably undertook to procure that the Solicitor for the Affairs of Her Majesty's Treasury (as nominee for HM Treasury) (i) would vote in favour of all of the resolutions set out in the notice convening the general meeting of the Company held on 26 November 2009 in accordance with the recommendation of the board (except for resolution 4, as set out in the notice of general meeting) and (ii) would take up its rights to subscribe for all of the new shares to which it is entitled under the rights issue.

The Company agreed to pay to HM Treasury the HMT Commitment Commission, being a commission of up to £143.7 million, in consideration, amongst other things, for the undertakings given by HM Treasury in the HMT Undertaking to Subscribe.

### COST REIMBURSEMENT DEED

Under the cost reimbursement deed dated 2 November 2009, the Group agreed to pay for the UK Government's set-up costs relating to the proposed participation of the Group in GAPS (including all costs of the UK Government relating to the proposed participation of the Group in, and its withdrawal from, GAPS) and the UK Government's costs associated with the European Commission's approval of state aid to the Group.

## MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### CREDIT GUARANTEE SCHEME

HM Treasury launched the Credit Guarantee Scheme in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charged a commercial fee for the guarantee of new short and medium term debt issuance. The fee payable to HM Treasury on guaranteed issues was based on a per annum rate of 50 basis points plus the median five-year Credit Default Swap spread. The drawdown window for the Credit Guarantee Scheme closed for new issuance at the end of February 2010. At 31 December 2009, the Group had £49,070 million of debt in issue under the Credit Guarantee Scheme. During the year, fees of £498 million were paid to HM Treasury in respect of guaranteed funding were included in the Group's income statement.

### GOVERNMENT SHAREHOLDING

The Government's shareholding in the Company is currently held by the Solicitor for the Affairs of HM Treasury as nominee for HM Treasury and managed by UKFI (a company wholly owned by HM Treasury) on behalf of HM Treasury. No formal relationship agreement has been concluded between the Group and the UK Government and no specific measures are in place to ensure that control is not abused by HM Treasury. However, the relationship falls within the scope of the revised framework document between HM Treasury and UKFI published on 13 July 2009. The framework document states that UKFI will manage the UK financial institutions in which HM Treasury holds an interest on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (as defined therein) (including with respect to individual lending or remuneration decisions). This document also makes it clear that such UK financial institutions will continue to be separate economic units with independent powers of decision and will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets).

These goals are consistent with the stated public policy aims of the UK Government, as articulated in a variety of public announcements (as at 10 May 2010). In the publication *An Introduction: Who We Are, What We Do and the Framework Document Which Governs the Relationship Between UKFI and HM Treasury*, it is stated that UKFI is to develop and execute an investment strategy for disposing of the investments in the banks in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. UKFI has also stated that it intends to engage robustly with banks' boards and management, holding both strategy and financial performance to account, and taking a strong interest in getting the incentives structures right on the board and beyond - accounting properly for risk and avoiding inefficient rewards for failure.

The Group, in common with other financial institutions, is also working closely with a number of Government departments and agencies on various industry-wide initiatives that are intended to support the Government's objective of greater stability in the wider financial system. These initiatives currently include the potential extension of the Bank of England's discount window facility whereby banks and building societies can exchange eligible securities and, potentially, other asset classes for HM Treasury bills.

The Group also engages in numerous transactions on arm's length commercial terms in the ordinary course of its business with the Government and its various departments and agencies, as well as with other companies in which the Government has invested. This includes financings, lendings, banking, asset management and other transactions with UK financial institutions in which the Government has invested. During 2008 and 2009, the Group has made use of these measures in order to maintain and improve a stable funding position.

## REGULATION

### OVERVIEW OF UK REGULATION

The cornerstone of the regulatory regime in the UK is the Financial Services and Markets Act 2000 (FSMA) which came into force on 1 December 2001. The FSA has responsibility under the FSMA for the regulation and oversight of a wide range of financial services activities in the UK. The FSA is responsible for the authorisation and supervision of institutions that perform regulated activities as defined in the FSMA. As part of its authorisation process, the FSA reviews applicants to ensure that they satisfy the necessary criteria, including suitability, competence and financial soundness, to engage in regulated activity.

These responsibilities include the regulation of mortgage lending, sales and administration (October 2004) and general insurance sales and administration (January 2005). More recently, on 1 November 2009, responsibility for the regulation of banking conduct of business and for payment services, under the Payment Services Regulations 2009, transferred to the FSA.

The Financial Services Act 2010 (FS Act) received Royal Assent on 8 April 2010. The FS Act establishes a new consumer financial education body, amends the FSMA to provide the FSA with a new financial stability statutory objective, gives the FSA powers to make rules on remuneration arrangements, short selling, living wills, consumer redress schemes, and extends its enforcement powers. The FSA is currently consulting on implementing certain powers in the FS Act.

Significant changes to the UK regulatory regime are likely following the UK general election on 6 May 2010.

As at 31 December 2009 there were approximately 50 UK authorised institutions across the Group. These are regulated by the FSA on both an individual and a consolidated basis.

### REGULATORY APPROACH OF THE FSA

The FSA's regulatory approach aims to focus and reinforce the responsibility of senior management of a financial institution to ensure that it takes reasonable care to organise and control its affairs responsibly and effectively and that it develops and maintains adequate risk management systems.

A risk-based approach for the supervision of all financial institutions is adopted by the FSA and the starting point for the FSA's supervision is based on a systematic analysis of an institution's risk profile. Having determined the level of inherent risk, a minimum capital adequacy requirement is established, which the institution is required to meet at all times.

The FSA carries out its supervision of UK financial institutions through the collection of information from a series of prudential returns covering sterling and non-sterling operations, on-site reviews (through its ARROW reviews and through industry-wide thematic reviews), desk-based reviews, meetings with senior management and reports obtained from skilled persons. For major retail groups such as the Group, a dedicated relationship team coordinates much of this activity via its Close and Continuous supervision regime.

Regular prudential reports required by the FSA include operating statements and returns covering (amongst other things) capital adequacy, liquidity, large single exposures and large exposures to related borrowers. Capital adequacy returns are submitted on a periodic basis for all the authorised institutions within the Group. Regular non-prudential reports required by the FSA include complaints data, daily transaction reporting returns and product sales data. The FSA reporting rules were revised through the introduction of the Integrated Regulatory Reporting Programme, which came into effect in 2008.

The FSA Handbook sets out rules and guidance across a range of issues with which financial institutions are required to comply. These include, amongst other things:

Principles for Businesses – 11 high level principles to which financial institutions are required to adhere.

Authorisation requirements and threshold conditions – these are standards that need to be met in order to be authorised and continue to be met on an ongoing basis.

Prudential rules – these relate to capital adequacy and liquidity.

Systems and controls requirements that are appropriate to the volume and complexity of activity undertaken.

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Conduct of Business rules that set out the requirements for aspects such as advising and selling, product disclosure, financial promotions (including compliance with the requirement that such promotions should be clear, fair and not misleading), responsible lending and default.

Reporting Requirements these set out periodic reporting requirements and event driven notifications that must be submitted to the FSA.

Training and Competence rules these are standards that apply to firms providing advice, amongst other services, to retail customers.

Code of Market Conduct this provides further rules and guidance on the market abuse offences set out in the FSMA. A key theme running through most of the FSA's rules and regulations is the concept of Treating Customers Fairly (TCF), contained in Principle 6 of the FSA's Principles for Businesses. From 31 December 2008, the FSA expects all firms to be able to demonstrate that full TCF compliance has been embedded within their business activities, operations and culture. As mentioned above, the FS Act amends the FSMA to provide the FSA with an added regulatory objective of financial stability, defined as contributing to the protection and enhancement of the stability of the UK financial system. In considering this objective, the FSA must have regard to the economic and fiscal consequences for the UK of instability of the UK financial system, the effects on the growth of the UK economy of any regulatory action taken to meet the financial stability objective and the impact on the stability of the UK financial system of events or circumstances outside the UK.

At this stage it is unclear how the addition of the financial stability objective will affect the operation of the FSA's policy and supervisory functions. It is clear that it could have significant ramifications for the FSA's approach to the regulation of systemic organisations, particularly as regards the setting of capital and liquidity requirements, and potentially may affect the willingness of the FSA to allow organisations to grow by acquisition where growth could have systemic implications.

The FS Act also gives the FSA a new financial stability information gathering power which applies to authorised and unauthorised persons and is aimed at assisting the FSA in identifying threats to financial stability. In its consultation paper, the FSA proposes that, when deciding whether to impose a financial stability information requirement, factors it will take into account include: (i) the nature and extent of the risks to financial stability; (ii) whether the information is readily available from another source; and (iii) whether the information may assist the FSA in fulfilling its functions.

### **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 set out in detail in the Memorandum of Understanding published jointly by HM Treasury, the FSA and the Bank of England at the end of October 1997 and updated in March 2006. 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 at home and abroad; and (iii) maintaining a broad overview of the financial system through its monetary stability role and the deputy governor's membership of the FSA's Board. HM Treasury, the FSA and the Bank of England (collectively the tri-partite) work together to achieve stability in the financial markets.

#### **UK GOVERNMENT**

The UK Government is responsible for the overall structure of financial regulation and the legislation which governs it. It has no operational responsibility for the activities of the FSA or the Bank of England. However, there are a variety of circumstances where the FSA and the Bank of England will need to alert HM Treasury (the representative of the UK Government) about possible problems, for example, where there may be a need for a support operation or a problem arises which could cause wider economic disruption.

In light of the current crisis in financial markets, the Banking Act 2009 secured Royal Assent in February 2009 and certain provisions, including those relating to the Special Resolution Regime (SRR), bank insolvency and bank administration, came into force at that time. The Banking Act provides the FSA, Bank of England and HM Treasury with tools for dealing with failing institutions as part of the SRR. These powers enable the Authorities to deal

## REGULATION

with and stabilise UK-incorporated institutions with permission to accept deposits pursuant to Part IV of the FSMA (each a relevant entity) that are failing or are likely to fail to satisfy the threshold conditions (within the meaning of section 41 of the FSMA).

The SRR consists of three 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 wholly-owned by the Bank of England; and (iii) 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.

If a parent undertaking is taken into temporary public ownership, HM Treasury may take various actions in relation to any securities issued by it without the consent of the holders thereof (Investors), including (among other things):

transferring securities free from any restrictions on transfer and free from any trust, liability or encumbrance;

delisting the securities;

converting securities into another form or class; or

prescribing that the transfer of shares takes place free from any trust.

Accordingly, the taking of any such actions could adversely affect the rights of Investors, the price or value of their investment, and the ability of such parent undertaking to satisfy its obligations under the issued securities or the related contracts.

Where the stabilisation powers are exercised, HM Treasury must make statutory provision for a scheme or other arrangements for determining the compensation, if any, due to those affected by an exercise of the powers. However, there can be no assurance that Investors would thereby recover compensation promptly and equal to any loss actually incurred.

### UK FINANCIAL OMBUDSMAN SERVICE (FOS)

The FOS was established on 1 December 2001 pursuant to the FSMA to provide customers 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 that cover most financial products and services provided in (or from) the UK, from insurance and pension plans to bank accounts and investments, for eligible complainants, private individuals and small businesses, charities or trusts. The jurisdiction of FOS was extended in 2007 to include firms conducting activities under the Consumer Credit Act. 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 firms.

### LENDING STANDARDS BOARD

The Lending Standards Board (formerly the Banking Code Standards Board) is responsible for monitoring and enforcing compliance with a new Lending Code introduced on 1 November 2009 which relates to lending to private customers and small businesses.

### UK OFFICE OF FAIR TRADING (OFT)

The OFT is the UK's consumer and competition authority. Its regulatory and enforcement powers impact the banking sector in a number of ways. For further details see note 52 to the consolidated financial statements and *Risk factors - Legal and regulatory risks*.

### UK INFORMATION COMMISSIONER'S OFFICE

This 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.

## EU REGULATION

The UK has implemented all of the directives introduced under the Financial Services Action Plan which was intended to create a single market for financial services across the EU. 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.

EU directives, which are required to be implemented in EU Member States through national legislation, have a strong influence over the framework for supervision and regulation of financial services in the UK. The directives aim to harmonise financial services regulation and supervision throughout the EU by setting standards in key areas such as capital adequacy, access to financial markets, consumer protection and compensation schemes.

Financial institutions, such as those in the Group, are primarily regulated in their home state by a local regulator but the EU directives prescribe criteria for the authorisation of such institutions and the prudential conduct of business supervision applicable to them.

## US OPERATIONS AND REGULATION

In the United States, Lloyds TSB Bank plc maintains a branch in New York and an agency in Miami, licensed by the States of New York and Florida, respectively. Lloyds Banking Group maintains representative offices in several US cities. The existence of branch and agency offices in the US subjects Lloyds Banking Group plc and its subsidiaries doing business or conducting activities in the US to oversight by the Federal Reserve Board and limits the nature of the activities in which Lloyds Banking Group plc and its subsidiaries can engage in the US. Lloyds TSB Bank's branch and agency offices are subject to extensive federal and state supervision and regulation relating to their operations.

A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US 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 US State Department currently designates as state sponsors of terrorism, including Iran, Syria, Cuba, and Sudan. In January 2008, the Group introduced an enhanced financial sanctions policy which applies to all of the Group's operations and severely restricts activity with certain high risk jurisdictions including the countries designated by the US State Department. From their acquisition in January 2009, HBOS plc and its subsidiaries became subject to the same policy and the Group has undertaken the activities necessary to implement policy requirements across the HBOS heritage businesses. The Group continues to reduce its outstanding exposures to such states which have arisen through historical business activity. In accordance with this policy, the Group intends to engage only in new business in such jurisdictions in very limited circumstances where the Group is satisfied concerning legal, compliance and reputational issues.

## REGULATION

Since its implementation the policy has resulted in a significant reduction in the contacts that the Group had (in terms of value and volume) and the Group expects a further reduction in its contacts in the coming years. The Group does not have, and does not anticipate having, a physical presence in any of the countries designated as state sponsors of terrorism.

At 31 December 2009, the Group does not believe 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 0.02 per cent of the Group's total assets and, for the year ended 31 December 2009, the Group believes that the Group's revenues from all activities relating to such states were less than 0.01 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.

## OTHER INTERNATIONAL REGULATION

The Group operates in many other countries around the world. The Group's overseas operations are subject to reporting and reserve requirements and controls imposed by the relevant central banks and regulatory authorities.

In view of the global financial crisis and the increased scrutiny financial regulators have come under, it is also expected that regulatory regimes in many jurisdictions will be significantly tightened. At a G20 meeting to tackle the financial crisis in November 2008, a set of common principles for the reform of financial markets was set out. These principles have been endorsed at subsequent G20 meetings and have the aim of strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; re-enforcing international co-operation and reforming international institutions. As a result of this and other domestic pressures, it is expected that Group entities in all jurisdictions will be subject to increased scrutiny.

## CURRENT REGULATORY THEMES

Regulatory themes which have a current bearing on the business of the Group include, but are not limited to, the following:

### LIQUIDITY REGIME

On 5 October 2009 the FSA published its new liquidity rules which significantly broaden the scope of the existing liquidity regime and are designed to enhance regulated firms' liquidity risk management practices and, in part, can be seen as a response to issues highlighted by the credit crisis. These new rules, which apply to a wider range of entities than the current liquidity regime, are based on the over-arching principle of regulated firms (their subsidiaries and branch offices) being self-sufficient and having adequate liquid resources to withstand particular liquidity stresses. The rules specify that this will be delivered through greatly enhanced systems and controls requirements and a regular and comprehensive liquidity risk assessment of the business which will be linked to the supervisory process and monitored through more granular and frequent reporting on the part of regulated firms. In particular, the rules have introduced enhanced quantification requirements which will ultimately require regulated firms to hold a greater quantity of higher quality liquid assets as a buffer against liquidity stresses. It is noted that the specific rules vary depending on the type of regulated firm and some regulated firms may be able to benefit from particular relaxations.

The new systems and controls requirements apply to most regulated firms from 1 December 2009 and the enhanced quantitative requirements will be introduced in stages over the course of 1 June to 1 November 2010.

Lloyds Banking Group believes that these new rules will apply to it and will likely require changes to its business model, in particular, the requirement to hold increased and higher quality liquid assets and the detailed reporting requirements (which may require Lloyds Banking Group to change or upgrade its systems) may result in reduced profitability for Lloyds Banking Group.

Lloyds Banking Group manages liquidity on a consolidated basis. In order to comply with certain FSA requirements regarding the management of liquidity resources on a consolidated basis certain FSA-authorized deposit-taking subsidiaries of Lloyds Banking Group plc have entered into intra-group facilities.

## FSA SUPERVISORY REVIEW INTO HISTORICAL HBOS DISCLOSURES

The FSA is conducting a supervisory review into the accuracy and completeness of financial disclosures made by HBOS in connection with its capital raisings in 2008, including information as to corporate impairments disclosed in the circulars and/or



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prospectuses issued by HBOS in connection with such capital raisings. The Group is cooperating fully with this review.

BASEL II Basel II has been implemented throughout the EU through the Capital Requirements Directive. This came into force for all European banks on 1 January 2007. With effect from 1 January 2008, for credit risk, the heritage Lloyds TSB Group adopted the Foundation Internal Ratings Based approach for its non-retail exposures and the Advanced (Retail) Internal Ratings Based approach for its retail exposures. The heritage HBOS Group adopted the Advanced Internal Ratings Based approach for both its non-retail and retail exposures.

Both the heritage Lloyds TSB Group and the heritage HBOS Group adopted the Advanced Measurement Approach for Operational Risk from 1 January 2008.

### CONTINUING OBLIGATIONS

Those Companies in the Group which have securities listed on the Official List or on other regulated markets intend to comply with their obligations as companies with securities admitted to the Official List in connection with further disclosures in relation to the impact of the reviews and inquiries being conducted by the UK Office of Fair Trading as disclosed above on the Group. Under the GAPS Withdrawal Deed, the Group has, among other things, agreed to implement any measures relating to personal current accounts agreed between the OFT and the UK banking industry.

### RETAIL BANKING INVESTIGATION

On 10 January 2007, the European Commission published the Final Report of its sector inquiry into European retail banking markets covering payment cards and (non-card) payment systems and current accounts and related services. The European Commission found that markets were fragmented along national lines, limiting consumer choice and leading to higher costs for current accounts, loans or payments.

High degrees of variation of prices, profit margins and selling patterns between EU Member States and high degrees of homogeneity within EU Member States were found to be indicative of persisting regulatory or behavioural barriers to competition.

## REGULATION

The Final Report identified competition concerns in several areas of retail banking, including:

the combination of sustained high profitability, high market concentration and evidence of entry barriers in some Member States raise concerns about banks' ability to influence the level of prices for consumers and small firms;

large variations in merchant and interchange fees between banks across the EU may indicate competition barriers;

the existence of high joining fees for payment cards, co-branding, surcharging and the practice of blending card fees where a retailer is charged the same merchant fee irrespective of the different costs of card types;

some credit registers, holding confidential data that lenders use to set loan rates, may be used to exclude new entrants to retail banking markets;

some aspects of co-operation among banks, including savings and co-operative banks, can reduce competition and deter market entry;

product tying by banks is widespread in Member States and can reduce consumer choice and increase banks' power in the market place to influence prices; and

obstacles to customer mobility in banking, notably the inconvenience of changing a current account, are high.

The Final Report also listed the following specific areas where enforcement action by the European Commission and the national competition authorities is appropriate:

high interchange fees and merchant fees in some payment card networks;

access barriers and discriminatory rules in relation to credit registers;

tying of products by some banks; and

bank co-operation (in respect to which the European Commission indicated that it intended to gather more information before acting).

Further specific regulatory matters are set out in *Business Legal actions* on page 7.

## LISTING INFORMATION

The information in this section 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.

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:		
2009	140.70	40.30
2008	483.25	118.50
2007	614.00	451.25
2006	581.00	489.75
2005	509.00	439.50
2004	476.25	391.75
2003	483.00	295.75
2002	817.00	427.50
2001	772.00	590.00
2000	774.50	517.00
Quarterly prices:		
2010		
First quarter	64.91	46.59
2009		
Fourth quarter	99.23	48.70
Third quarter	111.34	63.30
Second quarter	121.10	61.10
First quarter	140.70	40.30
2008		
Fourth quarter	290.25	118.50
Third quarter	346.50	217.25
Second quarter	483.25	306.75
First quarter	482.25	373.50
Monthly prices:		
April 2010	70.24	62.56
March 2010	64.91	50.26
February 2010	55.00	46.59
January 2010	58.58	50.69
December 2009	58.22	48.70
November 2009	94.25	55.15

On 30 April 2010, the closing price of shares on the London Stock Exchange was 66.13 pence, equivalent to \$1.012 per share translated at the Noon Buying Rate of \$1.5308 per £1.00 on 30 April 2010.

Lloyds Banking Group plc's American Depositary Receipts (ADRs) have been traded on the over-the-counter market in the US under the symbol LLDTY since March 2000. 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. The prices for Lloyds Banking Group plc's ADRs and ADSs, as quoted below, are in US dollars. Each ADS represents four ordinary shares.

## LISTING INFORMATION

The following table shows the reported high and low closing prices for the ADRs in the over-the-counter market in the US.

	Price per ADR (in US dollars) High	Price per ADR (in US dollars) Low
Annual prices:		
2001 (to 26 November 2001)	46.00	34.75
2000	45.27	33.50
Quarterly prices:		
2001		
Fourth quarter (to 26 November 2001)	43.88	38.25
Third quarter	44.00	35.50
Second quarter	43.94	38.94
First quarter	46.00	34.75

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:		
2009	8.40	2.22
2008	38.56	7.15
2007	48.44	36.70
2006	45.41	34.72
2005	39.06	31.12
2004	36.88	29.47
2003	32.55	19.65
2002	48.55	27.85
Quarterly prices:		
2010		
First quarter	3.88	2.92
2009		
Fourth quarter	6.44	3.21
Third quarter	7.37	4.17
Second quarter	7.36	4.10
First quarter	8.40	2.22
2008		
Fourth quarter	18.80	7.15
Third quarter	27.92	15.75
Second quarter	38.56	24.46
First quarter	38.52	31.12
2007		
Fourth quarter	46.95	36.70
Third quarter	47.22	41.25
Second quarter	47.20	44.72
First quarter	48.44	41.64
2006		
Fourth quarter	45.41	40.70
Third quarter	40.70	38.00
Second quarter	40.38	36.91
First quarter	40.32	34.72
Monthly prices:		
April 2010	4.37	3.92
March 2010	3.88	3.08

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February 2010	3.55	2.92
January 2010	3.87	3.26
December 2009	5.25	3.21
November 2009	6.20	5.40

On 30 April 2010, the closing price of ADSs on the New York Stock Exchange was \$4.07.

## LISTING INFORMATION

## ADR FEES

The Group's depository, 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 depository 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 depository may collect its annual fee for depository 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 depository may generally refuse to provide fee-attracting services until its fees for those services are paid.

Persons depositing or withdrawing shares must pay:

\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)

\$.02 (or less) per ADS

A fee equivalent to the fee that would be payable if securities distributed to you had been shares and the shares had been deposited for issuance of ADSs

\$.02 (or less) per ADSs per calendar year

Registration or transfer fees

Expenses of the depository

Taxes and other governmental charges the depository or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

Any charges incurred by the depository or its agents for servicing the deposited securities

*FEES RECEIVED TO DATE*

In 2009, the Company received from the depository \$311,220 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 depository, has agreed to reimburse the Company for expenses they incur that are related to establishment and maintenance expenses of the ADS program. The depository has agreed to reimburse the Company for its continuing annual stock exchange listing fees. The depository 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

For:

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

Any cash distribution to ADS registered holders

Distribution of securities distributed to holders of deposited securities which are distributed by the depository to ADS registered holders

Depository services

Transfer and registration of shares on our share register to or from the name of the depository or its agent when you deposit or withdraw shares

Cable, telex and facsimile transmissions (when expressly provided in the deposit agreement)

Converting foreign currency to US dollars

As necessary

As necessary

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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.

The depositary 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 deduction 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.

## DIVIDENDS

As a result of the UK Government's investment in the Group as part of the initial recapitalisation by the Company in November 2008, the rights issue announced in November 2009 and our participation in the Credit Guarantee Scheme, the Group has been deemed to have accepted state aid and subsequently the European Commission required us to undertake a restructuring plan. This, amongst other things, includes a behavioural commitment not to make discretionary payments of coupons or to exercise voluntary call options on hybrid securities from 31 January 2010 until 31 January 2012. This also prevents the Group from paying dividends on its ordinary shares for the same duration.

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. The board recognises the importance attached by shareholders to the Company's 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 table below sets out the interim and final dividends which were declared in respect of the ordinary shares for fiscal years 2001 through 2009. The sterling amounts have been converted into US dollars at the Noon Buying Rate in effect on each payment date.

	Interim dividend per share (£)	Interim dividend per share (\$)	Final dividend per share (£)	Final dividend per share (\$)
2002	0.107	0.167	0.235	0.374
2003	0.107	0.178	0.235	0.421
2004	0.107	0.190	0.235	0.447
2005	0.107	0.189	0.235	0.433
2006	0.107	0.202	0.235	0.468
2007	0.112	0.228	0.247	0.482
2008	0.114	0.203		
<b>2009</b>				



## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

A summary of the material provisions of Lloyds Banking Group plc's memorandum and articles of association is set out below. This has been updated from the summary that was incorporated into Lloyds Banking Group plc's annual report on Form 20-F for the year ended 31 December 2008 filed with the SEC on 7 May 2009.

Lloyds Banking Group plc is incorporated in Scotland under the UK Companies Act 1985 with registered number SC95000.

As resolved at the 2009 Annual General Meeting and in accordance with changes in UK company law with effect from 1 October 2009, Lloyds Banking Group plc deleted all provisions of its Memorandum of Association which, by virtue of Section 28 of the Companies Act 2006 (the Companies Act), are to be treated as part of the Articles of Association, including those provisions dealing with the Company's objects.

### OBJECTS OF LLOYDS BANKING GROUP PLC

As permitted under recent changes in UK company law, the objects of Lloyds Banking Group plc are unrestricted.

### 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 section 793 of 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. The limited voting shares confer the right to receive notice of and to attend and speak at all general meetings of Lloyds Banking Group plc, but do not confer a right to vote unless the business of the meeting includes the consideration of a resolution:

to approve an acquisition or disposal by Lloyds Banking Group plc or any of its subsidiaries in circumstances in which the approval of shareholders in general meeting is either required by virtue of securities of Lloyds Banking Group plc being listed on a recognised exchange, or is sought by the directors, due to the significance of the transaction; or

for the winding-up of Lloyds Banking Group plc; or

to vary the rights of the limited voting shares.

In any such case, the holder may vote the limited voting shares only in respect of such resolution and will have the same rights with regard to the number and exercise of votes as a holder of ordinary shares but, in the case of a variation in the rights of limited voting shares, shall also have the protection of a requirement for approval of the variation by way of a special resolution at a separate class meeting of the holders of limited voting shares. 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 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 of Lloyds Banking Group plc 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

Lloyds Banking Group plc must give at least 21 days' notice in writing of an annual general meeting. All other general meetings may be called by at least 14 days' notice in writing. The directors may make arrangements to regulate the level of attendance at any place specified 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. Annual general meetings of Lloyds Banking Group plc are to be held in Edinburgh or such other place in Scotland as the directors shall appoint.

**DIVIDENDS AND OTHER DISTRIBUTIONS AND RETURN OF CAPITAL**

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. 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.

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

The limited voting shares do not confer a right to participate in any distribution of profits by way of dividend. For any other distributions, the limited voting shares shall be deemed to confer rights and interests in the profits equally with the holders of ordinary shares according to the amounts paid up on such limited voting shares and ordinary shares respectively otherwise than in advance of calls.

On any distribution by way of capitalisation, the amount to be distributed will be appropriated amongst the holders of ordinary shares and limited voting shares in proportion to their holdings of ordinary shares and limited voting 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 and limited voting 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 unclaimed after a period of 12 years from the date of declaration of such dividend will be forfeited and revert to Lloyds Banking Group plc. No dividends or other monies payable on or in respect of a share shall bear interest against Lloyds Banking Group plc.

On a return of capital, whether in a winding-up or otherwise, the ordinary shares and the limited voting shares will rank equally in all respects and the preference shares will be entitled to the rights attaching to them on issue.

### CONVERSION OF LIMITED VOTING SHARES

Each limited voting share will be converted into an ordinary share:

on the day following the last date on which an amount could become due and payable to a holder of limited voting shares under a deed of covenant in favour of the Lloyds TSB Foundations. A deed of covenant is a legal document which records the obligation of one person to pay a specified sum to another for a specified number of years; or

if an offer is made to shareholders (or to all such shareholders other than the offeror and/or any body corporate controlled by the offeror and/or any persons acting in concert with the offeror) to acquire the whole or any part of the issued ordinary share capital of Lloyds Banking Group plc and the right to cast more than 50 per cent of the votes which may ordinarily be cast on a poll at a general meeting of Lloyds Banking Group plc becomes or is certain to become vested in the offeror and/or any bodies corporate controlled by the offeror and/or any persons acting in concert with the offeror. The publication of a scheme of arrangement under the statutes providing for the acquisition by any person of the whole or part of the ordinary share capital of Lloyds Banking Group plc shall be deemed to be the making of an offer for this purpose.

The ordinary shares resulting from conversion will 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 the date of conversion and will 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.

Holders of limited voting shares will be entitled to participate in any offer made by way of rights to holders of ordinary shares as if the limited voting shares had been converted at the relevant record date.

### 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 (subject to their terms of issue) be varied, modified 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.

However, for so long as the limited voting shares have not been converted (as described above):

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Lloyds Banking Group plc is prohibited from consolidating or subdividing any of the ordinary shares without consolidating or subdividing the limited voting shares in a like manner and to a like extent; and

Lloyds Banking Group plc will not create any new class of equity share capital, other than in connection with or pursuant to an employees' share scheme approved by Lloyds Banking Group plc in general meeting, provided that the creation of equity share capital which carries (as compared with the Existing Ordinary Shares) only restricted voting or no voting rights and no greater rights as regards dividends or capital shall not be deemed to be the creation of a new class of equity share capital.

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.

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, if the shares thereby transferred are not fully paid, 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.

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 Services 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 either:

the instrument of transfer 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.

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

The directors shall refuse to register the transfer of any share on which Lloyds Banking Group plc has a lien and shall refuse to register the transfer of any limited voting share unless the same is:

between existing holders of limited voting shares; or

under a scheme established or order made by the Charity Commissioners or by the Court to a transferee having charitable objects; or

in the course of a winding-up to an institution having charitable objects which prohibit distributions of income and property to members to at least the same extent as is imposed on the transferor by its Memorandum of Association; or

at the direction of the crown to another charity having similar objects.

The Articles of Association otherwise contain no restrictions on the free transferability of fully paid shares.

Lloyds Banking Group plc's shares are in registered form and the Articles of Association do not provide for bearer shares. The registration of share transfers may be suspended and the register may be closed at such times and for such periods as the directors may determine (not exceeding 30 days in any year), provided that if the shares are traded through an electronic trading system, the register may not be closed without the consent of the operator.

Subject to the statutes and the rules (as defined in the CREST Regulations), 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**

The Disclosure and Transparency Rules of the UK Financial Services 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) reach, exceed or fall below 3 per cent and each 1 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 believes to be interested in Lloyds Banking Group plc's shares, requiring that person to confirm whether he has such an interest and if so details of that interest.

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 that any dividends or other payments on the 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 empowered to sell, as the agent of a member, at the best price reasonably obtainable, any share registered in the name of a member remaining untraced for 12 years who fails to communicate with Lloyds Banking Group plc within three months following the publication of an advertisement of an intention to make such a disposal; provided that during the

12-year period at least three dividends have become payable and no dividend has been claimed.

Lloyds Banking Group plc shall be obliged to account to the member for the proceeds of the disposal. However, any net proceeds of sale unclaimed after 12 years from the date of sale shall be forfeited and shall revert to Lloyds Banking Group plc.

#### **FORFEITURE AND LIEN**

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 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.

## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

### **WINDING-UP**

If Lloyds Banking Group plc is wound up, the liquidator may, with the authority of a 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**

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 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 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 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.

### **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 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 may reasonably be expected at the time of authorisation to be a situation in which he has or can have a conflict, with the interests of Lloyds Banking Group plc.

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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.

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.



## MEMORANDUM AND ARTICLES OF ASSOCIATION OF LLOYDS BANKING GROUP PLC

### MATERIAL INTERESTS

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;

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.

Except as set out in the Articles of Association, a director shall not be entitled to vote nor be counted in the quorum 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

The ordinary remuneration of the directors is determined by ordinary resolution of Lloyds Banking Group plc and is 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. 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

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*.

## TAXATION

### UK TAXATION

The following discussion is intended only as a general guide to current UK tax legislation, what is understood to be current UK HM Revenue & Customs 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.

The UK HM Revenue & Customs is the UK government department responsible for assessing and collecting UK tax revenues. The discussion is intended as a general guide and only applies to persons who are the beneficial owners of their ordinary shares or ADSs. References below to a US holder are to that term as defined, and subject to the exclusions described in the introduction, below under *US federal income tax considerations*. It may not apply to certain shareholders or ADS holders, such as dealers in securities.

Tax can be complicated and individual circumstances may need to be considered in more detail. Any person who is in any doubt as to his tax position should consult his own professional adviser.

### TAXATION OF CHARGEABLE GAINS

#### UK RESIDENTS

A disposal (or deemed disposal) of ordinary shares or ADSs by a shareholder or holder of ADSs resident or (in the case of an individual) ordinarily resident for tax purposes in the UK may, depending on the shareholder's or ADS holder's particular circumstances, and subject to any available exemption or relief, give rise to a chargeable gain or an allowable loss for the purposes of UK taxation on chargeable gains.

#### INDIVIDUALS, OTHER THAN US HOLDERS, TEMPORARILY NON-RESIDENT IN THE UK

A shareholder or ADS holder who is an individual and who has, on or after 17 March 1998, ceased to be resident and ordinarily resident for tax purposes in the UK for a period of less than five 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.

#### US HOLDERS

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 less than five 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.

#### OTHER NON-UK RESIDENT PERSONS

Subject to the provisions set out above under *Individuals, other than US holders, temporarily non-resident in the UK*, shareholders or ADS holders who are neither resident nor ordinarily resident in the UK 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 shareholder or ADS holder might, depending on individual circumstances, be liable to UK tax on chargeable gains on any disposition of ordinary shares or ADSs. An individual holder of ordinary shares or ADSs 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.

## TAXATION OF DIVIDENDS

### UK RESIDENTS

Lloyds Banking Group plc will not be required to withhold tax at source when paying a dividend on the ordinary shares or ADSs.

An individual shareholder or ADS holder who is resident in the UK for tax purposes will be entitled to a tax credit in respect of any dividend received from Lloyds Banking Group plc and will be taxable on the gross dividend, which is the aggregate of the dividend received and related tax credit. The value of the tax credit will be equal to one-ninth of the dividend received (and, therefore, 10 per cent of the gross dividend). The gross dividend will be treated as an individual's marginal taxable income. The tax credit will, however, be treated as discharging the individual's liability to income tax in respect of the gross dividend, unless and except to the extent that the gross dividend falls above the threshold for the higher rate of income tax. A UK resident individual shareholder or ADS holder who is liable to income tax at the higher rate (40 per cent for the 2009-10 tax year) will be subject to tax at the rate applicable to dividends for such shareholders or ADS holders (32.5 per cent for the 2009-10 tax year) on the gross dividend. The tax credit will be set against but will not fully discharge such shareholders' or ADS holders' tax liability on the gross dividend and they will have to pay additional tax equal to 22.5 per cent of the gross dividend, being 25 per cent of the dividend received, to the extent that such sum, when treated as marginal income, falls above the threshold for the higher rate of income tax.

With effect from 6 April 2010, a new tax rate of 50 per cent will apply for taxable non-savings and savings income above £150,000. Dividends which would otherwise be taxable at the new 50 per cent rate would, however, be liable to income tax at a new rate of 42.5 per cent.

There will be no payment of the tax credit or any part of it to an individual whose liability to income tax on the dividend and the related tax credit is less than the tax credit.

UK resident shareholders or ADS holders who are not liable to UK tax on dividends, including pension funds and charities, will not be entitled to the payment of any tax credits in respect of dividends.

## TAXATION

Subject to certain exceptions, such as for dealers in securities and for some insurance companies with overseas business, UK resident corporate shareholders or ADS holders will generally not be subject to corporation tax in respect of dividends received from Lloyds Banking Group plc, but will not be entitled to the payment of any tax credit with respect to the dividends.

Shareholders who are within the charge to corporation tax will be subject to corporation tax on dividends paid by the Company, unless (subject to special rules for such shareholders that are small companies) the dividends fall within an exempt class and certain other conditions are met. It is expected that the dividends paid by the Company would generally be exempt. Such shareholders will not be able to claim repayment of tax credits attaching to dividends.

### US HOLDERS

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.

### OTHER NON-UK RESIDENT PERSONS

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 holder, other than a US holder, who is not resident for tax purposes in the UK.

Holders of ordinary shares or ADSs, other than US holders, who are not resident for tax purposes in the UK and who receive a dividend from Lloyds Banking Group plc will not have any further UK tax to pay in respect of the dividend, but will not normally be able to claim any additional payment in respect of the dividend from the UK HM Revenue & Customs under any applicable Double Tax Treaty.

## STAMP DUTY AND STAMP DUTY RESERVE TAX

### UK RESIDENTS, US HOLDERS AND OTHER NON-UK RESIDENT PERSONS

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.

Where Lloyds Banking Group plc issues ordinary shares or a holder of ordinary shares transfers such shares to the custodian or nominee for the depository to facilitate the issue of ADSs to him 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. Where a holder of ordinary shares transfers such shares to the custodian or nominee for the depository or clearance service this charge will generally be payable by the person receiving the ADSs or transferring the ordinary shares into the clearance service.

On 1 October 2009, the European Court of Justice (ECJ) ruled that such a charge, when levied in respect of an issue of shares into a clearance service, was prohibited by Article 11(a) of Council Directive 69/335/EEC. On 9 December 2009, the UK HM Revenue & Customs announced that, with immediate effect, the 1.5 per cent charge to SDRT on the issue of shares into a clearance service or depository receipt system within the European Union would no longer be applied. However, the limitation of their announcement to issues of shares into clearance or depository receipt systems within the European Union is disputed. There may be further implications of this decision, and in particular for the issue of shares into systems outside the European Union and for the treatment of transfers of shares after they have been placed into clearance services or depository receipt schemes.

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 effects such transfer is not executed in the UK and that it 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 hold such securities. The summary applies only to US holders that hold ADSs or ordinary shares as capital assets and does not address special classes of holders, such as:

certain financial institutions;

dealers or traders in securities who use a market-to-market method of accounting;

holders holding ADSs or shares as part of a hedge, straddle, conversion or other integrated transaction;

holders whose functional currency for US federal income tax purposes is not the US dollar;

holders liable for alternative minimum tax;

holders who acquired ADSs or shares pursuant to the exercise of any employee stock option or otherwise as compensation;

tax-exempt entities, including individual retirement accounts or Roth IRAs ;

persons holding ADSs or 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

holders that own or are deemed to own 10 per cent or more of the voting shares of Lloyds Banking Group plc.

## TAXATION

If an entity that is classified as a partnership for US federal income tax purposes holds ADSs or 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 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 shares.

The summary is 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. The US Treasury has expressed concerns that parties to whom American depository shares are pre-released, or intermediaries in the chain of ownership between holders and the issuer of the security underlying the American depository shares, may be taking actions that are inconsistent with the claiming of foreign tax credits by US holders of American depository shares. Such actions would also be inconsistent with the reduced rate of tax applicable to dividends received by certain non-corporate US holders. Accordingly, the availability of the reduced tax rate for dividends received by certain non-corporate US holders, described below, could be affected by actions taken by such parties or intermediaries.

This summary is based upon tax laws of the US including the 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. Prospective purchasers of the 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.

As used herein, a US holder is a beneficial owner of ADSs or shares, that is, for US federal income tax purposes:

a citizen or 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 or of any political subdivision thereof; 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.

## 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 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 dividend will generally be foreign-source dividend 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, certain dividends paid by qualified foreign corporations to certain non-corporate US holders in taxable years beginning before 1 January 2011 are taxable at a maximum tax rate of 15 per cent. A foreign corporation is treated as a qualified foreign corporation with respect to dividends paid on stock that is readily tradable on a securities market in the United States, such as the New York Stock Exchange where the Company's ADSs are traded. US holders should consult their tax advisers to determine whether the favourable rate will apply to dividends they receive and whether they are subject to any special rules that limit their ability to be taxed at this favourable rate.

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 such distribution is received by the Depositary (in the case of ADSs) or by the US holder (in the case of shares) 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 dollar amount 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 exchange of ADSs or shares will 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 shares 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 ADSs or shares were held for more than one year.

**INFORMATION REPORTING AND BACKUP WITHHOLDING**

Dividends paid on, and the sale proceeds from, ADSs or shares that are made within the US or through certain US-related financial intermediaries generally are subject to information reporting requirements, and may be subject to backup withholding, unless the US holder:

is an 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 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 rooms in Washington D.C., New York, New York and Chicago, Illinois. 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](http://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 United Kingdom. A substantial portion of the assets of Lloyds Banking Group plc, and a substantial portion of the assets of 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 United Kingdom, 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 are certain risk factors which could affect Lloyds Banking Group's future results and cause them to be materially different from expected results. The factors discussed below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties Lloyds Banking Group's businesses face. For information on Lloyds Banking Group's risk management policies and procedures, see *Operating and financial review and prospects Risk management*.

### GOVERNMENT-RELATED RISKS

***The Commissioners of Her Majesty's Treasury (HM Treasury) is the largest shareholder of the Company. Through its shareholding in, and other relationships with, the Company, HM Treasury is in a position to exert significant influence over the Group and its business.***

HM Treasury holds approximately 41.3 per cent of the ordinary share capital of the Company. This follows a dilution in February 2010 associated with the two exchange offers announced by the Group on 3 November 2009 (the Exchange Offers). In the longer term, the Exchange Offers could lead to further dilution of the HM Treasury shareholding through the potential conversion of the enhanced capital notes (the Enhanced Capital Notes or ECNs), into ordinary shares pursuant to their terms. It is not possible to calculate precisely the total dilutive effect any potential conversion of ECNs may have on HM Treasury's ownership interest in the Company but HM Treasury is expected to remain a significant shareholder in the Company.

In the longer term, it may become necessary for the Group to raise further capital or seek the support of the UK Government. Any such capital raising or support from the UK Government could result in an increase in HM Treasury's shareholding in the Company.

No formal relationship agreement has been concluded between the Group and the UK Government in respect of its shareholding in the Company and no specific measures are in place to limit the level of control which may be exercised by HM Treasury. However, the relationship falls within the scope of the revised framework document between HM Treasury and UK Financial Investments Limited published on 13 July 2009. The framework document states that UKFI will manage the UK financial institutions in which HM Treasury holds an interest on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (as defined herein) (including with respect to individual lending or remuneration decisions). This document also makes it clear that such UK financial institutions will continue to be separate economic units with independent powers of decision and will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets). Nevertheless, there is a risk that HM Treasury might seek to exert influence over the Group, and may disagree with the commercial decisions of the Group, including over such matters as the implementation of synergies, commercial and consumer lending policies and management of the Group's assets and/or business.

There is also a risk that, through its interests in the Company, the UK Government and HM Treasury may be able to influence the Group in other ways that would have a material adverse effect on the Group's business, including among other things, the election of directors, the appointment of senior management at the Company, staff remuneration policies, lending policies and commitments, management of the Group's business including, in particular, management of the Group's assets such as its existing retail and corporate loan portfolios, significant corporate transactions and the issue of new ordinary shares. Shareholders may disagree as to whether an action opposed or supported by HM Treasury is in the best interests of the Group generally. Furthermore, HM Treasury also has interests in other UK financial institutions, as well as an interest in the health of the UK banking industry and other industries generally, and those interests may not always be aligned with the commercial interests of the Group or its shareholders.

***The Group is subject to European state aid obligations following the approval of its restructuring plan by the European Commission on 18 November 2009. The implementation of this restructuring plan may have consequences that are materially adverse to the interests of the Group. Moreover, should a third party successfully challenge the European Commission's decision to approve the Group's restructuring plan, or should the Group require additional state aid in the future, further restructuring measures could be required and these may be materially adverse to the interests of the Group.***

As a result of HM Treasury's investment in the Company in the context of the placing and open offer in November 2008, the Group has been required to cooperate with HM Treasury to submit a restructuring plan to the European Commission setting out the Group's plans to restructure and return to a position of viability in which it no longer relies on state aid, including the aid received pursuant to its participation in HM Treasury's credit guarantee scheme (the Credit Guarantee Scheme), which was announced on 8 October 2008.

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On 18 November 2009 the European Commission, through its College of Commissioners, approved the Group's restructuring plan. The principal elements of the plan address competition distortions from all elements of state aid that the Group has received, including HM Treasury's participation in the placing and compensatory open offer in June 2009 and the rights issue in November 2009 (the Rights Issue), as well as any commercial benefit received by the Group following its announcement in March 2009 of the intention it held at that time to participate in GAPS. The approval also covers the Group's ongoing participation in HM Treasury's Credit Guarantee Scheme at current levels up to June 2010. The Company has agreed with HM Treasury in the deed of withdrawal relating to the Company's withdrawal from GAPS (the GAPS Withdrawal Deed) that it will comply with the terms of the European Commission's decision.

It is possible that a third party could challenge the decision of the College of Commissioners to approve the restructuring plan in the European Courts. The Group does not believe that any such challenge would be likely to succeed, but if it were to succeed the European Commission would need to reconsider its decision, which could result in more extensive remedies being applied including the disposal of a significantly larger proportion of the Group's assets and/or a significantly more stringent divestment timetable or more onerous behavioural restrictions than those contemplated in the approved restructuring plan.

The Group will also be subject to a variety of risks as a result of implementing the restructuring plan. There is no assurance that the price that the Group receives for any assets sold pursuant to the restructuring plan will be at a level the Group considers adequate or which it could obtain in circumstances in which the Group was not required to sell such assets in order to implement a state aid restructuring plan or if such sale were not subject to the restrictions contained in the terms thereof. In particular, should the Group fail to complete the disposal of the retail banking business that the Group is required to divest within four years, a divestiture trustee would be appointed to conduct the sale, with a mandate to complete the disposal with no minimum price (including at a negative price). In implementing the plan, the Group will lose existing customers, deposits and other assets (both directly through the sale and potentially through damage to the rest of the Group's business arising from implementing the restructuring plan) and the potential for realising additional associated revenues and margins that it otherwise might have achieved in the absence of such disposals. Such implementation may also result in disruption to the retained business, impacting on customers and separation costs which could potentially be substantial.

The effect of implementing the approved restructuring plan may be the emergence of one or more new viable competitors in the UK banking market or a material strengthening of one or more of the Group's competitors in that market. There can be no assurance that the Group will be able to continue to compete as effectively (whether against existing or new or strengthened competitors) and maintain or improve its revenues and margins in the resulting competitive environment, which could adversely affect the Group's results of operations and financial condition and its business generally. If any or all of the risks described in this paragraph, or any other currently unforeseen risks, materialise, there could be a negative impact, which could be material, on the Group's business, operations and competitive position.

## RISK FACTORS

Should the Group require any further state aid that was not covered in the European Commission's approval decision of 18 November 2009, this may require the Group to commit to further restructuring measures. Any such measures could be materially adverse to the interests of the Group.

***The Company has agreed to certain undertakings with HM Treasury in relation to the operation of its business in connection with the Company's placing and open offers in November 2008 and May 2009, in connection with the Group's participation in the Credit Guarantee Scheme and as part of its formerly proposed participation in GAPS. The implications of some of these undertakings remain unclear and they could have a material adverse effect on the Group's results of operations, financial condition and prospects. The Company also agreed to certain other commitments in the GAPS Withdrawal Deed.***

In connection with HM Treasury's participation in the placing and open offers in November 2008 and May 2009, the Group's participation in the Credit Guarantee Scheme and its possible participation in GAPS, the Company provided certain undertakings aimed at ensuring that the acquisition by HM Treasury of the Company's shares and the participation of the Group in the UK Government funding scheme as part of its support for the banking industry is consistent with the European state aid clearance. The state aid rules aim to prevent companies from being given an artificial or unfair competitive advantage as a result of governmental assistance. It is the Group's understanding that the undertakings are also aimed at supporting certain objectives of HM Treasury in providing assistance to the UK banking industry. These undertakings include (i) supporting UK Government policy in relation to mortgage lending and lending to businesses through to the end of February 2011, (ii) regulating the remuneration of management and other employees and (iii) regulating the rate of growth of the Group's balance sheet. There is a risk that these undertakings or any further requirements introduced by HM Treasury could have a materially adverse effect on the operations of the Group.

On 6 March 2009, in connection with the Group's then proposed participation in GAPS, the Company entered into a commitment to increase lending by £14 billion in the 12 months commencing 1 March 2009 to support UK businesses (£11 billion) and homeowners (£3 billion). As part of withdrawing from GAPS, the Company has agreed in the GAPS Withdrawal Deed to reaffirm its overall lending commitments and to maintain in the 12 months commencing 1 March 2010 similar levels of lending as in the 12 months commencing 1 March 2009, subject to adjustment of the lending commitments by agreement with the UK Government to reflect circumstances at the start of the 12 month period commencing 1 March 2010. On 23 March 2010, the Company entered into a commitment whereby it agreed to provide gross new lending to support UK businesses amounting to £44 billion and to support homeowners amounting to £23.1 billion, in respect of the year commencing 1 March 2010, in line with these requirements. The additional lending in 2009 and 2010 is subject to the Group's prevailing commercial terms and conditions (including appropriate risk-adjusted pricing and satisfaction of risk acceptance criteria) and, in relation to mortgage lending, the Group's standard credit and other acceptance criteria. The business lending commitment in 2010 is in addition subject to the availability of sufficient demand from customers who meet the above criteria and through the best endeavours of the Company, the availability of the capital, liquidity and funding position on acceptable terms necessary to support the level of lending that the Company has committed to during the 2010 commitment period.

This commitment could, however, limit the operational flexibility of the Group.

***Future legislative and regulatory changes could force the Group to comply with certain operational restrictions, take steps to raise further capital, or divest assets.***

In July 2009, the UK Government issued a White Paper (the White Paper) which builds on and responds to the previously published Turner Review (March 2009) and Bank of England Financial Stability Report (June 2009), both of which contained proposals for reform of the structure and regulation of the UK banking system.

Proposals in the White Paper included: enhanced regulatory powers for the FSA; introducing pre-funding for the UK's deposit guarantee scheme by 2012; requiring banks to develop and maintain detailed plans for winding down (or resolution); and more stringent capital and liquidity requirements for systemically significant firms. The Government's stated aim in linking capital requirements to the size and complexity of systemically significant firms, is that, "The capital requirements in place for systemically significant institutions would need to be sufficient to change incentives of banks to over-indulge in risky activities throughout the economic cycle. This should encourage them to reduce or at least better understand the riskier activities they undertake (for example, proprietary trading) and reduce the moral hazard problem by removing the incentive for firms to become systemically significant."

A second Turner Review discussion paper (October 2009) developed issues highlighted for further discussion in the March review, specifically how to offset the moral hazard created by the existence of systemically important banks and the cumulative impact of changes to the capital and liquidity schemes. Key proposals include: using contingent capital which converts to equity when

required; reducing the interconnectedness of large cross-border banks; restricting retail banks from engaging in proprietary trading activities; and emphasising the need to prioritise capital conservation and enhancement above employee bonus payments.

In November 2009 the draft Financial Services Bill was presented to Parliament and in April 2010 the Financial Services Act was passed. The Financial Services Act consolidated some of the proposals presented in the White Paper, in addition to enhancing the FSA's disciplinary and enforcement powers. Specifically, the Financial Services Act provides the FSA with a new regulatory objective to contribute to UK financial stability, and new powers in respect of (inter alia) altering firms' regulatory permissions, short selling, consumer redress schemes, recovery and resolution plans for authorised firms, disciplinary and enforcement proceedings (against firms and individuals) and the FSA's remuneration rules. The FSA's implementation of these changes, together with further proposals set out in the White Paper, Turner Reviews and elsewhere, if implemented, could have a significant impact on the operations, structure and costs of the Group.

There is a risk that further regulation or legislation that may be developed over time to implement these or new proposals could force the Group to divest core assets, withdraw from or not engage in some activities, and/or increase its capital. Such regulations or legislation, taken with the more regular and detailed reporting obligations which are expected to accompany regulatory reform, the development and maintenance of a wind down plan, and the move to pre-funding of the deposit protection scheme in the UK, would result in additional costs for the Group, and such costs could be material.

Such measures could have a material adverse effect on the Group's results of operations, financial condition and prospects.

On 5 October 2009, the FSA published its new liquidity rules which significantly broaden the scope of the existing liquidity regime and are designed to enhance regulated firms' liquidity risk management practices. Procedures to comply with the FSA's liquidity proposals are already incorporated within the Group's liquidity funding plans. These will result in more stringent requirements, which may lead to additional costs for the Group. See *Risk factors Financial soundness related risks The Group's businesses are subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits or the access to wholesale money markets continues to be limited or becomes more limited. The Group continues to be reliant on various government liquidity schemes and will face refinancing risk as transactions under these schemes mature*, for a fuller discussion of liquidity risks affecting the Group.

## RISK FACTORS

### ACQUISITION RISKS

***The Group may fail to realise the business growth opportunities, revenue benefits, cost synergies, operational efficiencies and other benefits anticipated from, or may incur unanticipated costs associated with, the acquisition of HBOS. As a consequence, the Group's results of operations, financial condition and prospects may suffer.***

The continued integration of the HBOS Group into the Group is complex, expensive and presents a number of challenges for the management of both the heritage Lloyds TSB Group, the HBOS Group and their respective staff and potentially their respective customers. The Group believes that it will achieve its reported anticipated cost synergies as well as other operating efficiencies and business growth opportunities, revenue benefits and other benefits from the acquisition of HBOS. However, these expected business growth opportunities, revenue benefits, cost synergies and other operational efficiencies and other benefits may not develop, including because the assumptions upon which the Group determined the acquisition of HBOS consideration may prove to be incorrect. For example, the expected cost synergies were calculated by the Group on the basis of the existing and projected cost and operating structures of the Group and its estimate of the existing and projected cost and operating structures of the HBOS Group. Statements of estimated synergies and other effectiveness and calculations of the costs of achieving them relate to future actions and circumstances which, by their nature, involve risks, uncertainties, contingencies and other factors. As a result, the synergies and other efficiencies referred to may not be achieved, or those achieved may be materially different from those estimated.

The Group may also face a number of other risks with respect to the acquisition of HBOS including: retaining key employees; redeploying resources in different areas of operations to improve efficiency; unifying financial reporting and internal control procedures; minimising the diversion of management attention from ongoing business concerns; overcoming integration challenges (particularly as the Company's management may be unfamiliar with some aspects of the HBOS Group's business and operations); and addressing possible differences between heritage Lloyds TSB's and heritage HBOS's business culture, risk management, compliance systems and processes, controls, procedures, systems, accounting practices and implementation of accounting standards.

Under any of these circumstances, the business growth opportunities, revenue benefits, cost synergies and other benefits anticipated by the Group to result from the acquisition of HBOS may not be achieved as expected, or at all, or may be delayed. To the extent that the Group incurs higher integration costs or achieves lower revenue benefits or fewer cost savings than expected, its operating results, financial condition and prospects may suffer.

### BUSINESS AND ECONOMIC RISKS

***The Group's businesses are subject to inherent risks arising from general and sector-specific economic conditions in the UK and other markets in which it operates. Adverse developments, such as the severe dislocation in the global financial markets, recession, and further deterioration of general economic conditions, particularly in the UK, have already adversely affected the Group's earnings and profits and could continue to cause its earnings and profitability to decline. In addition, any credit rating downgrades of sovereigns, particularly the United Kingdom, Spain and Republic of Ireland (or a perception that downgrades may occur) may severely destabilise the markets and could have a material adverse effect on the Group's operating results, financial condition and prospects.***

The Group's businesses are subject to inherent risks arising from general and sector-specific economic conditions in the markets in which it operates, particularly the United Kingdom, in which the Group's earnings are predominantly generated. Over approximately the past two and a half years, the global economy and the global financial system have been experiencing a period of significant turbulence and uncertainty. The very severe dislocation of the financial markets around the world, that began in August 2007 but substantially worsened in September 2008, triggered widespread problems at many large global and UK commercial banks, investment banks, insurance companies and other financial and related institutions. This dislocation has severely impacted general levels of liquidity, the availability of credit and the terms on which credit is available. This crisis in the financial markets led the UK Government and other governments to inject liquidity into the financial system and to require (and participate in) recapitalisation of the banking sector to reduce the risk of failure of certain large institutions and provide confidence to the market.

Despite this intervention, the volatility and market disruption in the banking sector has continued albeit with some easing since the second half of 2009. This market dislocation has also been accompanied by recessionary conditions and trends in many economies throughout the world, including the United Kingdom. The global economy has been in a severe recession, possibly the worst since World War II, although indications are that the UK has now emerged from its 18 month recession. The widespread and severe deterioration in the UK and virtually all other economies throughout the world, including, but not limited to, business and

consumer confidence, unemployment trends, the state of the housing market, the commercial real estate sector, equity markets, bond markets, foreign exchange markets, commodity markets, counterparty risk, inflation, the availability and cost of credit, lower transaction volumes in key markets, the liquidity of the global financial markets and market interest rates, has already and could continue to reduce the level of demand for, and supply of, the Group's products and services, lead to lower asset and other realisations and increased negative fair value adjustments and impairments of investments and other assets and materially and adversely impact its operating results, financial condition and prospects. While recent economic figures show a number of countries exiting recession, forecasts are that the recovery will be at a modest pace and is likely to be protracted. Any further significant deterioration in the UK and other economies in which the Group operates could have a material adverse impact on the future results of operations of the Group. Moreover, any return to economic growth may be modest and is likely to be insufficient to prevent unemployment rising further. The rate at which deterioration of the global and UK economies has occurred has proven very difficult to predict and this will apply to any further deterioration or any recovery.

Additionally, the profitability of the Group's businesses could be affected by increased insurance and other claims arising from market factors such as increased unemployment which may continue even following a return to economic growth in the markets in which the Group operates. Significantly higher unemployment in the UK and elsewhere, reduced corporate profitability, reduced personal non-salary income levels, increased corporate insolvency rates, increased personal insolvency rates, increased tenant defaults and/or increased interest rates may reduce borrowers' ability to repay loans and may cause prices of residential or commercial real estate or other asset prices to fall further, thereby reducing the collateral value on many of the Group's loans. This, in turn, would cause increased impairments in the event of default. Poor general economic conditions, lack of market liquidity and lack of transparency of asset structures have depressed asset valuations for the Group and could continue to do so if there is a further deterioration in general economic conditions.

The Group has significant exposures, particularly by way of loans, in a number of overseas jurisdictions, notably Ireland, Spain, Australia and the United States, and is therefore subject to a variety of risks relating to the performance of these economies as well.

In addition, the Group's businesses are subject to risks arising from the current UK macroeconomic environment, high and increasing levels of UK government debt and uncertainty around the outcome of the UK general election (including the possibility of a minority or coalition

## RISK FACTORS

administration which may be unable to take decisive fiscal and other measures to reduce government debt levels resulting in heightened market uncertainty). Further, any downgrade of the UK sovereign credit rating or the perception that such a downgrade may occur may severely destabilise the markets and have a material adverse effect on the Group's operating results, financial condition and prospects. This might also include impact on the Group's own credit ratings, borrowing costs and ability to fund itself.

A UK sovereign downgrade or the perception that such a downgrade may occur would be likely to have a material effect in depressing consumer confidence, restricting the availability, and increasing the cost, of funding for individuals and companies, further depressing economic activity, increasing unemployment, reducing asset prices and consequently increasing the risk of a double-dip recession.

These risks are exacerbated by concerns over the levels of the public debt of, and the weakness of the economies in, Italy, the Republic of Ireland, Greece, Portugal, and Spain in particular. Further instability in these countries or others within the Eurozone might lead to contagion, which may have a material adverse effect on the Group's operating results, financial condition and prospects.

The exact nature of the risks faced by the Group is difficult to predict and guard against in view of (i) the severity of the global financial crisis, (ii) difficulties in predicting whether the recovery will be sustained and at what rate, and (iii) the fact that many of the related risks to the business are totally, or in part, outside the control of the Group.

***The Group's businesses are inherently subject to the risk of market fluctuations, which could materially adversely affect its operating results, financial condition and prospects.***

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 business, pricing and hedging assumptions.

Market movements have had and will have an 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 pension schemes of the Group. Banking and trading activities that are undertaken by the Group are subject to interest rate risk, foreign exchange risk, inflation risk and credit spread risk. For example, changes in interest rate levels, yield curves and spreads affect the interest rate margin realised between lending and borrowing costs. Since August 2007, there has been a period of unprecedented high and volatile interbank lending margins over official rates (to the extent banks have been willing to lend at all), which has exacerbated these risks. The margins over official rates have recently reduced to historically more normal levels but volatility and increases in margins may return. Competitive pressures on fixed rates or product terms in existing loans and deposits sometimes restrict the Group in its ability to change interest rates applying to customers in response to changes in official and wholesale market rates.

The insurance businesses of the Group face market risk arising, for example, from equity, bond and property markets in a number of ways depending upon the product and associated contract; for example, the annual management charges received in respect of investment and insurance contracts fluctuate, as do the values of the contracts, in line with the markets. Some of these risks are borne directly by the customer and some are borne by the insurance businesses. Some insurance contracts involve guarantees and options that have increased in value in the current adverse investment markets and may continue to do so. There is a risk that the insurance businesses will bear some of the cost of such guarantees and options. The insurance businesses also have capital directly invested in the markets that are exposed to market risk. The performance of the investment markets will thus have a direct impact upon the embedded value of insurance and investment contracts and the Group's operating results, financial condition and prospects. Adverse market conditions affect investor confidence, which in turn can result in lower sales and/or reduced persistency.

Changes in foreign exchange rates affect the value of assets and liabilities denominated in foreign currencies and such changes and the degree of volatility with respect thereto may affect earnings reported by the Group. In the Group's international businesses, earnings and net assets are denominated in local currency, which will fluctuate with exchange rates in pounds sterling terms. It is difficult to predict with any accuracy changes in economic or market conditions, and such changes could have a material adverse effect on the Group's operating results, financial condition and prospects.

***The Group's businesses are conducted in highly competitive environments and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures.***



The markets for UK financial services, and the other markets within which the Group operates, are highly competitive, and management expects such competition to intensify in response to competitor behaviour, consumer demand, technological changes, the impact of consolidation, regulatory actions and other factors. Moreover, UK Government and/or European intervention in the banking sector may 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 to local banks in such jurisdictions. Any combination of these factors could result in a reduction in profit. The Group's financial performance and its ability to capture additional market share depends significantly upon the competitive environment and management's response to it.

The Group's financial performance may be materially and adversely affected by competition, including declining lending margins or competition for savings driving up funding costs which cannot be recovered from borrowers. Adverse persistency in the Group's insurance business is a risk to current and future earnings.

A key part of the Group's strategy involves building strong customer relationships in order to win a bigger share of its customers financial services spend. If the Group is not successful in retaining and strengthening customer relationships it will not be able to deliver on this strategy, and may lose market share, incur losses on some or all of its activities or fail to attract new and retain existing deposits, which could have a material adverse effect on its business, financial condition and results of operations.

***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, a further material adverse effect on the Group's operating results, financial condition and prospects.***

Financial markets have been subject to significant stress conditions resulting in steep falls in perceived or actual financial asset values, particularly due to the severe dislocation in the global financial markets.

The Group has material exposures to securities and other investments, including, but not limited to, asset-backed securities, structured investments and private equity investments, that are recorded at fair value and are therefore exposed to further negative fair value adjustments, particularly in view of market dislocation and the fragility of the economic recovery. Although the Board of Directors of the Company (the Board) believes that overall impairments for the Group have peaked, asset valuations in future periods, reflecting prevailing market conditions, may result in further

## RISK FACTORS

negative changes in the fair values of the Group's financial assets and these may also translate into increased impairments. In addition, the value ultimately realised by the Group for its securities and other investments may be lower than the 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.

The Group has made asset redesignations as permitted by recent amendments to IAS 39 ( Financial Instruments: Recognition and Measurement ). The effect of such redesignations has been, and would be, that any effect on the income statement of movements in the fair value of such redesignated assets that have occurred since 1 July 2008, in the case of assets redesignated prior to 1 November 2008, or may occur in the future, may not be recognised until such time as the assets become impaired or are disposed of.

In addition, to the extent that fair values are determined using financial valuation models, the data used by such models may not be available or may become unavailable due to changes in market conditions, particularly for illiquid assets, and particularly in times of substantial instability. In such circumstances, the Group's valuation methodologies require it to make assumptions, judgements 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, particularly in light of the uncertainty resulting from the current and ongoing crisis in the global financial markets, and any consequential impairments or write-downs could have a material adverse effect on the Group's operating results, financial condition and prospects.

## CREDIT-RELATED RISKS

***The Group's businesses are subject to inherent risks concerning borrower and counterparty credit quality which have affected and are expected to continue to affect the recoverability and value of assets on the Group's balance sheet.***

As one of the UK's largest lenders with substantial business and operations overseas, the Group has exposures to many different products and counterparties, and the credit quality of its exposures can have a significant impact on its earnings. The Group makes both secured and unsecured loans to retail and corporate customers and the Group's businesses are subject to inherent risks regarding the credit quality of, the recovery of loans to and amounts due from, customers and market counterparties. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets, and materially increase the Group's write-downs and allowances for impairment losses.

The Group estimates and establishes reserves for credit risks and potential credit losses inherent in its credit exposure. This process, which is critical to its results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how these economic conditions might impair the ability of its borrowers to repay their loans. As is the case with any such assessments, there is always a risk that the Group will fail to identify the proper factors or that it will fail to estimate accurately the impact of factors that it identifies.

As a result of the acquisition of HBOS, the composition of the Group's wholesale portfolio has materially changed, with much larger sectoral concentrations (for example in real estate, leveraged lending, asset-backed securities and floating rate notes issued by financial institutions) and higher levels of credit risk including substantially greater exposures, particularly in Ireland, Australia and the United States.

At the time of the acquisition of HBOS, the average rating of the HBOS Group's corporate lending portfolio was significantly weaker than that of the heritage Lloyds TSB Group, and this continues to be the case. HBOS had substantial lending to mid-sized and private companies, a greater exposure than the heritage Lloyds TSB Group to leveraged finance and subordinated loans, as well as significant exposure to the commercial real estate sector, including hotels and residential property developers, which has been particularly adversely affected by the recessionary environment. These concentrations in cyclically weak sectors, as well as exposure at various levels of the capital structure, mean that the heritage HBOS wholesale business is potentially exposed to high and volatile levels of impairments.

It should be noted that the heritage HBOS portfolio in Ireland is heavily exposed to the commercial and residential real estate sectors, which have been negatively impacted by the current economic recession, the portfolio in Australia has material exposure to real estate and leveraged lending, and in the United States there are notable exposures to sectors such as gaming and real estate which are cyclically weak and have been negatively impacted by the economic recession. As in the UK, the heritage HBOS portfolio overseas is also particularly 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.

UK house prices have declined significantly, albeit modest increases have been evident in recent months, reflecting a correction of severely inflated asset values, triggered by the economic downturn and lower availability of credit. Economic or other factors may lead to further contraction in the mortgage market and further decreases in housing prices. Many borrowers in the UK borrow on short-term fixed or discounted floating rates and when such rates expire the continued reduced supply and stricter terms of mortgages, together with the potential for higher mortgage rates, could lead to higher default and delinquency rates. The Group provides mortgages to buy-to-let investors where increasing unemployment, an excess supply of rental property or falls in rental demand could also impact the borrowers' income and ability to service the loans. If interest rates rise, or the current economic recovery falters, causing further decreases in house prices and/or increases in unemployment, the Group's retail portfolios could generate substantial impairment losses which could materially affect its operations, financial condition and prospects. Furthermore, the Group has direct exposure to self-certification and sub-prime mortgages in the UK and is therefore subject to the risks inherent in this type of mortgage lending in the event of decreases in house prices, increases in unemployment or a reduction in borrowers' incomes and the risk that the Group has incorrectly assessed the credit quality or willingness to pay of borrowers as a result of incomplete or inaccurate disclosure by those borrowers. At present, mortgage default and delinquency rates are cushioned by unprecedented low rates of interest which have improved customer affordability, and this has created the risk of increased defaults and delinquency rates as the economy recovers from the recession and interest rates start to rise.

Although the Board believes that overall impairments for the Group have peaked, there is a risk of further increases in the impairment charges for some businesses and there remain ongoing concerns with regard to the outlook for the Irish economy in particular. Moreover, there remains a risk that further material impairments in the Group's portfolios could come to light, particularly in the event of any further significant deterioration in the economic environment although the performance of some of the Group's exposures might deteriorate further even in the absence of further economic decline, particularly in Ireland. Any such unforeseen material further impairments could have a material and adverse effect on the Group's operations, financial condition and prospects.

***Concentration of credit and market risk could increase the potential for significant losses.***

The Group has exposure to concentration risk where its business activities focus particularly on a similar type of customer or product or geographic location including the UK market, which could be adversely affected by changes in economic conditions. Additionally, the heritage HBOS strategy of supporting UK entrepreneurs together with its joint venture model and its focus on commercial property lending has given rise to significant single

## RISK FACTORS

name and risk capital exposure. Given the Group's high concentrations of property exposure, further decreases in residential or commercial property values and/or further tenant defaults are likely to lead to higher impairment losses, which could materially affect its operations, financial condition and prospects.

The Group's efforts to diversify or hedge 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, the 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, 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 adversely affect the Group's operating results, financial condition and prospects. The acquisition of HBOS has in some cases increased the Group's exposure to concentration risk, since the combination of two portfolios inevitably gives rise to some greater concentrations than would otherwise have been permitted. Market conditions at present mean that it is difficult to achieve sales to ameliorate these concentrations.

***If the perceived creditworthiness of market counterparties does not improve or continues to deteriorate, the Group may be forced to record further credit valuation adjustments on securities insured or guaranteed by such parties, which could have a material adverse effect on the Group's results of operations, financial condition and prospects.***

The Group has credit exposure to market counterparties through securities insured or guaranteed by such parties and credit protection bought from such parties with respect to certain over-the-counter derivative contracts, mainly credit default swaps (CDSs) which are carried at fair value. The fair value of these underlying CDSs and other securities, and the Group's exposure to the risk of default by the underlying counterparties, depend on the valuation and the perceived credit risk of the instrument insured or guaranteed or against which protection has been bought. Market counterparties have been adversely affected by their exposure to residential mortgage-linked products, and their perceived creditworthiness has deteriorated significantly since 2007. They may continue to be substantially adversely impacted by such or other events. Their creditworthiness may further deteriorate as a consequence of the deterioration of the value of underlying assets. Although the Group seeks to limit and manage direct exposure to market counterparties, indirect exposure may exist through other financial arrangements and counterparties. If the financial condition of market counterparties or their perceived creditworthiness deteriorates further, the Group may record further credit valuation adjustments on the underlying instruments insured by such parties in addition to those already recorded. Any primary or indirect exposure to the financial condition or creditworthiness of these counterparties could have a material adverse impact on the results of operations, financial condition and prospects of the Group.

***The Group's borrowing costs and access to the capital markets depend significantly on the Company's credit ratings and market perception of the Company's financial resilience and those of Lloyds TSB Bank plc, HBOS plc and Bank of Scotland plc and any deterioration could materially adversely affect the Group's results of operations, financial condition and prospects.***

As at 30 April 2010, the long-term credit ratings for the Company were A1 from Moody's Investors Service Limited, A from Standard & Poor's Ratings Services, AA- (AA minus) from Fitch Ratings Limited and A (high) from DBRS. As at 30 April 2010, the long-term credit ratings for Lloyds TSB Bank plc were Aa3 from Moody's Investors Service Limited, A+ (A plus) from Standard & Poor's Ratings Services, AA- (AA minus) from Fitch Ratings Limited and AA (low) from DBRS. As at 30 April 2010, the long-term credit ratings for HBOS plc were A1 from Moody's Investors Service Limited, A from Standard & Poor's Rating Services, AA- (AA minus) from Fitch Ratings Limited and AA (low) from DBRS. As at 30 April 2010, the long-term credit ratings for Bank of Scotland plc were Aa3 from Moody's Investors Service Limited, A+ (A plus) from Standard & Poor's Ratings Services, AA- (AA minus) from Fitch Ratings Limited and AA (low) from DBRS.

As at 30 April 2010, the Company also had short-term ratings of A-1 from Standard & Poor's Ratings Services and F1+ from Fitch Ratings Limited. Lloyds TSB Bank plc had short-term ratings of P-1 from Moody's Investors Service Limited, A-1 from Standard & Poor's Ratings Services, F1+ from Fitch Ratings Limited and R-1 (middle) from DBRS. HBOS plc had short-term ratings of P-1 from Moody's Investors Service Limited, A-1 from Standard & Poor's Ratings Services, F1+ from Fitch Ratings Limited and R-1 (middle) from DBRS. Bank of Scotland plc had short-term ratings of P-1 from Moody's Investors Service Limited, A-1 from Standard & Poor's Ratings Services, F1+ from Fitch Ratings Limited and R-1 (middle) from DBRS.

Reduction in the credit ratings of the Group or deterioration in the capital market's perception of the Group's financial resilience, could significantly increase its borrowing costs, limit its access to the capital markets and trigger additional collateral requirements in derivative contracts and other secured funding arrangements. Therefore, any further reduction in credit ratings or deterioration of

market perception could materially adversely affect the Group's access to liquidity and competitive position, increase its funding costs and, hence, have a material adverse effect on the Group's business, financial position and results of operations. These material adverse effects could also follow from a reduction in the credit ratings of Lloyds TSB Bank plc, HBOS plc or Bank of Scotland plc.

## FINANCIAL SOUNDNESS RELATED RISKS

***The Group's businesses are subject to inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail deposits or the access to wholesale money markets continues to be limited or becomes more limited. The Group continues to be reliant on various government liquidity schemes and will face refinancing risk as transactions under these schemes mature.***

The Group's businesses are subject to risks concerning liquidity, which are inherent in banking operations. If access to liquidity is constrained for a prolonged period of time, this could affect the Group's profitability. Whilst the Group expects to have sufficient access to liquidity to meet its funding requirements even in a stressed scenario, under extreme and unforeseen circumstances a prolonged and severe restriction on the Group's access to liquidity (including government and central bank funding and liquidity support) could affect the Group's ability to meet its financial obligations as they fall due or to fulfil its commitments to lend, and 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 impact on the Group's solvency, including its ability to meet its regulatory minimum liquidity requirements. These risks can be exacerbated by many enterprise-specific factors, including an over-reliance on a particular source of funding (including, for example, securitisations, covered bonds, foreign markets and short-term and overnight money markets), changes in credit ratings, or market-wide phenomena such as market dislocation and major disasters. There is also a risk that corporate and institutional counterparties may look 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. In addition, the funding structure employed by the Group may prove to be inefficient giving rise to a level of

## RISK FACTORS

funding cost that is not sustainable in the long run. The funding needs of the Group will increase to the extent that customers, including conduit vehicles of the Group, draw down under existing credit arrangements with the Group and such increases in funding needs may be material. In order to continue to meet its funding obligations and to maintain or grow its businesses generally, the Group relies on customer savings and transmission balances, as well as ongoing access to the global wholesale funding markets, central bank liquidity facilities (for example, Bank of England, European Central Bank and Federal Reserve Bank of New York) and the UK Government Credit Guarantee Scheme. The ability of the Group to access wholesale and retail funding sources on satisfactory economic terms is subject to a variety of factors, including a number of factors outside of 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 loss of confidence in the UK banking system, any of which could affect the Group's profitability or, in the longer term under extreme circumstances, its ability to meet its financial obligations as they fall due.

Medium-term growth in the Group's lending activities will depend, in part, on the availability of retail funding on appropriate terms, for which there is increasing competition. See *Risk factors Business and economic risks The Group's businesses are conducted in highly competitive environments and the Group's financial performance depends upon management's ability to respond effectively to competitive pressures* for a discussion of the competitive nature of the banking industry and competitive pressures that could have a negative impact on the availability of customer deposits and retail funding. This reliance has increased in the recent past given the difficulties in accessing wholesale funding. Increases in the cost of such funding will impact on the Group's margins and affect profit, and a lack of availability of such retail deposit funding could impact on the Group's future growth.

The ongoing availability of retail deposit funding is dependent on a variety of factors outside the Group's control, such as general economic conditions and market volatility, the confidence of retail depositors in the economy in general and in the Group in particular, the financial services industry specifically and the availability and extent of deposit guarantees. These or other factors could lead to a reduction in the Group's ability to access retail deposit funding on appropriate terms in the future. Any loss in consumer confidence in the banking businesses of the Group could significantly increase the amount of retail deposit withdrawals in a short space of time and this may have an adverse effect on the Group's profitability. 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 impact on the Group's solvency.

In addition, if the current difficulties in the wholesale funding markets are not resolved or central bank provision of liquidity to the financial markets is abruptly curtailed, it is likely that wholesale funding will prove even more difficult to obtain. Such liquidity constraints could affect the Group's profitability. Whilst the Group expects to have sufficient access to liquidity to meet its funding requirements even in a stressed scenario, under extreme and unforeseen circumstances a prolonged and severe restriction on the Group's access to these traditional sources of liquidity could have a material adverse effect on the Group's business, financial position and results of operations, and 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 and which, in turn, could have a material impact on the Group's solvency.

Whilst various governments, including the UK Government, and central banks have taken substantial measures to ease the crisis in liquidity, (for example, the UK Credit Guarantee Scheme), there can be no assurance that these measures will succeed in materially improving the liquidity position of major UK banks, including the Group in the longer term. In addition, the availability and the terms on which any such measures will continue to be made available to the Group in the longer term are uncertain. The Group does not have influence over the policy making behind such measures. Further, there can be no assurance that these conditions will not lead to an increase in the overall concentration risk and cost of funding of the Group. The Group has substantially relied on the Bank of England liquidity facilities as well as the UK Government funding scheme. The Group does not expect that there will be any extension or renewal of the Special Liquidity Scheme (which was closed for new transactions in January 2009) or the Credit Guarantee Scheme (which was closed for new issuance in February 2010). Accordingly, the Group will face a refinancing concentration during 2011 and 2012 associated with the maturity of the Special Liquidity Scheme transactions and Credit Guarantee Scheme issuance undertaken by the Group prior to the closure of those schemes. While the Group expects that the impact of this refinancing concentration can be mitigated by a combination of alternative funding over the course of the next two years and reductions in the Group's net wholesale funding requirement over the same period, there can be no assurance that these mitigation efforts will be successful. Under the GAPS Withdrawal Deed, the Company has agreed to develop with the FSA a medium term funding plan aimed at reducing dependence on short term funding, to be regularly reviewed by the FSA and the Bank of England. If the Group's funding plan is not successful in mitigating the impact of this refinancing concentration in 2011, the Group could at that time face serious liquidity constraints, which would have a material adverse impact on its solvency.

At the time of the acquisition of HBOS, the HBOS Group had a funding profile that involved the need to refinance a higher volume of maturing wholesale funding than that of heritage Lloyds TSB. As this continues to be the case, the funding profile of the Group involves substantially higher refinancing risk than the funding profile of heritage Lloyds TSB on a stand-alone basis. The Group will also continue to be dependent on its credit ratings in order to be able to attract wholesale investors into its debt issuance

programmes; should the ratings fall, the cost of refinancing will increase and it may not be possible to refinance borrowings as they mature on favourable terms. 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 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 and prospects.***

Against the backdrop of the lack of liquidity and the recent high cost of funds relative to official rates in the interbank lending market, which was unprecedented in recent history, 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 United Kingdom. Financial services institutions that deal with each other are interrelated as a result of trading, investment, clearing, counterparty and other relationships. This risk is sometimes referred to as systemic risk and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with whom the Group interacts on a daily basis, all of which could have an 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, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds and other institutional clients, resulting in a significant credit concentration. The Group is exposed to counterparty risk as a result of recent financial institution failures and nationalisations and will continue to be exposed to the risk of loss if counterparty financial institutions fail or are otherwise unable to meet their obligations. 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 and adverse effect on the Group's results of operations, financial condition and prospects.

## RISK FACTORS

### ***The Group is subject to the risk of having insufficient capital resources to meet the minimum required by regulators***

The Group is subject to extensive regulation and regulatory supervision in relation to the levels of capital in its business. Currently, the Group meets and exceeds its regulatory capital requirements. The Group expects to continue to meet both its regulatory capital requirements and the additional capital requirements imposed by the FSA Stress Test. However, the FSA could apply increasingly stringent stress case scenarios in determining the required capital ratios for the Group and other banks, increase the minimum regulatory requirements imposed on the Group, introduce liquidity restrictions, introduce new ratios and/or change the manner in which it applies existing regulatory requirements to recapitalised banks including those within the Group. Specifically, in relation to the consultation papers issued by the Basel Committee on Banking Supervision ( Strengthening the resilience of the banking sector and International framework for liquidity risk measurement, standards and monitoring ), the Group is participating in the industry-wide consultation and calibration exercises taking place through 2010. In order to meet additional regulatory capital requirements, the Group may be forced to raise further capital.

Further, within the Group, the heritage Lloyds TSB and HBOS businesses may have approaches to the Basel II modelling of regulatory capital requirements which may differ according to the assumptions used. The two model methodologies are being aligned where appropriate. These models rely on a number of assumptions and changes to these assumptions and/or the methodologies adopted may result in changes to the Group's combined reported level of regulatory capital.

The Group's ability to maintain its targeted and regulatory capital ratios in the longer term could be affected by a number of factors, including net synergies and implementation costs following the acquisition of HBOS, and its level of risk-weighted assets, post-tax profit and fair value adjustments. In addition to the fair value adjustments, the Group's core tier 1 capital ratio will be directly impacted by any shortfall in forecasted after-tax profit (which could result, most notably, from greater than anticipated asset impairments and/or adverse volatility relating to the insurance or lending businesses). Furthermore, under Basel II, capital requirements are inherently more sensitive to market movements than under previous regimes and capital requirements will increase if economic conditions or negative trends in the financial markets worsen.

If the regulatory capital requirements, liquidity restrictions or ratios applied to the Group are increased in the future, any failure of the Group to maintain such increased regulatory capital ratios could result in administrative actions or sanctions, which in turn may have a material adverse effect on the Group's operating results, financial condition and prospects. A shortage of available capital would also affect the Group's ability to pay dividends, continue organic growth or pursue acquisitions or other strategic opportunities. In particular, changes in regulatory capital requirements imposed by the Group's regulators could cause the Group to defer the re-introduction of ordinary dividends or change its dividend policy.

The Group's life assurance and general insurance businesses in the UK are subject to capital requirements prescribed by the FSA, and the Group's life and general insurance companies outside the UK are subject to local regulatory capital requirements. In July 2007, the European Commission published a draft proposal for primary legislation to define broad framework principles for Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry. Solvency II aims to establish a revised set of EU-wide capital requirements where the required regulatory capital will be dependent upon the risk profile of the entities, together with risk management standards, that will replace the current Solvency I requirements. Solvency II is still in development, but there is a risk that the final regime could increase the amount of regulatory capital the Group's life assurance and general insurance businesses are required to hold, thus decreasing the amount of capital available for other uses.

## **INSURANCE AND PENSION SCHEME RELATED RISKS**

### ***The Group's insurance businesses and employee pension schemes are subject to risks relating to insurance claim rates, pension scheme benefit payment levels and changes in insurance customer and employee pension scheme member behaviour.***

The life and pensions insurance businesses of the Group and its employee pension schemes are exposed to short-term and longer-term variability arising from uncertain longevity and ill-health rates. Adverse developments in any of these factors will increase the size of the Group's insurance and employee pension scheme liabilities and may adversely affect the Group's financial condition and results of operations.

Customer behaviour in the life and pensions insurance business may result in increased propensity to cease contributing to or cancel insurance policies at a rate in excess of business assumptions. The consequent reduction in policy persistency and fee income has an adverse impact upon the profitability of the life and pensions business of the Group. The behaviour of employee pension scheme members affects the levels of benefits payable from the schemes. For example, the rate at which members cease



employment affects the aggregate amount of benefits payable by the schemes. This rate may differ from applicable business assumptions. Adverse variances may increase the size of the Group's aggregate pension liabilities and may adversely affect the Group's financial condition and results of operations.

The general insurance businesses of the Group are exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims, higher levels of theft can increase claims on property, contents and motor vehicle insurance and changes to unemployment levels can increase claims on loan protection insurance. These claims rates may differ from business assumptions and negative developments may adversely affect the Group's financial condition and results of operations.

UK banks recognise an insurance asset in their balance sheets representing the value of in-force business (VIF) 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 financial condition and results of operations.

Also, as further described in *Risk factors – Business and economic risks* *The Group's businesses are inherently subject to the risk of market fluctuations, which could materially adversely affect its operating results, financial condition and prospects*, the Group's insurance assets are subject to the risk of market fluctuations.

## RISK FACTORS

### LEGAL AND REGULATORY RISKS

***The Group's businesses are subject to substantial regulation, and regulatory and governmental oversight. Adverse regulatory developments or changes in government policy could have a significant material adverse effect on the Group's operating results, financial condition and prospects.***

The Group conducts its businesses subject to ongoing regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies, voluntary codes of practice and interpretations in the UK and the other markets where it operates. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector, which the Group expects to continue for the foreseeable future. Future changes in regulation, fiscal or other policies are unpredictable and beyond the control of the Group and could materially adversely affect the Group's business.

Areas where changes could have an adverse impact include, but are not limited to:

- (i) the monetary, interest rate and other policies of central banks and regulatory authorities;
- (ii) general changes in government or regulatory policy, or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which the Group operates, may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;
- (iii) changes to prudential regulatory rules relating to capital adequacy and liquidity frameworks;
- (iv) external bodies applying or interpreting standards or laws differently to those applied by the Group historically;
- (v) changes in competition and pricing environments;
- (vi) further developments in requirements relating to financial reporting, corporate governance, conduct of business and employee compensation;
- (vii) expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; and
- (viii) other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for the Group's products and services.

In the United Kingdom and elsewhere, there is increased political and regulatory scrutiny of the banking industry and, in particular, retail banking. The UK Government, the FSA and other regulators in the United Kingdom or overseas may intervene further in relation to areas of industry risk already identified, or in new areas, which could adversely affect the Group.

Increased regulatory intervention may lead to requests from regulators to carry out wide ranging reviews of past sales and/or sales practices. In the United Kingdom, the Competition Commission, the FSA and the Office of Fair Trading (OFT) have recently carried out, or are currently conducting, several inquiries. Regulatory reviews and investigations may result in enforcement actions and public sanction, which could expose the Group to an increased risk of litigation in addition to financial penalties and/or the deployment of such regulatory tools as the relevant regulator deems appropriate in the circumstances.

In addition, the Group faces increased political and regulatory scrutiny as a result of the Group's perceived size and systemic importance following the acquisition of HBOS. Such scrutiny may focus on, or include review of, the historical operations of the HBOS Group as well as the characteristics of the enlarged Group. The outcome of any regulatory review, proceeding or complaint against the Group, including HBOS, is inherently uncertain and difficult to predict. In clearing the acquisition of HBOS without a reference to the UK Competition Commission, the Secretary of State noted that there were some competition concerns identified by the OFT in the markets for personal current accounts and mortgages in Great Britain and the market for SME banking in Scotland. The OFT has also reiterated that it will consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition.

In April 2009 the OFT indicated its intention to focus its efforts in the financial services markets on the banking sector, including credit, leasing and debt recovery activities. Amongst other plans, it has announced its intention to launch a review of the unsecured consumer credit sector in 2009.

The FSA published the Turner Review ( A Regulatory Response to the Global Banking Crisis ) on 18 March 2009. The Turner Review assesses the various factors which contributed to the severe financial problems suffered by banks at the end of 2008, and then considers a wide range of proposals to counter these factors and reform global financial regulation. These proposals include significantly increasing banks' minimum regulatory capital requirements, regulating banks' liquidity requirements, requiring banks to establish capital buffers, a maximum growth leverage ratio to prevent banks' excessive expansion, authorities' power to obtain information on significant unregulated financial institutions, central counterparty clearing of credit derivatives, and a major shift in the supervisory approach of the FSA, with an increased focus on high impact, complex and systemically important firms, business models and approved persons' technical skills. New arrangements for co-ordinated cross-border supervision of international and EU banking groups are also proposed. The FSA has also published a discussion paper intended to elicit market participants' comments on many of the proposals contained in the Turner Review. The impact of the proposals on banks and their business models is likely, in the view of the Group, to be very significant. The fundamental changes to capital and liquidity requirements could have a substantial impact on the shape of banks' business models. In the Group's view, banks can also expect a shift from the previous 'light touch' principles-based regime to an intensive, and interventionist, rules-based regime. The cost of compliance with these proposals may well lead to reduced profitability, as well as to a lower return on equity.

The FSA published a Feedback Statement on the Turner Review and associated discussion paper on 30 September 2009. This continues the debate regarding how systemically important firms are dealt with, suggesting they should be required to produce recovery and resolution plans ( 'living wills' ) setting out how operations would be resolved in the event that the bank fails. Given the Group's systemic importance this is highly significant. If a bank's living will is deemed insufficient by the FSA and contains serious obstacles to resolution it could result in restructuring of the relevant bank's group.

A second Turner Review discussion paper (October 2009) developed issues highlighted for further discussion in the March review, specifically how to offset the moral hazard created by the existence of systemically important banks and the cumulative impact of changes to the capital and liquidity schemes. Key proposals include: using contingent capital which converts to equity when required; reducing the interconnectedness of large cross-border banks; restricting retail banks from engaging in proprietary trading activities; and emphasising the need to prioritise capital conservation and enhancement above employee bonus payments.

## RISK FACTORS

Amendments to a number of EU directives are being considered, including the Distance Marketing Directive, Markets in Financial Instruments Directive; Capital Requirements Directive, E-Money Directive, Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the Financial Groups Directive.

Compliance with any changes in regulation or with any regulatory intervention resulting from political or regulatory scrutiny may significantly increase the Group's costs, impede the efficiency of its internal business processes, limit its ability to pursue business opportunities, or diminish its reputation. Any of these consequences could have a material adverse effect on the Group's operating results, financial condition and prospects.

***In the United Kingdom, firms 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.***

In the United Kingdom, the Financial Services Compensation Scheme (FSCS) was established under the FSMA and is the UK's statutory fund of last resort for customers of authorised financial services firms. 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 FSA, including firms within the Group. The recent arrangements put in place to protect the depositors of Bradford & Bingley and other failed deposit-taking institutions involving the FSCS are expected to result in a significant increase in the levies made by the FSCS on the industry. The Group continues to provide for its share of the management expenses levy and the estimated interest cost on the FSCS borrowings. Going forward, further provisions in respect of these costs are likely to be necessary until the borrowings are repaid. 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 although it may be significant and the associated costs to the Group may have a material adverse effect on its results of operations and financial condition.

The FSA requires that UK deposit-taking institutions develop systems by 31 December 2010 to produce a Single Customer View (SCV), providing an aggregated view of each customer's eligibility for compensation in the event of a failure. In the event that the Group fails to deliver such a project to the regulator's standards or timetables, there is the risk of public sanction, financial penalty and/or the deployment by the FSA of such other regulatory tools as it deems appropriate to the circumstances. Other potential changes to the FSCS arrangements with the potential to require the Group to incur additional costs or expose the Group to risks may arise from ongoing discussions at the national and European Union levels around the future design of deposit protection schemes, including but not limited to potentially increasing the level of protection which is accorded to deposits and/or moving to pre-funding of compensation schemes. FSA intends to carry out a consultation exercise in the fourth quarter of 2010 before introducing any further proposals relating to the FSCS.

From 1 January 2010 (subject to the rules of the FSCS):

eligible deposit claimants remain entitled to receive 100 per cent. compensation for financial loss up to £50,000;

eligible investment business and mortgage advice and arranging claimants are entitled to receive 100 per cent. compensation for financial loss up to £50,000; and

eligible insurance claimants are entitled to receive 90 per cent. of the claim (except compulsory insurance for which it is 100 per cent. of the claim).

On 16 March 2009, the European Directive on Deposit Guarantee Schemes (1994/19/EC) was amended by Directive 2009/14/EC (the Amended Directive). The Amended Directive required EU Member States, by 30 June 2009, to increase the minimum level of coverage they provide for deposits from 20,000 to 50,000 and to reduce the payout period in the event of bank failure from three months to 20 days. Furthermore, by 31 December 2010, Member States must set coverage for the aggregate deposits of each depositor at 100,000.

The FSA announced further changes to the FSCS on 24 July 2009, which in part seek to implement the fast payout rules set out under the Amended Directive referred to above through a SCV. In addition, the other key changes announced by the FSA to the FSCS include the following:

Changing the payout of compensation to avoid customers who hold loans and deposits with the same institution having any debt deducted from their compensation;

Widening eligibility of the FSCS to include more individuals;

Introducing a requirement that deposit takers must disclose the existence of the FSCS and the level of protection it offers to help familiarise consumers with the services it provides; and

If an institution operates under a number of trading names, it must tell its customers which of the different trading names are covered by a particular authorisation.

***The Group is exposed to various forms of legal and regulatory risk, including the risk of mis-selling financial products, acting in breach of legal or regulatory principles or requirements and giving negligent advice, any of which could have a material adverse effect on its results or its relations with its customers.***

The Group is exposed to many forms of legal and regulatory risk, which may arise in a number of ways. Primarily:

- (i) certain aspects of the Group's business may be determined by the authorities, the Financial Ombudsman Service (FOS) or the courts as not being conducted in accordance with applicable laws or regulations, or, in the case of 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) contractual obligations may either not be enforceable as intended or may be enforced against the Group in an adverse way;
- (iv) the Group holds accounts for a number of customers that might be or are subject to interest from various regulators and authorities including the Serious Fraud Office, those in the US and others. The Group is not aware of any current investigation into the Group as a result of any such enquiries but cannot exclude the possibility of the Group's conduct being reviewed as part of any such investigations;
- (v) the intellectual property of the Group (such as trade names) may not be adequately protected; and
- (vi) the Group may be liable for damages to third parties harmed by the conduct of its business.

## RISK FACTORS

In addition, the Group faces risk where legal or regulatory proceedings, or other complaints are brought against it in the UK High Court or elsewhere, or in jurisdictions outside the UK, including other European countries and the United States (which may include class action lawsuits), for example, see note 52 to the consolidated financial statements. A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and terrorist financing and enforcing compliance with US economic sanctions.

Failure to manage these risks adequately could impact the Group adversely, both financially and reputationally, through an adverse impact on the Group's brands.

## OPERATIONAL RISKS AND RELATED ISSUES

### ***The Group could fail to attract or retain senior management or other key employees.***

The Group's success depends on the ability and experience of its senior management and other key employees. The loss of the services of certain key employees, particularly to competitors, could have a material adverse effect on the Group's results of operations, financial condition and prospects. In addition, as the Group's businesses develop, both in the UK and in other jurisdictions, future success will depend on the ability to attract and retain highly-skilled and qualified personnel, which cannot be guaranteed, particularly in light of the increased regulatory intervention in financial institutions and management compensation arrangements coming under government prescription. For example, the Group's remuneration arrangements are subject to the FSA's Rule and supporting Code on remuneration (which only apply to certain financial institutions), effective from 1 January 2010 for the 2009 performance year. In addition, in the GAPS Withdrawal Deed, the Company has acknowledged to HM Treasury its commitment to the principle that, from 2010, it should be at the leading edge of implementing the G20 principles, the FSA code and any remuneration provisions accepted by the Government from the Walker Review, provided that this principle shall always allow the Group to operate on a level playing field with its competitors. Furthermore, the Company has agreed with HM Treasury the specific deferral and clawback terms which will apply to any bonuses in respect of the 2009 performance year and these may affect the Group's ability to offer competitive remuneration arrangements.

Therefore, depending on the nature of the remuneration arrangements developed, staff retention and recruitment may become more difficult. The failure to attract or retain a sufficient number of appropriate personnel could significantly impede the Group's financial plans, growth and other objectives and have an adverse effect on its business, financial position and results of operations.

In addition, failure to manage trade union relationships effectively may result in disruption to the business and its operations causing potential financial and reputational loss.

### ***Weaknesses or failures in the Group's internal processes and procedures and other operational risks could materially adversely affect the Group's results of operations, financial condition and prospects and could result in reputational damage.***

Operational risks, through inadequate or failed internal processes and/or systems (including financial reporting and risk monitoring processes) 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 their ability to process and report 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 in such internal controls and processes could have a negative impact on the Group's results or its ability to report adequately such results during the affected period. Furthermore, damage to the Group's reputation (including to customer confidence) arising from actual or perceived inadequacies, weaknesses or failures in Group systems or processes could have a significant adverse impact on the Group's businesses. 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 FSA (as the case may be).

### ***Terrorist acts, other acts of war, geopolitical, pandemic or other such events could have a material adverse impact on the Group's results of operations, financial condition and prospects.***

Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts/events may create economic and political uncertainties, which could have a material adverse impact on UK and international economic conditions generally, and more specifically on the business and results of the Group in ways that cannot necessarily be predicted.

## OTHER RISKS

***The Group's financial statements are based in part on assumptions and estimates which, if wrong, could cause losses in the future.***

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to the Group's results and financial position, based upon materiality and significant judgements and estimates, include impairment of financial assets; valuation of financial instruments; pensions; goodwill; insurance and taxation; which are discussed in detail in Critical Accounting Estimates and Judgements set out on pages F-19 to F-23 of this document.

If the judgements, estimates and assumptions used by the Group in preparing its consolidated financial statements are subsequently found to be incorrect, there could be a material impact on the Group's results of operations and a corresponding impact on its funding requirements and capital ratios.

***The Company is a holding company and as a result, is dependent on dividends from its subsidiaries to meet its obligations including its obligations with respect to its debt securities, and to provide funds for payment of dividends to shareholders.***

Lloyds Banking Group plc is a non-operating holding company and as such the principal sources of its income are from operating subsidiaries who also hold the principal assets of the Group. As a separate legal entity, the Company relies on remittance of their dividends and other funds in order to be able to pay obligations to shareholders and debt holders as they fall due.

## RISK FACTORS

### ***Possible volatility in the price of Lloyds Banking Group plc ordinary shares.***

The market price of the Lloyds Banking Group plc ordinary shares could be volatile and subject to significant fluctuations due to a variety of factors, including changes in market sentiment regarding Lloyds Banking Group plc ordinary shares (or securities similar to them), any regulatory changes affecting Lloyds Banking Group's operations, variations in its operating results, developments in the industry or its competitors, the operating and share price performance of other companies in the industries and markets in which Lloyds Banking Group operates, or speculation about the Group's business in the press, media or investment communities. Stock markets have from time to time, including recently and particularly with respect to certain financial institution shares, experienced significant price and volume fluctuations. Such fluctuations have affected market prices for securities, including the Lloyds Banking Group plc ordinary shares, and may be unrelated to the Group's operating performance or prospects. Furthermore, the Group's operating results and prospects from time to time may be below the expectations of market analysts and investors. Any of these events could result in a decline in the market prices of Lloyds Banking Group plc ordinary shares. In general, prospective investors should be aware that the value of an investment in Lloyds Banking Group plc ordinary shares may go down as well as up.

### ***Failure to manage the risks associated with changes in taxation rates or law, or misinterpretation of the law, could materially and adversely affect the Group's results of operations, financial condition and prospects.***

Tax risk is the risk associated with changes in taxation rates or law, or misinterpretation of the law. This could result in increased charges, financial loss including penalties, and reputational damage. Failure to manage these risks adequately could impact the Group materially and adversely and could have a material negative impact on the Group's performance.

### ***Following the acquisition of HBOS, any further increase in HM Treasury's shareholding percentage in the Company, or the aggregation of HM Treasury's interests with that of other shareholders holding 5 per cent or more, could lead to the Group suffering adverse tax consequences.***

Certain companies have material tax losses and reliefs which they anticipate carrying forward to reduce tax payable in the future and restrictions on the ability to utilise these losses and reliefs could affect the post-tax profitability and capital position of the Group.

Following the acquisition of HBOS, actions which could possibly cause the loss of these reliefs to occur would include any further increase in HM Treasury's shareholding in Lloyds Banking Group plc, or the aggregation of HM Treasury's interests with that of other shareholders holding 5 per cent or more. These actions, if coupled with the occurrence of certain specified events in relation to the Group companies (including a major change in the nature or conduct of a trade carried on by such a Group company or an increase in capital of such a Group company with an investment business) would, in the case of legacy HBOS Group companies, and could, in the case of legacy Lloyds TSB Group companies, cause restrictions on the ability to utilise these losses and reliefs.

The Company considers that it will be able to conduct its business, and the business of the Group, in a manner which avoids the occurrence of these specified events. However, the ability to do so cannot be predicted with any certainty at the date of this document.



## FORWARD LOOKING STATEMENTS

This annual report includes certain forward looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995 with respect to the business, strategy and plans 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, likely, estimated, 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 occur in the future.

Examples of such forward looking statements include, but are not limited to, projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, expenditures or any other financial items or ratios; statements of plans, objectives or goals of Lloyds Banking Group or its management including in respect of the integration of HBOS and the achievement of certain synergy targets; statements about the future business and economic environments in the United Kingdom (UK) and elsewhere including future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments and any impact on the Group; statements about strategic goals, 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 results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by Lloyds Banking Group or on Lloyds Banking Group's behalf include, but are not limited to the risks identified above under *Risk factors*, as well as general economic conditions in the UK and internationally; inflation, deflation, interest rates, policies of the Bank of England and other G8 central banks and interest rate, exchange rate, market and monetary fluctuations; changing demographic developments including mortality and changing customer behaviour including consumer spending, saving and borrowing habits, borrower credit quality, technological changes, natural and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes, people and systems; terrorist acts and other acts of war or hostility and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, taxation, government policies, including those relating to share ownership, or accounting standards or practices and similar contingencies outside Lloyds Banking Group's control; the ability to derive cost savings and other benefits as well as mitigate exposures from the acquisition and integration of HBOS; inadequate or failed internal or external processes, people and systems; exposure to regulatory scrutiny, legal proceedings or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the ability to secure new customers and develop more business from existing customers; the degree of borrower credit quality; the ability to achieve value-creating mergers and/or acquisitions at the appropriate time and prices and the success of Lloyds Banking Group in managing the risks of the foregoing.

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 law, the forward looking statements contained in this annual report 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 annual report 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.

## LLOYDS BANKING GROUP STRUCTURE

The following is a list of the significant subsidiaries of Lloyds Banking Group plc at 31 December 2009.

Name of subsidiary undertaking	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business	Registered office
Lloyds TSB Bank plc	England	100%	Banking and financial services	25 Gresham Street London EC2V 7HN
Scottish Widows plc	Scotland	100%*	Life assurance	69 Morrison Street Edinburgh EH3 8Y
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
Clerical Medical Investment Group Limited	England	100%*	Life assurance	33 Old Broad Street London EC2N 1HZ

\* Indirect interest

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INDEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

<u>Report of the Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated income statement for the three years ended 31 December 2009, 31 December 2008 and 31 December 2007</u>	F-3
<u>Consolidated statement of comprehensive income for the three years ended 31 December 2009, 31 December 2008 and 31 December 2007</u>	F-4
<u>Consolidated balance sheet at 31 December 2009 and 31 December 2008</u>	F-5
<u>Consolidated statement of changes in equity for the three years ended 31 December 2009, 31 December 2008 and 31 December 2007</u>	F-7
<u>Consolidated cash flow statement for the three years ended 31 December 2009, 31 December 2008 and 31 December 2007</u>	F-8
<u>Notes to the consolidated financial statements</u>	F-9

F-1

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## REPORT OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

### TO THE SHAREHOLDERS OF LLOYDS BANKING GROUP PLC

In our opinion, the accompanying consolidated income statement, consolidated statement of comprehensive income, consolidated balance sheet, consolidated statement of changes in equity and consolidated cash flow statement present fairly, in all material respects, the financial position of Lloyds Banking Group plc and its subsidiaries (the Company) at 31 December 2009 and 2008 and the results of their operations and cash flows for each of the three years in the period ended 31 December 2009, in conformity with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB). Also, in our opinion the Company maintained, in all material respects, effective internal control over financial reporting as of 31 December 2009, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). The Company's management is responsible for these 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 the Management Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. 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.

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.

As described in *Corporate governance – Management report on internal control over financial reporting*, management's assessment of and conclusion on the effectiveness of internal control over financial reporting as of 31 December 2009 excludes internal controls over the HBOS plc business which was acquired in a purchase business combination on 16 January 2009, except for controls over certain assets where the progress of integration with the Company's assets made it possible for these to be included. We have also excluded HBOS plc from our audit of internal control over financial reporting, except for controls over certain assets where the progress of integration with the Company's assets made it possible for these to be included. The HBOS plc business which has not been included represented approximately 49 per cent of the Company's total income and 56 per cent of the Company's total assets for the year ended 31 December 2009.

PricewaterhouseCoopers LLP  
Edinburgh, United Kingdom

25 February 2010, except for note 4 to the consolidated financial statements, as to which the date is 13 May 2010

**CONSOLIDATED INCOME STATEMENT**

for the year ended 31 December 2009

	Note	2009 £ million	2008 <sup>1</sup> £ million	2007 <sup>1</sup> £ million
Interest and similar income		<b>28,238</b>	17,569	16,874
Interest and similar expense		<b>(19,212)</b>	(9,851)	(10,775)
<b>Net interest income</b>	5	<b>9,026</b>	7,718	6,099
Fee and commission income		<b>4,254</b>	3,231	3,224
Fee and commission expense		<b>(1,517)</b>	(694)	(600)
Net fee and commission income	6	<b>2,737</b>	2,537	2,624
Net trading income	7	<b>19,098</b>	(9,186)	3,123
Insurance premium income	8	<b>8,946</b>	5,412	5,430
Other operating income	9	<b>5,490</b>	528	942
<b>Other income</b>		<b>36,271</b>	(709)	12,119
<b>Total income</b>		<b>45,297</b>	7,009	18,218
Insurance claims	10	<b>(22,019)</b>	2,859	(7,522)
<b>Total income, net of insurance claims</b>		<b>23,278</b>	9,868	10,696
Operating expenses	11	<b>(15,984)</b>	(6,100)	(5,568)
<b>Trading surplus</b>		<b>7,294</b>	3,768	5,128
Impairment	12	<b>(16,673)</b>	(3,012)	(1,796)
Share of results of joint ventures and associates	13	<b>(752)</b>	4	10
Profit on sale of businesses	9			657
Gain on acquisition	14	<b>11,173</b>		
<b>Profit before tax</b>		<b>1,042</b>	760	3,999
Taxation	15	<b>1,911</b>	38	(679)
<b>Profit for the year</b>		<b>2,953</b>	798	3,320
Profit attributable to minority interests		<b>126</b>	26	32
Profit attributable to equity shareholders		<b>2,827</b>	772	3,288
<b>Profit for the year</b>		<b>2,953</b>	798	3,320
<b>Basic earnings per share</b>	16	<b>7.5p</b>	6.7p	28.9p
<b>Diluted earnings per share</b>	16	<b>7.5p</b>	6.6p	28.7p

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

<sup>1</sup> Restated for IFRS 2 (Revised)

**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**

for the year ended 31 December 2009

	<b>2009</b>	2008 <sup>1</sup>	2007 <sup>1</sup>
	<b>£ million</b>	£ million	£ million
<b>Profit for the year</b>	<b>2,953</b>	798	3,320
<b>Other comprehensive income</b>			
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax:			
Change in fair value	<b>1,936</b>	(2,031)	(436)
Transferred to income statement in respect of disposals	<b>(74)</b>	(19)	(5)
Transferred from income statement in respect of impairment	<b>453</b>	102	49
Other transfers to income statement	<b>(67)</b>	(66)	(6)
	<b>2,248</b>	(2,014)	(398)
Movement in cash flow hedging reserve, net of tax:			
Effective portion of changes in fair value taken to other comprehensive income	<b>(382)</b>	(24)	(14)
Net gains transferred to the income statement	<b>92</b>	12	(1)
	<b>(290)</b>	(12)	(15)
Currency translation differences, net of tax	<b>(219)</b>	(362)	16
<b>Other comprehensive income for the year, net of tax</b>	<b>1,739</b>	(2,388)	(397)
<b>Total comprehensive income for the year</b>	<b>4,692</b>	(1,590)	2,923
Total comprehensive income attributable to minority interests	<b>107</b>	54	31
Total comprehensive income attributable to equity shareholders	<b>4,585</b>	(1,644)	2,892
<b>Total comprehensive income for the year</b>	<b>4,692</b>	(1,590)	2,923

<sup>1</sup> Restated for IFRS 2 (Revised)

**CONSOLIDATED BALANCE SHEET**

at 31 December 2009

	Note	2009 £ million	2008 £ million
<b>Assets</b>			
Cash and balances at central banks		<b>38,994</b>	5,008
Items in the course of collection from banks		<b>1,579</b>	946
Trading and other financial assets at fair value through profit or loss	17	<b>150,011</b>	45,064
Derivative financial instruments	18	<b>49,928</b>	28,884
Loans and receivables:			
Loans and advances to banks	19	<b>35,361</b>	38,733
Loans and advances to customers	20	<b>626,969</b>	240,344
Debt securities	23	<b>32,652</b>	4,416
		<b>694,982</b>	283,493
Available-for-sale financial assets	25	<b>46,602</b>	55,707
Investment properties	26	<b>4,757</b>	2,631
Investments in joint ventures and associates	13	<b>479</b>	55
Goodwill	27	<b>2,016</b>	2,256
Value of in-force business	28	<b>6,685</b>	1,893
Other intangible assets	29	<b>4,087</b>	197
Tangible fixed assets	30	<b>9,224</b>	2,965
Current tax recoverable		<b>680</b>	300
Deferred tax assets	42	<b>5,006</b>	833
Other assets	31	<b>12,225</b>	5,801
<b>Total assets</b>		<b>1,027,255</b>	436,033

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

The directors approved the consolidated financial statements on 25 February 2010, except for note 4, as to which the date is 13 May 2010.

**Sir Winfried Bischoff**  
Chairman

**J Eric Daniels**  
Group Chief Executive

**Tim J W Tookey**  
Group Finance Director

**F-5**



## CONSOLIDATED BALANCE SHEET

at 31 December 2009

	Note	2009 £ million	2008 £ million
<b>Equity and liabilities</b>			
<b>Liabilities</b>			
Deposits from banks	32	82,452	66,514
Customer deposits	33	406,741	170,938
Items in course of transmission to banks		1,037	508
Trading and other financial liabilities at fair value through profit or loss	34	28,271	6,754
Derivative financial instruments	18	40,485	26,892
Notes in circulation		981	
Debt securities in issue	35	233,502	75,710
Liabilities arising from insurance contracts and participating investment contracts	36	76,179	33,792
Liabilities arising from non-participating investment contracts	38	46,348	14,243
Unallocated surplus within insurance businesses	39	1,082	270
Other liabilities	40	29,320	11,456
Retirement benefit obligations	41	780	1,771
Current tax liabilities		51	
Deferred tax liabilities	42	209	
Other provisions	43	983	230
Subordinated liabilities	44	34,727	17,256
<b>Total liabilities</b>		<b>983,148</b>	<b>426,334</b>
<b>Equity</b>			
Share capital	45	10,472	1,513
Share premium account	46	14,472	2,096
Other reserves	47	7,086	(2,476)
Retained profits	48	11,248	8,260
<b>Shareholders equity</b>		<b>43,278</b>	<b>9,393</b>
Minority interests		829	306
<b>Total equity</b>		<b>44,107</b>	<b>9,699</b>
<b>Total equity and liabilities</b>		<b>1,027,255</b>	<b>436,033</b>

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

## CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

## Attributable to equity shareholders

	Share capital and premium £ million	Other reserves £ million	Retained profits <sup>1</sup> £ million	Minority interests £ million	Total <sup>1</sup> £ million
<b>Balance at 1 January 2007</b>	2,695	336	8,124	352	11,507
Total comprehensive income		(396)	3,288	31	2,923
Dividends			(1,957)	(19)	(1,976)
Purchase/sale of treasury shares			(1)		(1)
Employee share option schemes: Value of employee services			17		17
Proceeds from shares issued	35				35
Repayment of capital to minority shareholders				(80)	(80)
<b>Balance at 31 December 2007</b>	2,730	(60)	9,471	284	12,425
Total comprehensive income		(2,416)	772	54	(1,590)
Dividends			(2,042)	(29)	(2,071)
Private placement of ordinary shares	760				760
Purchase/sale of treasury shares			16		16
Employee share option schemes: Value of employee services			43		43
Proceeds from shares issued	119				119
Repayment of capital to minority shareholders				(3)	(3)
<b>Balance at 31 December 2008</b>	3,609	(2,476)	8,260	306	9,699
Total comprehensive income		1,758	2,827	107	4,692
Dividends				(116)	(116)
Issue of ordinary shares:					
Placing and open offer	649	3,781			4,430
Issued on acquisition of HBOS	1,944	5,707			7,651
Placing and compensatory open offer	3,905				3,905
Rights issue	13,112				13,112
Issued to Lloyds TSB Foundations	41				41
Transfer to merger reserve	(1,000)	1,000			
Redemption of preference shares	2,684	(2,684)			
Purchase/sale of treasury shares			45		45
Employee share option schemes: Value of employee services			116		116
Adjustment on acquisition				5,567	5,567
Extinguishment of minority interests				(5,035)	(5,035)
<b>Balance at 31 December 2009</b>	24,944	7,086	11,248	829	44,107

<sup>1</sup>Restated for IFRS 2 (Revised)

**CONSOLIDATED CASH FLOW STATEMENT**

for the year ended 31 December 2009

	Note	2009 £ million	2008 <sup>1</sup> £ million	2007 <sup>1</sup> £ million
<b>Profit before tax</b>		<b>1,042</b>	760	3,999
Adjustments for:				
Change in operating assets	55(A)	<b>61,942</b>	(43,025)	(16,982)
Change in operating liabilities	55(B)	<b>(105,927)</b>	80,933	21,541
Non-cash and other items	55(C)	<b>8,907</b>	(4,017)	2,785
Tax received (paid)		<b>301</b>	(810)	(859)
<b>Net cash (used in) provided by operating activities</b>		<b>(33,735)</b>	33,841	10,484
<b>Cash flows from investing activities</b>				
Purchase of available-for-sale financial assets		<b>(455,816)</b>	(144,680)	(21,667)
Proceeds from sale and maturity of available-for-sale financial assets		<b>490,561</b>	110,470	19,468
Purchase of fixed assets		<b>(2,689)</b>	(1,436)	(1,334)
Proceeds from sale of fixed assets		<b>2,129</b>	579	982
Acquisition of businesses, net of cash acquired	55(F)	<b>16,227</b>	(19)	(8)
Disposal of businesses, net of cash disposed	55(G)	<b>411</b>		1,476
<b>Net cash provided by (used in) investing activities</b>		<b>50,823</b>	(35,086)	(1,083)
<b>Cash flows from financing activities</b>				
Dividends paid to equity shareholders			(2,042)	(1,957)
Dividends paid to minority interests	55(E)	<b>(116)</b>	(29)	(19)
Interest paid on subordinated liabilities		<b>(2,622)</b>	(771)	(709)
Proceeds from issue of subordinated liabilities	55(E)	<b>4,187</b>	3,021	
Proceeds from issue of ordinary shares	55(E)	<b>21,533</b>	879	35
Repayment of subordinated liabilities	55(E)	<b>(6,897)</b>	(381)	(300)
Repayment of capital to minority shareholders	55(E)	<b>(33)</b>	(3)	(80)
<b>Net cash provided by (used in) financing activities</b>		<b>16,052</b>	674	(3,030)
Effects of exchange rate changes on cash and cash equivalents		<b>(210)</b>	1,440	82
Change in cash and cash equivalents		<b>32,930</b>	869	6,453
Cash and cash equivalents at beginning of year		<b>32,760</b>	31,891	25,438
<b>Cash and cash equivalents at end of year</b>	55(D)	<b>65,690</b>	32,760	31,891

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

<sup>1</sup> Restated for IFRS 2 (Revised)

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 1 BASIS OF PREPARATION

The consolidated financial statements of Lloyds Banking Group plc (prior to 16 January 2009 known as Lloyds TSB Group plc) have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 *Financial Instruments: Recognition and Measurement* relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB.

The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts. The 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 *Operating and financial review and prospects Risk management Principal risks and Operating and financial review and prospects Financial soundness* and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

To provide a more relevant presentation of the Group's financial instruments, additional line items have been added to the consolidated balance sheet to show debt securities classified as loans and receivables separately. Comparatives have been reclassified to conform to the revised presentation.

The following IFRS pronouncements relevant to the Group have been adopted in these consolidated financial statements:

- (i) *IAS 1 Presentation of Financial Statements*. The revised standard prohibits the presentation of items of income and expense (that is non-owner changes in equity) in the statement of changes in equity, requiring non-owner changes in equity to be presented separately from owner changes in equity. All non-owner changes in equity are required to be shown in a performance statement. Entities can choose whether to present one performance statement (the statement of comprehensive income) or two statements (the income statement and statement of comprehensive income). The Group has elected to present two statements: an income statement and a statement of comprehensive income. The financial statements have been prepared under the revised disclosure requirements; the application of this revised standard, which affects presentation only, has not had any impact on amounts recognised in these financial statements.
- (ii) *Amendment to IFRS 2 Share-based Payment Vesting Conditions and Cancellations*. This amendment to IFRS 2 restricts the definition of vesting condition to a condition that includes an explicit or implicit requirement to provide services. Any other conditions are non-vesting conditions, which have to be taken into account to determine the fair value of the equity instruments granted. In the case that the award does not vest as the result of a failure to meet a non-vesting condition that is within the control of either the entity or the counterparty, this must be accounted for as a cancellation. The main impact of this amendment for the Group arises from cancellations by employees of contributions to the Group's Save-As-You-Earn (SAYE) schemes; in the event of a cancellation the Group must recognise immediately the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Under the former IFRS 2, such cancellations would have resulted in the reversal of the costs recognised in current and prior periods in respect of the SAYE schemes concerned for the relevant employees. The amendment is applied retrospectively and has resulted in a restatement of the 2008 comparatives. The effect has been to increase operating expenses and reduce profit before tax by £43 million in 2009 (2008: £47 million; 2007: £1 million) but has had no effect on the Group's balance sheet or shareholders' equity as the increased expense is offset by movements in retained profits.
- (iii) *Amendments to IFRS 7 Financial Instruments: Disclosures Improving Disclosures about Financial Instruments*. The amendments require enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of a three level fair value measurement hierarchy for financial instruments carried on the Group's balance sheet at fair value. As the amendments only result in additional disclosures, the amendments have not had any impact on amounts recognised in these financial statements.
- (iv) *IFRS 8 Operating Segments*. This new standard replaces IAS 14 *Segment Reporting* and requires reporting of financial and descriptive information about operating segments which are based on how financial information is reported and evaluated

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internally. The segment information for the year ended 31 December 2009 and for the corresponding comparative period is presented in note 4. The application of this new standard, which affects disclosures only, has not had any impact for amounts recognised in these financial statements.

The application of the following IFRS pronouncements which all became effective in 2009 has had no material impact on these financial statements:

*Amendments to IFRIC 9 Reassessment of Embedded Derivatives and IAS 39 Financial Instruments: Recognition and Measurement.* This amendment clarifies that a reassessment of embedded derivatives is required whenever a financial asset has been reclassified out of the fair value through profit or loss category.

*IFRIC 13 Customer Loyalty Programmes.* This interpretation addresses accounting by entities who grant customer loyalty award credits to customers as part of sales transactions and which can be redeemed in the future for free or discounted goods or services. The majority of customer loyalty award schemes are operated by third parties.

*IFRIC 16 Hedges of a Net Investment in a Foreign Operation.* This interpretation provides guidance on accounting for hedges of net investments in foreign operations in an entity's consolidated financial statements.

*IAS 23 Borrowing Costs.* This revised standard requires interest and other costs incurred in connection with the borrowing of funds to be recognised as an expense excepting that those which are directly attributable to the acquisition, construction or production of assets that take a substantial period of time to get ready for their intended use or sale must be capitalized as part of the cost of those assets.

*Amendments to IAS 32 and IAS 1 Puttable Financial Instruments and Obligations Arising on Liquidation.* The amendments require some puttable financial instruments (being those which give the holder the right to put the instrument back to the issuer for cash or another financial asset) and some financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation to be classified as equity.

*Improvements to IFRSs* (issued May 2008). Sets out minor amendments to IFRS standards as part of annual improvements process. Most amendments clarified existing practice.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2009 and which have not been applied in preparing these financial statements are given in note 56.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES

The Group's accounting policies are set out below.

#### (A) CONSOLIDATION

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures.

##### (1) SUBSIDIARIES

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. 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. Details of the principal subsidiaries are given in note 9 to the parent company financial statements.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control, typically through acting as fund manager and the life funds having a beneficial interest greater than 50 per cent, are consolidated. The minority unitholders interest is reported in other liabilities.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The Group applies a policy of treating transactions with minority interests as transactions with parties external to the Group. Disposals to minority interests result in gains and losses for the Group that are recorded in the income statement. Purchases from minority interests result in goodwill, being the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary.

##### (2) JOINT VENTURES AND ASSOCIATES

Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally 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 and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

#### (B) GOODWILL

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill 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. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. 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 except where it has been written off directly to reserves in the past.

**(C) OTHER INTANGIBLE ASSETS**

Other intangible assets include brands, core deposit intangibles, purchased credit card relationships, customer-related intangibles and capitalised software enhancements. 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:

Capitalised software enhancements	up to 5 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangibles	up to 8 years
Purchased credit card relationships	5 years

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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (D) REVENUE RECOGNITION

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense 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.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected 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 in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see accounting policy 2(H)).

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. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

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

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see accounting policy 2(O)).

#### (E) FINANCIAL ASSETS AND LIABILITIES

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets 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. Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

##### (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 accounting policy 2(F)).

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.

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



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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. As noted in accounting policy 2(A)(2), certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.

where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

The Group is permitted to reclassify, at fair value at the date of transfer, non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the trading category if they are no longer held for the purpose of being sold or repurchased in the near term, as follows:

if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity;

if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in rare circumstances.

**F-11**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (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 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. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in 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, at fair value at the date of transfer, a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. For assets transferred, gains or losses recognised in equity in respect of these assets as at the date of transfer are amortised to profit or loss over the remaining life of the asset using the effective interest method.

#### (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 accounting policy 2(D)) less provision for impairment (see accounting policy 2(H)).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. These loans and advances to customers 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.

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 together with any related costs or fees incurred.

#### (5) SALE AND REPURCHASE AGREEMENTS

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

(6) DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

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 the risks and rewards, but has transferred control. Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**2 ACCOUNTING POLICIES** continued**(F) DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING**

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Valuation of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) 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.

The method of recognising the movements in the fair value of the derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. 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 the same. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and 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.

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

**(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 in net investments 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. 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (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 and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

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

Delinquency in contractual payments of principal and/or interest;

Indications that the borrower or group of borrowers is experiencing significant financial difficulty;

Restructuring of debt to reduce the burden on the borrower;

Breach of loan covenants or conditions; and

Initiation of bankruptcy or individual voluntary arrangement proceedings.

For impaired debt instruments which are classified as loans and receivables, 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.

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

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the balance sheet carrying value of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate.

For the Group's portfolios of smaller balance homogenous loans, such as the residential mortgage, personal lending and credit card portfolios, allowances are calculated for groups of assets taking into account historical cash flow experience. For the Group's other lending portfolios, allowances are established on a case-by-case basis. The calculation of the present value of the estimated future cash flows of a collateralised asset or group of assets reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

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

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

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

written off decrease the amount of impairment losses recorded in the income statement.

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see accounting policy 2(A)). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

## (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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (I) INVESTMENT PROPERTY

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the life insurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income for investment property within the life insurance funds and as other operating income for other investment property.

#### (J) TANGIBLE FIXED ASSETS

Tangible fixed assets are 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:

Premises (excluding land):

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

Leasehold improvements: shorter of 10 years or, if lease renewal is not likely, the remaining period of the lease

Equipment:

Fixtures and furnishings: 10-20 years

Other equipment and motor vehicles: 2-8 years

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

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

#### (K) 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.



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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.

**F-15**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (L) PENSIONS AND OTHER POST-RETIREMENT BENEFITS

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

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

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

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

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

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

#### (M) 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. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement over the remaining vesting period, 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 in accordance with the revised IFRS 2 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 over any remaining vesting period.

#### (N) TAXATION

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

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

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

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such deferred tax is subsequently transferred to the income statement together with the deferred gain or loss.

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

F-16

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (O) INSURANCE

The Group undertakes both life insurance and general insurance business.

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 entitles the holder 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 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.

#### (1) LIFE INSURANCE BUSINESS

##### *(1) 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*

**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 Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in unallocated surplus (see below). Further details on the realistic capital regime are given on page 91. Changes in the value of these liabilities are recognised through insurance claims.

**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.

Changes in the value of these liabilities are recognised in the income statement through insurance claims.

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. Changes in the value of the liability are recognised in the income statement through insurance claims. 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 income allocated to non-participating investment contracts are included 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 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 is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through fee and commission expense in the income statement. All other costs are recognised as expenses when incurred.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (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 is 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 and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

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

#### (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 losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured 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.

**(P) 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). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation 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.

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 accounting policy 2(F)(3)). On disposal 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 2 ACCOUNTING POLICIES continued

#### (Q) PROVISIONS

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

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

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

#### (R) SHARE CAPITAL

##### (1) SHARE ISSUE COSTS

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.

##### (2) DIVIDENDS

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

##### (3) TREASURY SHARES

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. Where such shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

#### (S) 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.

## 3 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The preparation of the Group's financial statements 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 discussed below.

#### ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2(H)(1). 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. Impairment allowances are established to recognise incurred impairment losses in the Group's loan portfolios carried at amortised cost. In determining whether an impairment has occurred at the balance sheet date the Group considers whether there is any observable data indicating that there has been a measurable decrease in the estimated future cash



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flows or their timings. Where this is the case, the impairment loss is the difference between the carrying value of the loan and the present value of the estimated future cash flows discounted at the loan's original effective interest rate.

At 31 December 2009 gross loans and receivables totalled £710,362 million (2008: £287,220 million) against which impairment allowances of £15,380 million (2008: £3,727 million) had been made (see note 24). Impairment allowances are made up of two components, those determined individually and those determined collectively.

### INDIVIDUAL COMPONENT

All impaired loans which exceed a certain threshold, principally within the Group's Wholesale division, are individually assessed for impairment having regard to expected future cash flows including those that could arise from the realisation of security. The determination of these allowances often requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of commercial real estate collateral. 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.

F-19

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 3 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS continued

#### COLLECTIVE COMPONENT

Impairment allowances for portfolios of smaller balance homogenous loans, such as residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis. Collective impairment allowances are calculated on a portfolio basis using models which take into account factors such as historical experience of accounts progression through the various stages of delinquency, historical loss rates, the credit quality of the portfolio, and the value of any collateral held, which is estimated, where appropriate, using indices such as house price indices.

The calculation of the collective impairment allowance is therefore subject to estimation uncertainty. The variables used in the collective impairment models are kept under regular review to ensure that as far as possible they reflect current economic circumstances. However, significant management judgement is applied in assessing whether current economic conditions and borrowers' behaviour are fully reflected in the historical loss data and other inputs to the impairment models.

The collective impairment allowance 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.

Given the relative size of the Group's mortgage portfolio, a key variable is UK house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices within the Group's mortgage portfolio were 10 per cent lower than those estimated at 31 December 2009, the house price index related impact on the impairment charge would be an increase of approximately £350 million.

In the Wholesale division, the collective unimpaired provision is sensitive to the time between the loss event and the date the impairment is recognised. This is known as the loss emergence period (LEP). If the LEP moved by one month in respect of the loan portfolio assessed for collective unimpaired provisions, this would result in an increase in the collective unimpaired provision of approximately £420 million.

#### IMPAIRMENT OF AVAILABLE-FOR-SALE FINANCIAL ASSETS

In determining whether an impairment loss has been incurred in respect of an available-for-sale financial asset, the Group performs an objective review of the current financial circumstances and future prospects of the issuer and, in the case of equity shares, considers whether there has been a significant or prolonged decline in the fair value of that asset below its cost. This consideration requires management judgement. Among factors considered by the Group is whether the decline in fair value is a result of a change in the quality of the asset or a downward movement in the market as a whole. An assessment is performed of the future cash flows expected to be realised from the asset, taking into account, where appropriate, the quality of underlying security and credit protection available. The increase in the fair value of available-for-sale financial assets during the year was £2,234 million (2008: reduction of £2,721 million). Impairment losses in respect of available-for-sale financial assets transferred from reserves to the income statement totalled £602 million (2008: £130 million).

#### VALUATION OF FINANCIAL INSTRUMENTS

Financial instruments classified by management as trading and other financial assets and liabilities at fair value through profit or loss, derivative financial instruments and available-for-sale financial assets are carried at fair value which is determined as being the amount for which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Management judgement is required in determining the appropriate classification of financial instruments.

In 2009, the Group adopted *Amendments to IFRS 7 Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments* which, among other matters, established a three level valuation hierarchy for disclosure of fair value measurements of financial instruments carried on the Group's balance sheet at fair value.

Management judgement is required in determining the categorisation of the Group's financial instruments that are carried at fair value. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is less judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and level 3 is determined

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using valuation techniques including discounted cash flow analysis and valuation models. These require management judgement and therefore contain significant estimation uncertainty (note 53).

In particular significant judgement is required by management in determining appropriate assumptions to be used for level 3 financial instruments. At 31 December 2009, the Group classified £7,460 million of financial assets and £235 million of financial liabilities as level 3 (note 53).

The largest asset class classified as level 3 is the Group's venture capital and unlisted equity investments. Venture capital investments are valued using International Private Equity and Venture Capital (IPEV) Guidelines which require significant management judgement in determining appropriate earnings multiples to be applied in determining fair value. Unlisted equity investments are valued using a number of different techniques which require management to select the most appropriate assumptions, including earnings multiples, valuations relative to net assets, and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3. Fair value is determined using valuation models which require significant judgement in determining appropriate values for inputs including prepayment rates, probability of default, loss given default and yield curves.

The valuation techniques used are set out in note 53 on page F-96. This provides details of the inputs into valuation models that have the potential to significantly impact the value determined, sets out the assumptions used for those inputs and provides the effects of applying reasonably possible alternative assumptions.

**F-20**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 3 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS continued

#### TAXATION

At 31 December 2009 the Group carried deferred tax assets on its balance sheet of £5,006 million (2008: £833 million) and deferred tax liabilities of £209 million (2008: £nil) (note 42).

This statutory presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 42 also presents the Group's deferred tax assets and liabilities by tax category. The largest category of deferred tax asset which contains significant estimation uncertainty and which requires management judgement in assessing its recoverability relates to tax losses carried forward. At 31 December 2009, the Group recognised a deferred tax asset of £5,925 million (2008: £856 million) in respect of tax losses carried forward. The significant increase reflects the taxable losses generated by certain Group companies, primarily Bank of Scotland plc in the last two years and Lloyds TSB Bank plc during 2009.

Applicable accounting standards permit the recognition of deferred tax assets only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to an assessment of management's projections of future taxable income based on business plans and ongoing tax planning strategies. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the Group to deliver expected integration benefits, amongst other variables. At 31 December 2009, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

At 31 December 2009 the Group carried an asset for current tax recoverable of £680 million (2008: £300 million) and current tax liabilities of £51 million (2008: £nil). In determining the carrying value of these balances, management have taken account of tax issues that are subject to ongoing discussion with HM Revenue & Customs and other tax authorities. Inherent in this is management's assessment of legal and professional advice, case law and other relevant guidance. The determination of the outcome of such matters requires significant management judgement in assessing the various risks and applying appropriate probability weightings in determining the carrying value of current and deferred tax balances.

#### PENSIONS

The net liability recognised in the balance sheet at 31 December 2009 in respect of the Group's retirement benefit obligations was £780 million (2008: £1,771 million) of which £619 million (2008: £1,657 million) related to defined benefit pension schemes. As explained in note 2(L), the Group adopts the corridor approach to pensions accounting and consequently does not recognise actuarial losses of £2,936 million (2008: £267 million). The defined benefit pension schemes' gross deficit totalled £3,555 million (2008: £1,924 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

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

Two important assumptions are the rate of inflation and the expected lifetime of the schemes' members. The assumed rate of inflation affects the rate at which salaries are projected to grow and therefore the size of the pension that employees receive upon retirement and also the rate at which pensions in payment increase. Over the longer term rates of inflation can vary significantly. At 31 December 2009 it was assumed that the rate of inflation would be 3.4 per cent per annum (2008: 3.0 per cent), although if this was increased by 0.2 per cent the overall deficit would increase by approximately £795 million and the annual cost by approximately £69 million. A reduction of 0.2 per cent would reduce the overall deficit by approximately £763 million and the annual cost by approximately £60 million.

The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. Assumptions used by

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management reflect recent longevity experience and extrapolate the improving trend. An increase of one year in the expected lifetime of scheme members would increase the overall deficit by approximately £590 million and the annual cost by approximately £79 million; a reduction of one year would reduce the overall deficit by approximately £603 million and the annual cost by approximately £76 million.

The size of the overall deficit is also sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variations. At 31 December 2009 the discount rate used was 5.7 per cent (2008: 6.3 per cent); a reduction of 0.2 per cent would increase the overall deficit by approximately £985 million and the annual cost by approximately £82 million, while an increase of 0.2 per cent would reduce the net deficit by approximately £937 million and the annual cost by approximately £68 million.

**F-21**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 3 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS continued

#### FAIR VALUE OF IDENTIFIABLE NET ASSETS OF HBOS

The acquisition of the HBOS Group in January 2009 was accounted for in accordance with applicable accounting standards which require the recognition of the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. As part of this process, it is also necessary to identify and recognise certain assets and liabilities which are not included on the acquiree's balance sheet, for example the value of the internally generated brands and other intangible assets.

The exercise to fair value the HBOS Group balance sheet was inherently highly subjective and required management to make a number of assumptions and estimates. The overall effect was to reduce the book value of the assets acquired by £11,975 million, after the recognition of brands and other intangibles not previously included on the HBOS Group balance sheet totalling £4,650 million. This was offset by a reduction in the value of the HBOS Group's liabilities of £13,216 million, resulting in a net increase in the value of the net assets acquired of £1,241 million (note 14).

The fair value adjustments to the HBOS Group's assets principally reflect a reduction of £13,512 million in the value of customer lending. For a significant proportion of these balances there was no active market and therefore in determining the acquisition-date fair values discounted cash flow models have been used. The calculations were performed using benchmark interest rates and market-based credit spreads for the different lending portfolios, having regard to management's view of the level of expected credit losses. The size of the adjustment reflects the market-wide reduction in interest rates since the lending was originated and a deterioration in the credit quality of the portfolio in the worsening economic environment.

The reduction in the value of the HBOS Group's liabilities was largely due to the lower values attributed to debt instruments issued by HBOS, for example commercial paper, medium-term notes and subordinated debt. In many cases market prices were available to value these instruments and the lower fair values reflect market concern in January 2009 over the creditworthiness of HBOS.

During 2009, the effects of the fair value adjustments have started to unwind and be recognised in the Group's income statement. The determination of the extent to which the adjustments unwind often requires significant judgement principally relating to the assessment of the extent to which losses incurred subsequent to the date of acquisition were expected and consequently reflected in the fair value adjustment made to write down the value of the lending. In the period since the acquisition impairment losses of £6,859 million have been incurred which were reflected in the acquisition fair value adjustments.

#### GOODWILL

At 31 December 2009 the Group carried goodwill on its balance sheet totalling £2,016 million (2008: £2,256 million), all of which relates to acquisitions made a number of years ago.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. The impairment review is performed by projecting future cash flows, excluding finance and tax, based upon budgets and plans and making appropriate assumptions about rates of growth and discounting these using a rate that takes into account prevailing market interest rates and the risks inherent in the business. If the present value of the projected cash flows is less than the carrying value of the underlying net assets and related goodwill an impairment charge is required in the income statement. This calculation requires the exercise of significant judgement by management; if the estimates made prove to be incorrect or performance does not meet expectations which affects the amount and timing of future cash flows, goodwill may become impaired in future periods. Further details are given in note 27.

The Group's goodwill is allocated to cash generating units in the Insurance division (Scottish Widows) and in the Asset Finance business in the Wholesale division. Goodwill attributable to the Group's Asset Finance business, for which an impairment charge was recognised in the Group's financial statements for the year ended 31 December 2008, has been reviewed for impairment due to the continuing uncertainties over the short-term macroeconomic environment. As a consequence, the carrying value of the consumer finance cash generating unit within Asset Finance has been reassessed and has resulted in the related element of the goodwill being written off and the Group recognising a further impairment charge of £240 million in the year ended 31 December 2009. Further details are given in note 27.

#### LIFE INSURANCE BUSINESS

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The Group carries in its balance sheet a value in-force asset, representing the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts, of £5,140 million at 31 December 2009 (2008: £1,893 million). The Group also recognises an acquired value in-force asset of £1,545 million at 31 December 2009 (2008: nil) representing contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 2(O)(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions. These assumptions are inherently uncertain and changes could significantly affect the value attributed to these assets.

At 31 December 2009 the Group carried substantial liabilities to holders of life, pensions and investment contracts in its balance sheet. Liabilities arising from insurance contracts and participating investment contracts were £56,800 million and £18,089 million respectively (2008: £21,518 million and £11,619 million) and those arising from non-participating investment contracts totalled £46,348 million (2008: £14,243 million). The methodology used to value the liabilities is described in note 2(O)(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour.

The process for determining key assumptions that have been made for life insurance assets and liabilities at 31 December 2009 is detailed in notes 28 and 36. The impact on profit before tax of changes in key assumptions is detailed in note 37.

**F-22**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 3 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS continued

#### GENERAL INSURANCE BUSINESS

At 31 December 2009 the Group held a provision of £502 million (2008: £183 million) in respect of the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The methodology for valuing these liabilities, which includes the use of statistical techniques, is described in note 2(O)(2).

While management believes that the liability carried at year end is adequate, the application of statistical techniques requires significant judgement. An increase of 10 per cent in the cost of claims would result in the recognition of an additional loss of approximately £48 million. Similarly, an increase of 10 per cent in the ultimate number of such claims would lead to an additional loss of approximately £44 million; some relief would arise from reinsurance contracts held.

#### 4 SEGMENTAL ANALYSIS

The Group is a leading financial services group, whose businesses provide 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. This assessment includes a consideration of each segment's net interest revenue and consequently the total interest income and expense for all reportable segments is presented on a net basis. The segments are differentiated by the type of products provided, by whether the customers are individuals or corporate entities and by the geographical location of the customer.

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.

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

#### *Segmental analysis for 2009 and 2008*

During 2009, following the acquisition of HBOS, the Group's activities were reorganised into four financial reporting segments: Retail, Wholesale, Wealth and International and Insurance. Consequently, the comparative information has been restated to be consistent with the reorganised structure of the Group. The segmental results and comparatives are presented on the basis reviewed by the chief operating decision maker in 2009 (the combined businesses basis) and therefore include the pre-acquisition results of HBOS for 2008 and for the period from 1 January 2009 to 16 January 2009.

The Retail division, with its brands including Lloyds TSB, Halifax, Bank of Scotland, Birmingham Midshires and Cheltenham & Gloucester, is a UK provider of current accounts, savings, personal loans, credit cards and mortgages serving over 30 million customers through a large branch network in the UK. The division is also a general insurance and bancassurance distributor selling a wide range of long-term savings, investment and general insurance products.

The Wholesale division serves in excess of a million businesses ranging from start-ups and small enterprises to global corporations, with a range of propositions fully segmented according to customer need. The enlarged division, following the acquisition of HBOS, comprises Corporate Markets, Treasury and Trading and Asset Finance. Corporate Markets comprises Corporate, Commercial, Corporate Real Estate, Specialist Finance and Wholesale Markets.



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Wealth and International was created to give increased focus and momentum to the Group's private banking and asset management activities and to closely co-ordinate the management of its international businesses. Wealth comprises the Group's private banking, wealth and asset management businesses in the UK and overseas. International comprises corporate, commercial, asset finance and retail businesses in Australia, Ireland and continental Europe.

The Insurance division is a bancassurance provider in the UK providing a wide range of long-term savings, investment and protection products, together with individual and corporate pensions. It is also a distributor of payment protection and home insurance in the UK. The division consists of three business units: life, pensions and investments UK; life, pensions and investments Europe; and general insurance.

Other includes the results of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and procurement services, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions, including hedge ineffectiveness.

**F-23**

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 4 SEGMENTAL ANALYSIS continued

	Retail £m	Wholesale £m	Wealth and International £m	Insurance £m	Other £m	Combined businesses basis total £m
<b>Year ended 31 December 2009</b>						
Net interest income	7,970	4,710	1,217	(287)	(884)	12,726
Other income (net of fee and commission expense)	1,804	4,199	1,128	2,944	1,800	11,875
Total income	9,774	8,909	2,345	2,657	916	24,601
Insurance claims				(637)		(637)
Total income, net of insurance claims	9,774	8,909	2,345	2,020	916	23,964
Operating expenses	(4,566)	(4,106)	(1,544)	(974)	(419)	(11,609)
Trading surplus	5,208	4,803	801	1,046	497	12,355
Impairment	(4,227)	(15,683)	(4,078)			(23,988)
Share of results of joint ventures and associates	(6)	(720)	(21)	(22)	2	(767)
Profit (loss) before tax and fair value unwind	975	(11,600)	(3,298)	1,024	499	(12,400)
Fair value unwind	407	6,897	942	(49)	(2,097)	6,100
Profit (loss) before tax	1,382	(4,703)	(2,356)	975	(1,598)	(6,300)
External revenue	14,221	5,965	2,859	3,780	(2,224)	24,601
Inter-segment revenue	(4,447)	2,944	(514)	(1,123)	3,140	
Segment revenue	9,774	8,909	2,345	2,657	916	24,601
Segment external assets	383,588	394,057	94,051	135,814	19,745	1,027,255
Segment customer deposits	224,149	153,389	29,037		166	406,741
Other segment items reflected in income statement above:						
Depreciation and amortisation	196	1,284	84	152	147	1,863
Movement in value of in-force business			(5)	1,097		1,092
Defined benefit scheme charges	190	112	40	39	156	537
Other segment items:						
Additions to tangible fixed assets	65	2,969	53	255	487	3,829
Investments in joint ventures and associates at end of year	30	189	123	(14)	151	479

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 4 SEGMENTAL ANALYSIS continued

	Retail £m	Wholesale £m	Wealth and International £m	Insurance £m	Other £m	Combined businesses basis total £m
<b>Year ended 31 December 2008</b>						
Net interest income	8,454	5,752	1,314	(345)	(272)	14,903
Other income (net of fee and commission expense)	2,739	(302)	1,191	3,493	(188)	6,933
Total income	11,193	5,450	2,505	3,148	(460)	21,836
Insurance claims				(481)		(481)
Total income, net of insurance claims	11,193	5,450	2,505	2,667	(460)	21,355
Operating expenses	(4,963)	(4,591)	(1,476)	(1,129)	(77)	(12,236)
Trading surplus (deficit)	6,230	859	1,029	1,538	(537)	9,119
Impairment	(3,695)	(10,394)	(731)		(60)	(14,880)
Share of results of joint ventures and associates	7	(944)	(21)	2	4	(952)
Profit (loss) before tax	2,542	(10,479)	277	1,540	(593)	(6,713)
External revenue	15,228	(150)	1,883	6,020	(1,145)	21,836
Inter-segment revenue	(4,035)	5,600	622	(2,872)	685	
Segment revenue	11,193	5,450	2,505	3,148	(460)	21,836
Segment external assets	393,827	517,269	86,394	127,249	1,979	1,126,718
Segment customer deposits	216,282	157,941	34,095		844	409,162
Other segment items reflected in income statement above:						
Depreciation and amortisation	197	1,603	71	80	343	2,294
Movement in value of in-force business				(625)		(625)
Defined benefit scheme charges	163	106	31	36	(1)	335
Other segment items:						
Additions to tangible fixed assets	127	2,241	254	411	735	3,768
Investments in joint ventures and associates at end of year	78	1,032	117	(38)	50	1,239

F-25

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 4 SEGMENTAL ANALYSIS continued

## RECONCILIATION OF COMBINED BUSINESSES BASIS TO STATUTORY RESULTS

The combined businesses 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 combined businesses basis.

	Lloyds Banking Group statutory £m	Pre-acquisition results of HBOS £m	Removal of:			Fair value unwind £m	Combined businesses basis £m
			Acquisition related <sup>1</sup> £m	Volatility £m	Insurance gross up £m		
<b>Year ended 31 December 2009</b>							
Net interest income	9,026	243		11	1,280	2,166	12,726
Other income	36,271	(1,123)		(479)	(21,659)	(1,135)	11,875
Total income	45,297	(880)		(468)	(20,379)	1,031	24,601
Insurance claims	(22,019)	1,349			20,318	(285)	(637)
Total income, net of insurance claims	23,278	469		(468)	(61)	746	23,964
Operating expenses	(15,984)	(293)	4,589		61	18	(11,609)
Trading surplus (deficit)	7,294	176	4,589	(468)		764	12,355
Impairment	(16,673)	(456)				(6,859)	(23,988)
Share of results of joint ventures and associates	(752)			(10)		(5)	(767)
Gain on acquisition	11,173		(11,173)				
Fair value unwind						6,100	6,100
<b>Profit (loss) before tax</b>	<b>1,042</b>	<b>(280)</b>	<b>(6,584)</b>	<b>(478)</b>			<b>(6,300)</b>

<sup>1</sup> Includes gain on acquisition, integration costs, amortisation of purchased intangibles and goodwill impairment.

	Removal of:							Combined businesses basis £m
	Statutory basis <sup>1</sup> £m	HBOS statutory £m	Reclassifi- cations £m	Results of BankWest and St. Andrews £m	Volatility £m	Amortisation of purchased intangibles and goodwill impairments £m	Insurance gross up £m	
<b>Year ended 31 December 2008</b>								
Net interest income	7,718	8,171	1,906	(524)	(9)		(2,359)	14,903
Other income	(709)	(4,559)	(234)	(148)	2,358		10,225	6,933
Total income	7,009	3,612	1,672	(672)	2,349		7,866	21,836
Insurance claims	2,859	6,192	(1,570)				(7,962)	(481)
Total income, net of insurance claims	9,868	9,804	102	(672)	2,349		(96)	21,355

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Operating expenses	(6,100)	(6,880)		400		258	86	(12,236)
Trading surplus (deficit)	3,768	2,924	102	(272)	2,349	258	(10)	9,119
Impairment	(3,012)	(12,050)		182				(14,880)
Share of results of joint ventures and associates	4	(956)						(952)
Non-operating income		56	(56)					
Loss on disposal		(799)	(46)	845				
Profit (loss) before tax	760	(10,825)		755	2,349	258	(10)	(6,713)
Assets As at 31 December 2008	Statutory basis £m	HBOS statutory £m	Reclassifications £m	Lloyds TSB and HBOS share issues <sup>2</sup> £m	Fair value adjustments £m	Consolidation adjustments £m		Reported basis £m
	436,033	689,917	15,198	16,770	(11,975)	(19,225)		1,126,718

1 Restated for IFRS 2 (Revised).

2 Includes £4,500 million of ordinary share capital and £1,000 million of preference shares issued by Lloyds TSB Group plc to HM Treasury on 13 January 2009 and 15 January 2009, respectively and £8,500 million of ordinary share capital and £3,000 million of preference shares issued by HBOS plc to HM Treasury on 15 January 2009 (net of costs).

**F-26**

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**4 SEGMENTAL ANALYSIS** continued*Segmental analysis for 2008 and 2007*

The information to restate 2007 on a combined businesses basis is not readily available and the Group has determined that the cost to develop it was excessive. Therefore segmental information for 2007 is presented on the continuing businesses basis used by the chief operating decision maker in 2008 to assess the Group's operations. In order to provide comparability with the segmental information for 2007 the Group has also presented its segmental information for 2008 on a continuing businesses basis.

At 31 December 2008 the Group's activities were organised into three segments: UK Retail Banking, Insurance and Investments and Wholesale and International Banking. Services provided by UK Retail Banking encompass the provision of banking and other financial services to personal customers, private banking and mortgages. Insurance and Investments offers life assurance, pensions and savings products, general insurance and asset management services. Wholesale and International Banking provides banking and related services for major UK and multinational companies, banks and financial institutions, and small and medium-sized UK businesses. It also provides asset finance to personal and corporate customers, manages the Group's activities in financial markets through its treasury function and provides banking and financial services in some overseas locations.

As part of its transition to Basel II on 1 January 2008, the Group has updated its capital and liquidity pricing methodology. The main difference in this approach is to allocate a greater share of certain funding costs, previously allocated to the Central group items segment, to individual divisions. To enable a meaningful period-on-period comparison, the segmental analysis for the year ended 31 December 2007 has been restated to reflect these changes.

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central Group Items <sup>1</sup> £m	Inter-segment eliminations £m	Continuing businesses excluding insurance gross up <sup>1</sup>
<b>Year ended 31 December 2008</b>						
Net interest income	4,110	(62)	3,303	(293)		7,058
Other income (net of fee and commission expense)	1,766	1,749	829	(203)		4,141
Total income	5,876	1,687	4,132	(496)		11,199
Insurance claims		(193)				(193)
Total income, net of insurance claims	5,876	1,494	4,132	(496)		11,006
Operating expenses	(2,611)	(591)	(2,350)	(77)		(5,629)
Trading surplus	3,265	903	1,782	(573)		5,377
Impairment	(1,472)	(2)	(1,508)	(30)		(3,012)
Share of results of joint ventures and associates				4		4
Profit (loss) before tax	1,793	901	274	(599)		2,369
 1 Restated for IFRS 2 (Revised)						
External revenue	9,804	3,236	7,679	1,025		21,744
Inter-segment revenue	1,002	185	2,395	1,152	(4,734)	
Segment revenue	10,806	3,421	10,074	2,177	(4,734)	21,744
Segment external assets	127,502	66,549	238,832	3,150		436,033
Segment customer deposits	85,926	2,103	82,909			170,938

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Other segment items reflected in income statement above:

Depreciation and amortisation	215	50	421		686
Movement in value of in-force business		(325)			(325)
Defined benefit scheme charges	103	21	85	(45)	164
Other segment items:					
Additions to tangible fixed assets	167	236	837	196	1,436

F-27

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## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 4 SEGMENTAL ANALYSIS continued

	UK Retail Banking £m	Insurance and Investments £m	Wholesale and International Banking £m	Central Group Items <sup>1</sup> £m	Inter-segment eliminations £m	Continuing businesses excluding insurance gross up <sup>1</sup>
<b>Year ended 31 December 2007</b>						
Net interest income	3,695	(106)	2,380	(368)		5,601
Other income (net of fee and commission expense)	1,797	1,741	1,644	352		5,534
Total income	5,492	1,635	4,024	(16)		11,135
Insurance claims		(302)				(302)
Total income, net of insurance claims	5,492	1,333	4,024	(16)		10,833
Operating expenses	(2,548)	(611)	(2,152)	(7)		(5,318)
Trading surplus	2,944	722	1,872	(23)		5,515
Impairment	(1,224)		(572)			(1,796)
Share of results of joint ventures and associates				10		10
Profit (loss) before tax	1,720	722	1,300	(13)		3,729
<sup>1</sup> Restated for IFRS 2 (Revised)						
External revenue	9,132	3,164	9,924	290		22,510
Inter-segment revenue	958	230	1,487	1,591	(4,266)	
Segment revenue	10,090	3,394	11,411	1,881	(4,266)	22,510
Segment external assets	115,012	73,377	163,294	1,663		353,346
Segment customer deposits	82,081	2,153	72,321			156,555
Other segment items reflected in income statement above:						
Depreciation and amortisation	205	51	371			627
Movement in value of in-force business		(77)				(77)
Defined benefit scheme charges	114	31	91	(60)		176
Other segment items:						
Additions to tangible fixed assets	80	458	604	178		1,320

## RECONCILIATION OF CONTINUING BUSINESSES BASIS TO STATUTORY RESULTS

	Removal of							Continuing businesses excluding insurance gross up <sup>1</sup>
	Statutory <sup>1</sup> £m	Volatility £m	Provision for historic US dollar payments £m	Financial Services Compensation Scheme levy £m	Goodwill impairment £m	Continuing businesses <sup>1</sup> £m	Removal of insurance gross up £m	£m
Net interest income	7,718	(9)				7,709	(651)	7,058



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Other income	(709)	1,226				517	3,624	4,141
Total income	7,009	1,217				8,226	2,973	11,199
Insurance claims	2,859					2,859	(3,052)	(193)
Total income, net of insurance claims	9,868	1,217				11,085	(79)	11,006
Operating expenses	(6,100)		180	122	100	(5,698)	69	(5,629)
Trading surplus	3,768	1,217	180	122	100	5,387	(10)	5,377
Impairment	(3,012)					(3,012)		(3,012)
Share of results of joint ventures and associates	4					4		4
Profit before tax	760	1,217	180	122	100	2,379	(10)	2,369

1 Restated for IFRS 2 (Revised)

F-28

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**4 SEGMENTAL ANALYSIS** continued

	Removal of						Continuing businesses excluding insurance gross up <sup>1</sup> £m	
	Statutory <sup>1</sup> £m	Volatility £m	Discontinued businesses £m	Profit on sale of businesses £m	Settlement of overdraft claims £m	Continuing businesses <sup>1</sup> £m		
2007								
Net interest income	6,099	(7)	(70)			6,022	(421)	5,601
Other income	12,119	506	(858)			11,767	(6,233)	5,534
Total income	18,218	499	(928)			17,789	(6,654)	11,135
Insurance claims	(7,522)		605			(6,917)	6,615	(302)
Total income, net of insurance claims	10,696	499	(323)					