Lloyds Banking Group plc
Form 20-F
March 25, 2013

As filed with the Securities and Exchange Commission on 25 March 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

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

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended 31 December 2012

OR

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

OR

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

Commission file number 001-15246

LLOYDS BANKING GROUP plc

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

Scotland
(Jurisdiction of Incorporation or Organization)

25 Gresham Street
London EC2V 7HN
United Kingdom
(Address of Principal Executive Offices)

Claire Davies, Group Secretary
Tel +44 (0) 20 7356 1043, Fax +44 (0) 20 7356 3506
25 Gresham Street
London EC2V 7HN
United Kingdom
(Name, telephone, e-mail and/or facsimile number and address of Company contact person)

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

Title of each class	Name of each exchange on which registered
Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares	The New York Stock Exchange
7.75% Public Income Notes due 2050	The New York Stock Exchange
4.875% Senior Notes due 2016	The New York Stock Exchange
6.375% Senior Notes due 2021	The New York Stock Exchange
Floating Rate Notes due 2014	The New York Stock Exchange

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

None

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

None

The number of outstanding shares of each of Lloyds Banking Group plc s classes of capital or common stock as of 31 December 2012 was:

Ordinary shares, nominal value 10 pence each	70,342,844,289
Limited voting shares, nominal value 10 pence each	80,921,051
Preference shares, nominal value 25 pence each	412,215,065
Preference shares, nominal value 25 cents each	1,843,990
Preference shares, nominal value 25 euro cents each	173,350

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

Yes x No o

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

Yes o No x

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

Yes x No o

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

Yes o No o

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

Large accelerated filer x Accelerated filer o Non-Accelerated filer o

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

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

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

Item 17 o Item 18 o

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

Yes o No x

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PRESENTATION OF INFORMATION

In this annual report, references to the Company are to Lloyds Banking Group plc; references to Lloyds Banking Group , Lloyds or the Group are to Lloyds Banking Group plc and its subsidiary and associated undertakings; references to Lloyds 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 are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to euro cent are to one-hundredth of one euro; and references to Japanese yen , Japanese ¥ or ¥ are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2012, which was $1.6262 = £1.00. The Noon

Buying Rate on 31 December 2012 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 2012, total Lloyds Banking Group assets were £924,552 million and Lloyds Banking Group had some 92,788 employees (on a full-time equivalent basis). Lloyds Banking Group plc s market capitalisation at that date was £33,705 million. The Group reported a loss before tax for the 12 months to 31 December 2012 of £570 million, and the capital ratios at that date were 17.3 per cent for total capital, 13.8 per cent for tier 1 capital and 12.0 per cent for core tier 1 capital.

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

	2012	2011	2010
	£m	£m	£m
Net interest income	**9,075**	12,698	12,546
Other income	**29,831**	14,145	31,410
Total income	**38,906**	26,843	43,956
Insurance claims	**(18,396)**	(6,041)	(19,088)
Total income, net of insurance claims	**20,510**	20,802	24,868
Operating expenses	**(15,931)**	(13,050)	(16,470)
Trading surplus	**4,579**	7,752	8,398
Impairment	**(5,149)**	(8,094)	(10,952)
Loss on disposal of businesses			(365)
Loss before tax	**(570)**	(342)	(2,919)

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

The Group has four primary operating divisions, which constitute the Group s reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. Retail provides banking, mortgages and other financial services to personal customers in the UK. Commercial Banking provides banking and related services to business clients, from small businesses to large corporates. Wealth, Asset Finance and International provides private banking and asset management and asset finance in the UK and overseas and operates the Group s international retail businesses. Insurance provides long term savings, protection and investment products in the UK and Europe and provides general insurance to personal customers in the UK.

Profit before tax is analysed on pages 14 to 24 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group s segments, on pages 27 to 45 on a management basis and an underlying basis. The key principles adopted in the preparation of these bases of reporting are described on page 27. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group s internal reporting based around these segments (which reflect the Group s organisational and management structures) in order to assess performance and allocate resources; this reporting is on a management basis and an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group s statutory profit before tax. Accordingly, the Group presents its segmental management basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission s Regulation G are set out on pages F-25 to F-30. The following table shows the results of Lloyds Banking Group s Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance segments and Group Operations and Central items in the last three fiscal years, and their aggregation.

	2012	2011	2010
	£m	£m	£m
Retail	**3,670**	3,636	3,986
Commercial Banking	**238**	75	1,098
Wealth, Asset Finance and International	**(1,176)**	(2,684)	(3,243)
Insurance	**1,065**	1,422	1,326
Group Operations and Central items:			
Group Operations	**(51)**	(56)	(52)

Central items	**1,081**	292	(903)
	1,030	236	(955)
Profit before tax Management basis	**4,827**	2,685	2,212

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

SELECTED CONSOLIDATED FINANCIAL DATA

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

	2012	2011	2010	2009	2008[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims[2]	**20,510**	20,802	24,868	22,526	9,872
Operating expenses	**(15,931)**	(13,050)	(16,470)	(15,984)	(6,100)
Trading surplus[2]	**4,579**	7,752	8,398	6,542	3,772
Impairment losses	**(5,149)**	(8,094)	(10,952)	(16,673)	(3,012)
Gain on acquisition				11,173	
(Loss) profit before tax	**(570)**	(342)	(2,919)	1,042	760
(Loss) profit for the year	**(1,343)**	(378)	(2,594)	2,953	798
(Loss) profit for the year attributable to equity shareholders	**(1,427)**	(451)	(2,656)	2,827	772
Total dividend for the year[3]					648
Balance sheet data at 31 December (£m)					
Share capital	**7,042**	6,881	6,815	10,472	1,513
Shareholders equity	**43,999**	45,920	43,725	43,278	9,393
Customer deposits	**426,912**	413,906	393,633	406,741	170,938
Subordinated liabilities	**34,092**	35,089	36,232	34,727	17,256
Loans and advances to customers	**517,225**	565,638	592,597	626,969	240,344
Total assets	**924,522**	970,546	992,438	1,027,255	436,033
Share information					
Basic (loss) earnings per ordinary share[4]	**(2.0)p**	(0.7)p	(4.0)p	7.5p	6.7p
Diluted (loss) earnings per ordinary share[4]	**(2.0)p**	(0.7)p	(4.0)p	7.5p	6.6p
Net asset value per ordinary share	**62p**	67p	64p	68p	155p
Total dividend per ordinary share[3]					11.4p
Equivalent cents per share[3,5]					20.3c
Market price per ordinary share (year end)	**47.9p**	25.9p	65.7p	50.7p	126.0p
Number of shareholders (thousands)	**2,733**	2,770	2,798	2,834	824
Number of ordinary shares in issue (millions)[6]	**70,343**	68,727	68,074	63,775	5,973
Financial ratios (%)[7]					
Dividend payout ratio					83.9
Post-tax return on average shareholders equity	**(3.1)**	(1.0)	(5.8)	8.8	7.0
Post-tax return on average assets	**(0.14)**	(0.04)	(0.26)	0.28	0.21
Average shareholders equity to average assets	**4.8**	4.5	4.6	3.1	2.9
Cost: income ratio[2,8]	**77.7**	62.7	66.2	71.0	61.8
Capital ratios (%)[9]					
Total capital	**17.3**	15.6	14.5	12.4	11.1
Tier 1 capital	**13.8**	12.5	11.0	9.6	7.9
Core tier 1 capital	**12.0**	10.8	9.6	8.1	5.5

1 Restated in 2009 for IFRS 2 (Revised).

2 As the Group s share of results of joint ventures and associates is no longer significant, this is now included within other operating income; comparatives have been re-presented on a consistent basis.

3 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.

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

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

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

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

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

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

EXCHANGE RATES

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

	2013 February	**2013 January**	**2012 December**	**2012 November**	**2012 October**	**2012 September**
US dollars per pound sterling:						
High	**1.58**	**1.63**	**1.63**	**1.61**	**1.62**	**1.63**
Low	**1.51**	**1.57**	**1.60**	**1.58**	**1.59**	**1.59**

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

	2012	2011	2010	2009	2008
US dollars per pound sterling:					
Average	**1.59**	1.61	1.54	1.57	1.84

On 15 March 2013, the latest practicable date, the US dollar Noon Buying Rate was $1.5124 = £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.

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company s issued ordinary share capital. Following further issues of ordinary shares, the UK Government s holding has been reduced to approximately 39.2 per cent at 15

March 2013.

STRATEGY OF LLOYDS BANKING GROUP

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

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

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

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

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

BUSINESS

STRENGTHEN THE GROUP S BALANCE SHEET AND LIQUIDITY POSITION

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

SIMPLIFY THE GROUP TO IMPROVE AGILITY AND EFFICIENCY

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

The programme had delivered run-rate cost savings of £847 million at the end of 2012. The simplification programme is central to the successful delivery of the Group s strategy and the Group continues to make progress in driving further cost savings and efficiencies through the business whilst improving the customer experience.

INVEST TO BE THE BEST BANK FOR CUSTOMERS

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

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

SUMMARY

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

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

BUSINESS AND ACTIVITIES OF LLOYDS BANKING GROUP

Following a reorganisation during 2012, the Group s activities are now organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. The impact of this reorganisation was as follows:

- The Group s Wholesale and Commercial divisions have been combined to form Commercial Banking;
- The Asset Finance business unit, previously reported within Wholesale, is now reported within the Wealth, Asset Finance and International segment;
- The Group s Continental European wholesale business and the wholesale Australian business have been transferred from Wealth, Asset Finance and International to Commercial Banking.

Further information on the Group s segments is set out on pages 32 to 44 and in note 4 to the financial statements.

MATERIAL CONTRACTS

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

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

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BUSINESS

ENVIRONMENTAL MATTERS

REDUCING THE GROUP S ENVIRONMENTAL IMPACT

As a responsible business, the Group is working to reduce its environmental footprint and support the UK Government s targets to move towards a low-carbon economy.

The Group s Environmental Action Plan incorporates programmes to reduce its impacts in the areas of energy, paper, business travel, waste and water. Specific initiatives include no travel weeks, embedding an enhanced dry mixed recycling process and optimisation of building controls to reduce the energy used.

All programmes are on track to meet their 2020 targets with some delivering early. More detail on the progress of the Group s initiatives is available in the 2012 Responsible Business Report, which will be published in May 2013.

As an example the No Travel Week policy has changed the Group s business travel culture since its introduction in June 2011. By promoting viable technology alternatives travel bookings have decreased by 130,000 during this period. The Group has also met the World Wild Life Fund 1 in 5 challenge and made significant progress against the target to reduce business travel by 20 per cent by 2020.

As well as benefitting the environment, making fewer journeys means colleagues are away from home less, improving their health and well being.

These programmes have contributed to the Group s reportable CO_2 emissions reducing by around 9 per cent from the previous period.

CO_2 Emissions (tonnes)

	2012	2011
Total UK CO_2 emissions	**374,361**	410,237
Scope 1 emissions	**49,414**	58,572
Scope 2 emissions	**290,726**	308,844
Scope 3 emissions	**34,221**	42,821

The Group reports those energy emissions arising from its own direct business activities where it holds the title to the energy supply contract direct with the energy supplier. The Group has improved the accuracy of energy data for the 2011 reporting period, replacing estimates with actual data. The Group has also applied the latest DEFRA conversion factors to both reporting periods. Reporting periods are from the 1 October to the 30 September each year.

SUPPORTING THE GREEN ECONOMY

In supporting the Green Economy, real opportunities need to be created for the provision of finance for low carbon products, services and green technologies in a socially inclusive way. To achieve this the Group recognises the need to work with governments and other stakeholders to address the global sustainability mega trends that will impact its future.

As one of the most active participants in the Project Finance market, Lloyds Banking Group is playing a key role in finding solutions to current and future funding requirements. The Group currently has commitments to renewable energy projects in the UK with capacity totalling over 1800MW. More detail will be available in the 2012 Responsible Business Report.

PROPERTIES

At 31 December 2012, Lloyds Banking Group occupied 3,128 properties in the UK. Of these, 896 were held as freeholds and 2,232 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group s head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 347 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis, principally in North America, Europe and Asia.

LEGAL ACTIONS AND REGULATORY MATTERS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory challenge both in the UK and overseas. Set out below is a summary of the more significant matters. Further details are included in notes 44 and 53 to the financial statements.

INTERCHANGE FEES

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

MasterCard has appealed the General Court s judgment to the Court of Justice of the European Union. MasterCard is supported by several card issuers, including Lloyds Banking Group. Judgment is not expected until late 2013 or later.

In parallel:

- the European Commission is also considering further action, including introducing legislation to regulate interchange fees, following its 2012 Green Paper (Towards an integrated European market for cards, internet and mobile payments) consultation;
- the European Commission is pursuing an investigation with a view to deciding whether arrangements adopted by VISA for the levying of the MIF in respect of cross-border credit card payment transactions also infringe European Union competition laws. In this regard VISA reached an agreement (which expires in 2014) with the European Commission to reduce the level of interchange fee for cross-border debit card transactions to the interim levels agreed by MasterCard; and

the Office of Fair Trading (OFT) may decide to renew its ongoing examination of whether the levels of interchange fees paid by retailers in respect of MasterCard and VISA credit cards, debit cards and charge cards in the UK infringe competition law. The OFT had placed the investigation on hold pending the outcome of the MasterCard appeal to the General Court.

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

PAYMENT PROTECTION INSURANCE

Following the unsuccessful legal challenge by the British Bankers Association against the FSA and the Financial Ombudsman Service, the Group held discussions with the FSA with a view to seeking clarity around the detailed implementation of the FSA Policy Statement which set out evidential provisions and guidance on the fair assessment of a complaint and the calculation of redress in respect of payment protection insurance (PPI) sales standards. As a result, the Group concluded that there are certain circumstances where customer redress will be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such redress, including administration expenses.

During the first half of 2012 there was an increase in the volume of complaints received and, although the level of complaints declined during the second half of 2012, they are higher than had been anticipated at 31 December 2011. As a consequence, the Group believes that it is appropriate to increase its provision by a further £3,575 million at 31 December 2012. This increases the total estimated cost of redress, including administration expenses, to £6,775 million; redress payments made and expenses incurred on the 1.15 million claims paid to the end of December 2012 amounted to £4,344 million. However, there are still a number of uncertainties as to the eventual redress costs, in particular the total number of complaints and the activities of claims management companies and regulatory bodies.

INTERBANK OFFERED RATE SETTING INVESTIGATIONS

A number of government agencies in the UK, US and elsewhere, including the UK Financial Services Authority, the US Commodity Futures Trading Commission, the US Securities and Exchange Commission (SEC), the US Department of Justice and a number of State Attorneys General, as well as the European Commission, are conducting investigations into submissions made by panel members to the bodies that set various interbank offered rates including the BBA London Interbank Offered Rates (LIBOR) and the European Banking Federation s Euribor. Certain Group companies were (at the relevant times) and remain members of various panels whose members make submissions to these bodies including the BBA LIBOR panels. No Group company is or was a member of the Euribor panel. Certain Group companies have received subpoenas and requests for information from certain government agencies and the Group is co-operating with their investigations. In addition certain Group companies, together with other panel banks, have been named as defendants in private lawsuits, including purported class action suits in the US with regard to the setting of LIBOR. It is currently not possible to predict the scope and ultimate outcome of the various regulatory investigations or private lawsuits, including the timing and scale of the potential impact of any investigations and private lawsuits on the Group.

LITIGATION IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY

As previously disclosed, Clerical Medical Investment Group Limited (CMIG) has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. In its accounts for the year ended 31 December 2011 the Group recognised a provision of £175 million with respect to this litigation and following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group recognised a further provision of £150 million with respect to this litigation in its third quarter results, increasing the total provision to £325 million.

However, there are still a number of uncertainties as to the full impact of the FCJ s decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

INTEREST RATE HEDGING PRODUCTS

In June 2012, a number of banks, including the Group, reached agreement with the FSA to carry out a thorough assessment of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. The

Group agreed that on conclusion of this review it would provide redress to any of these customers where appropriate.

Following the completion of a pilot review of IRHP sales to small and medium-sized businesses and agreement reached with the FSA on 30 January 2013 on the principles to be adopted during the course of the wider review, the Group has revised its estimate of the cost of redress and related administration costs and increased its provision by £310 million, bringing the total amount charged in 2012 to £400 million. At 31 December 2012, £20 million of the provision had been utilised. A number of uncertainties remain as to the eventual costs given the inherent difficulties in determining the number of customers within the scope of the review and the average compensation to customers.

SHAREHOLDER COMPLAINTS

In November 2011 the Group and two former members of the Group s Board of Directors were named as defendants in a purported securities class action filed in the United States District Court for the Southern District of New York. The complaint asserted claims under the Securities Exchange Act of 1934 in connection with alleged material omissions from statements made in 2008 in connection with the acquisition of HBOS. No quantum is specified. In October 2012 the court dismissed the complaint. An appeal against this decision has been filed. The Group continues to consider that the allegations are without merit.

FSA INVESTIGATION INTO BANK OF SCOTLAND AND FSA REPORT ON HBOS

In 2009, the FSA commenced a supervisory review into HBOS. The supervisory review was superseded when the FSA commenced an enforcement investigation into Bank of Scotland plc in relation to its Corporate division between 2006 and 2008. These proceedings have now concluded. The FSA published its Final Notice on 9 March 2012. No financial penalty was imposed on the Group or Bank of Scotland plc. The FSA has committed to producing a public interest report on HBOS. The FSA has indicated that the report is expected to be published in the summer.

BUSINESS

OTHER LEGAL ACTIONS AND REGULATORY MATTERS

In addition, during the ordinary course of business the Group is subject to other threatened and actual legal proceedings (which may include class action lawsuits brought on behalf of customers, shareholders or other third parties), regulatory investigations, regulatory challenges and enforcement actions, both in the UK and overseas. All such material matters are periodically reassessed, with the assistance of external professional advisers where appropriate, to determine the likelihood of the Group incurring a liability. In those instances where it is concluded that it is more likely than not that a payment will be made, a provision is established to management s best estimate of the amount required to settle the obligation at the relevant balance sheet date. In some cases it will not be possible to form a view, either because the facts are unclear or because further time is needed properly to assess the merits of the case and no provisions are held against such matters. However the Group does not currently expect the final outcome of any such case to have a material adverse effect on its financial position, operations or cash flows.

COMPETITIVE ENVIRONMENT

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

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

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

See *Risk Factors   Competition Related Risks   The Group remains subject to various regulatory developments and increased governmental scrutiny which could result in further proposals or initiatives to increase competition in markets which the Group operates* and *Business and Economic Risks   The Group s businesses are conducted in highly competitive environments and the Group s financial performance depends upon management s ability to respond effectively to competitive pressures*.

RECENT DEVELOPMENTS

LLOYDS BANKING GROUP BOARD UPDATE

The Group made the following announcement on 11 January 2013

JP Morgan Chase, Inc. has announced that Mr T. Timothy Ryan Jr. will join its management team as Global Head of Regulatory Strategy and Policy.

As a consequence, Mr Ryan will retire from the Board of Lloyds Banking Group plc on 18 April 2013.

LLOYDS BANKING GROUP: CHANGES TO BOARD

The Group made the following announcement on 28 February 2013

Lloyds Banking Group is pleased to announce the appointment of Nicholas Luff as an independent Non-executive Director. Mr Luff will join the Board on 5 March 2013 and will serve as a member of the Audit and Risk Committees.

Following Martin Scicluna s retirement from the Board on 31 March 2013, Mr Luff will succeed him as Chair of the Audit Committee on 1 April 2013.

UPDATE ON LLOYDS BANKING GROUP 2012 ANNUAL REMUNERATION

The Group made the following announcement on 1 March 2013

Lloyds Banking Group has concluded its discussions on remuneration policy and annual bonuses for 2012.

CHIEF EXECUTIVE S ANNUAL BONUS

In recognition of the Group s performance in 2012, the Remuneration Committee has decided to make an annual performance award to the Group Chief Executive of £1,485,000 deferred in shares. The deferral period for this award will be extended to five years, and so will not be released until 2018.

This award is subject to the normal performance adjustment policy and will only vest if a share price of 73.6p has been reached for a given period of time or the Government has sold at least 33 per cent of its shareholding at prices above 61p. The Board believes that these additional conditions are in the interests of all shareholders and support the common aim of repaying the taxpayer. HM Treasury has informed us that 61p is the average price at which the equity support provided to Lloyds Banking Group is recorded in the Public Finances.

This award will not be released before the fifth anniversary and will be forfeited if neither of these conditions have been met by that date. Given these conditions, it is estimated that the expected value of this award is around £750,000.

GROUP BONUS POOL

The Group s overall performance, and the views of stakeholders, were taken into account when considering the size of the Group bonus pool. As a result, the pool for 2012 has been set at £365 million. This represents a reduction of approximately 3 per cent from the previous year s levels, with the reduction being applied to a greater degree to senior staff.

Average value of bonus per employee in 2012 is similar to 2011 at £3,900. For employees other than Executive Directors, annual bonus awards remain limited to an immediate cash bonus of £2,000, with any amounts over £2,000 being subject to deferral and performance adjustment. Bonus awards for Executive Directors are deferred until at least 2015.

BUSINESS

NOTIFICATION OF TRANSACTIONS BY PERSONS DISCHARGING MANAGERIAL RESPONSIBILITIES IN ORDINARY SHARES OF THE GROUP OF 10 PENCE EACH (SHARES)

The Group made the following announcement on 4 March 2013

The Group announced on 30 March 2011 and 9 March 2012 that the deferred bonus awards for 2010 and 2011 granted under the Lloyds Banking Group Deferred Bonus Plan 2008 would vest in tranches over the period September 2011 to September 2015 and be released in Shares.

In this respect, the Group announces that on 4 March 2013, after the settlement of income tax and national insurance contributions, members of the Group Executive Committee listed in the table below received, for nil consideration, the number of Shares as set out by their name.

Name	Shares
A Brittain	144,885
J Colombás	129,414
M Fisher	194,927
A Lorenzo	153,175
D Nicholson	28,069
T Strauss	72,212
M Young	38,405

PROPOSED PLACING OF SHARES IN ST JAMES S PLACE PLC

The Group made the following announcement on 11 March 2013

Lloyds Banking Group plc (Lloyds , or the Group) announces today its intention to sell an anticipated minimum 102 million ordinary shares (the Placing Shares) in St James s Place plc (St James s Place), representing approximately 20 per cent of St James s Place s existing issued ordinary share capital (the Placing).

The Placing reflects Lloyds strategy to simplify the Group and focus on its core customer franchise. The proceeds of the Placing will be used for general corporate purposes.

Institutional shareholders (the Placees) will be sought for the Placing Shares on the Group s behalf by a sole bookrunner through an accelerated bookbuild. The price at which the Placing Shares are to be placed will be agreed by Lloyds and the sole bookrunner at the close of the bookbuilding process. The result of the Placing will be announced as soon as possible after the close of the bookbuilding process.

Following completion of the Placing, assuming the sale of a 20 per cent stake, Lloyds will hold approximately 37 per cent of the issued share capital of St James s Place, and has agreed with the sole bookrunner that it will not, for a period of at least 365 days following completion of the Placing, make any further disposals from its remaining holding in St James s Place. Lloyds continues to be supportive of the St James s Place management team, which will remain unchanged as a result of the Placing.

INFORMATION ON ST JAMES S PLACE

St James s Place is a FTSE 250 financial services group that provides wealth management services to individuals, trustees and businesses. With around 140,000 wealth management clients and £34.8 billion in funds under management, it is well established as one of the UK s leading wealth managers. As at 31 December 2012, it had gross assets of £33.8 billion.

EFFECT OF THE PROPOSED PLACING ON LLOYDS BANKING GROUP

On completion of the Placing, assuming the sale of a 20 per cent stake, the Group will realise a gain on sale of approximately £350 400 million, including the effect of holding the Group s residual stake at fair value. On this basis, the Placing is expected to increase the Group s core tier 1 capital by approximately £600 million, equivalent to an approximate 20 basis points benefit to its core tier 1 capital ratio (under current capital rules). The Placing is expected to increase the Group s net tangible assets per share by approximately 1.7 pence.

Following the Placing, the Group will no longer consolidate the results of St James s Place in its accounts, and expects to account for St James s Place as an associate, reflecting the Group s share of its profit within its income statement. The statutory profit after tax but before minority interest attributable to St James s Place in the Group s accounts for the year ending 31 December 2012 was £76 million.

BUSINESS

PLACING OF SHARES IN ST JAMES S PLACE PLC

The Group made the following announcement on 12 March 2013

Further to its announcement on 11 March 2013 of its intention to sell shares in St James s Place plc (St James s Place), Lloyds Banking Group (Lloyds , or the Group) announces that 101,703,070 shares have been placed at a price of £5.10 per share (the Placing). The gross proceeds of the Placing are approximately £520 million.

Settlement of the Placing will take place on Friday 15 March 2013. On completion, Lloyds will hold 185,554,264 St James s Place shares (approximately 37 per cent of St James s Place s issued share capital) and will continue to have representation on its board.

Lloyds has agreed with the sole bookrunner that, for a period of 365 days following completion of the Placing, it will not make any further disposals from its remaining holding in St James s Place.

EFFECT OF THE PLACING ON LLOYDS

As a result of the Placing, the Group will realise a gain on sale of approximately £400 million, including the effect of holding the Group s residual stake at fair value. The Placing will increase the Group s core tier 1 capital by approximately £600 million, equivalent to an approximate 20 basis points benefit to its core tier 1 capital ratio (under current capital rules). The Placing will increase the Group s net tangible assets per share by approximately 1.7 pence.

As a result of the reduction in its shareholding the Group will no longer consolidate St James s Place s results in its accounts, and expects to account for St James s Place as an associate, reflecting the Group s share of St James s Place s profit within its income statement. The statutory profit after tax but before minority interest attributable to St James s Place in the Group s accounts for the year ending 31 December 2012 was £76 million.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

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OVERVIEW AND TREND INFORMATION

MARKETPLACE TRENDS

THE ECONOMY

2012 turned out to be a year of two very different halves. The aftermath of the financial crisis continued to influence the global economy during the first half of the year, with worsening conditions in Eurozone sovereign and bank credit markets a particular drag on growth. But an improvement in crisis response in the second half of the year reduced financial market stresses and economic prospects have brightened as a result.

The weakness of developed economies since the end of the initial financial crisis-driven recession in 2009 is due to the high levels of indebtedness that many countries accumulated prior to 2008. These have been holding back economic growth through deleveraging of, initially, the private sector, but now governments too. Private sector deleveraging now looks largely complete in the US and significant progress has been made in the UK. But some Eurozone countries still appear to have significantly further to go. Across the UK, Eurozone and the US governments also need to rein in borrowing significantly. Thus, with many countries trying to reduce debt all at the same time, there has been no external offset to weak demand at home in each country. Under-anticipation of the weakness of growth in some Eurozone countries led to slippage against fiscal targets, which in turn has often triggered further cuts in government spending or higher taxes, feeding back to even weaker growth. As markets lost confidence in countries with particularly high government debt or deficit levels through 2011 and the first half of 2012, a further feedback loop developed between rising sovereign bond yields and a deteriorating outlook for government finances, raising the prospect of Eurozone break-up. Naturally this impacted consumer and business confidence, further damaging economic growth through 2012.

The response to the sovereign debt crisis in the Eurozone has improved since the middle of 2012. Decisive support from the European Central Bank to struggling sovereigns, a slightly softer stance on further austerity and agreement on steps towards a banking union have together reversed the trend of spiralling sovereign yields. At the same time banks funding costs have been reduced and the outlook for their capital positions improved by stronger liquidity and the declining risk of Eurozone break-up, helping to limit the need for more bank recapitalisations which would be a further burden on governments. Some concerns remain over continued pressure for further austerity in weak countries, and over the detail of banking union which at this stage doesn t appear to sever the link between banks and sovereigns. But the sign of increased willingness and ability of Eurozone authorities to deal with crisis development has already raised financial market confidence and is key to the future improvements in consumer and business confidence necessary to secure sustained economic recovery.

The weakness of the Eurozone was a significant drag on the UK economy in 2012, with net exports worsening from the previous year. With inflation squeezing consumer spending power and government spending growing well below its normal rate, the economy was broadly flat through 2012, excluding the volatility caused by the Olympics and an additional Bank holiday for the Queen s Diamond Jubilee. As a result, the path of this UK economic recovery has fallen even further behind that seen in previous recoveries.

Early estimates suggest the UK economy grew only marginally by 0.2 per cent in 2012 from 2011. The unemployment rate, however, is estimated to have fallen from 8.4 per cent in the last quarter of 2012 to 7.8 per cent in the three months to December 2012, a direction and scale of change that would normally only be associated with healthy economic growth. Some of the rise in employment is likely to have been a temporary boost from the Olympics but it also appears that productivity has fallen from pre-crisis levels, boosting growth in companies unit wage costs and being a likely contributor to inflation remaining higher than expected. Company failures have also continued to improve, down from 4,294 in England and Wales in the final quarter of 2011 to 3,834 by the final quarter of 2012, and the failure rate has improved from 0.8 per cent to 0.7 per cent of companies, close to its pre-recession trough. House prices appear to have turned upwards during the final two months of the year, ending the year 2.3 per cent up on end 2011, but commercial property prices fell on average by 4.2 per cent.

Based on data for the first three quarters of 2012, the Irish economy appears to have grown weakly after having expanded in 2011 for the first time since 2007. The unemployment rate is estimated to have started to fall around mid-year, and at 14.6 per cent at the end of 2012 was lower than 14.8 per cent at the end of 2011. Strict austerity measures in recent years, targeted at improving international competitiveness, are beginning to pay off falling domestic demand is now being more than offset by increasing net exports. The huge correction in property markets also appears to be nearing completion. CRE prices fell by 6.5 per cent in 2012, the smallest fall since the decline started in 2008 and house prices ended 2012 4.5 per cent lower than at the end of 2011, but with a trend of monthly increases since May.

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Future economic developments in the UK and Ireland continue to be highly contingent on (i) how successful political leaders are at maintaining progress against the Eurozone crisis and enacting a tough but gradual fiscal tightening in the US, (ii) to what extent the UK private sector can offset the effect of a shrinking public sector, and (iii) how the implementation of new regulation on banks impacts their ability to supply credit. With consensus forecasts for 2013 having stabilised in recent months, the most likely outlook for the Eurozone is another broadly flat year (Chart 2).

The current consensus view for 2013 UK GDP growth is better, at 1.0 per cent. The low level of imbalances in the economy relative to the 2008 position suggests that weak growth should not deteriorate into significant recession provided the Eurozone continues to move towards a solution to the sovereign debt crisis. Indeed, the abatement of the inflation squeeze on consumers should help growth improve. But with growth expected to pick up only gradually, held back by fiscal tightening and weak export markets, the Bank Rate is expected to stay at current low levels through 2013 and most probably longer, and property prices are expected to be broadly stable. The recent improvement in unemployment is expected to moderate. The recent loss of the UK s AAA rating is not assumed to have a material impact on the outlook since it had largely been expected by financial markets.

The current consensus view for 2013 Irish GDP growth is 0.9 per cent, and the unemployment rate there is expected to improve only very gradually. House prices are expected to continue their recent rise, but the overall pace of increase is likely to be very slow.

However, whilst a definitive agreed and fully-implemented solution to the Eurozone crisis remains lacking there continues to be some risk that ongoing uncertainty around the Eurozone economic outlook, the survival of the Euro currency and the availability of credit could cause a return to a recession in the UK and Ireland, albeit that risk has declined over the past six months. Such a scenario would likely result in higher UK corporate failures, a second leg of falling property prices, albeit by less than during the 2008-9 recession, and rising commercial tenant defaults. Irish property prices would also fall further. In turn, this would have a negative impact on the Group s income, funding costs and impairment charges. The Group has made significant progress in reducing its holdings of assets which are outside of the Group s risk appetite, although its secondary and tertiary commercial real estate portfolios in Business Support and leverage finance portfolios do remain vulnerable.

THE IMPACT ON THE GROUP S MARKETS

The weak economic recovery has kept growth in the Group s markets subdued. With the economy expected to grow only weakly in 2013, the Group s central expectation is that growth in its markets will also remain weak.

For the market as a whole, net new mortgage lending has amounted to just 0.6 per cent of outstanding balances during 2012, very similar to the previous two years. Consumers use of unsecured credit has begun to improve slightly consumers made net borrowings of 0.9 per cent of outstanding balances in 2012 after 3 years of making net repayments. Household deposits rose by 5.7 per cent in 2012, however, well above the 2-3% growth rates of the previous 3 years although still only just over half the pre-crisis rate.

Companies have continued to hold back investment spending and prioritise cash flow, feeding both into lower borrowing and higher deposits. Non-financial companies made net repayments of 2.6 per cent of sterling lending from banks and building societies in 2012, after repayments of 2.9 per cent in 2011, 3.5 per cent in 2010 and 2.4 per cent in 2009. These aggregates reflect a significant amount of refinancing in capital markets by large companies. Company deposits with UK banks rose by 4.9 per cent in 2012, the greatest rate of increase for 5 years.

The Group s central expectation of a year of only gradual recovery for the UK economy in 2013 is likely to be accompanied by a slight fallback in customer deposit growth with demand for borrowing improving only slowly.

CRITICAL ACCOUNTING POLICIES

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

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

FUTURE ACCOUNTING DEVELOPMENTS

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RESULTS OF OPERATIONS 2012, 2011 AND 2010

SUMMARY

	2012 £m	2011 £m	2010 £m
Net interest income	**9,075**	12,698	12,546
Other income[1]	**29,831**	14,145	31,410
Total income	**38,906**	26,843	43,956
Insurance claims	**(18,396)**	(6,041)	(19,088)
Total income, net of insurance claims	**20,510**	20,802	24,868
Operating expenses	**(15,931)**	(13,050)	(16,470)
Trading surplus	**4,579**	7,752	8,398
Impairment	**(5,149)**	(8,094)	(10,952)
Loss on disposal of businesses			(365)
Loss before tax	**(570)**	(342)	(2,919)
Taxation	**(773)**	(36)	325
Loss for the year	**(1,343)**	(378)	(2,594)
Profit attributable to non-controlling interests	**84**	73	62
Loss attributable to equity shareholders	**(1,427)**	(451)	(2,656)
Loss for the year	**(1,343)**	(378)	(2,594)

1 As the Group s share of results of joint ventures and associates is no longer significant, this is now included within other operating income; comparatives have been re-presented on a consistent basis.

2012 COMPARED WITH 2011

For the year ended 31 December 2012, the Group recorded a loss before tax of £570 million compared with a loss before tax in 2011 of £342 million; the result in 2012 included a provision in respect of redress to customers relating to past sales of Payment Protection Insurance of £3,575 million (2011: £nil).

Total income increased by £12,063 million, or 45 per cent, to £38,906 million in 2012 compared with £26,843 million in 2011, comprising a £15,686 million increase in other income only partly offset by a decrease of £3,623 million in net interest income.

Net interest income was £9,075 million in 2012; a decrease of £3,623 million, or 29 per cent compared to £12,698 million in 2011. There was a credit of £109 million in 2012 arising from liability management gains compared to a credit of £696 million in 2011 (see page 17) and an adverse impact of £1,647 million from an increase in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group. After adjusting for these items, there was a reduction in net interest income of 12 per cent reflecting a decrease in average interest-earning assets across all Divisions, mainly due to subdued lending demand and the disposal of assets outside of the Group s risk appetite. It was also driven by a decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds.

Other income was £15,686 million, or 111 per cent, higher at £29,831 million in 2012 compared to £14,145 million in 2011. Fee and commission income was £204 million, or 4 per cent, lower at £4,731 million compared to £4,935 million in 2011. Fee and commission expense increased by £47 million or 3 per cent to £1,438 million compared with £1,391 million in 2011. Net trading income increased by £13,922 million to £13,554 million in 2012 compared to a deficit of £368 million in 2011; this increase included an improvement of £14,024 million in gains on policyholder investments held within the insurance business, offset by a similar increase in the related claims expense. Insurance premium income was largely unchanged at £8,284 million in 2012 compared with £8,170 million in 2011; an increase of £114 million or 1 per cent. During 2012 the Group exchanged certain existing subordinated debt securities for new securities and also took advantage of opportunities to buy back some of its other issued securities; these exchanges resulted in a loss on extinguishment of the existing securities of £338 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued and other consideration paid. Together with related fees and costs, liability management activities resulted in gains of £599 million recognised in 2011. Excluding the impact of liability management activities, other operating income was £2,838 million higher at £5,038 million in 2012 compared to £2,200 million in 2011; this largely reflected profits on the sale of government bonds as the Group repositions its portfolio and a positive variance of £891 million in the income arising from the movement in value of in-force insurance business.

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

Operating expenses increased by £2,881 million, or 22 per cent to £15,931 million in 2012 compared with £13,050 million in 2011; the main reasons for the increase being the £3,575 million payment protection insurance provision raised in 2012, only partly offset by a past service pension credit of £250 million in the same year. Staff costs were £717 million, or 12 per cent lower at £5,449 million in 2012 compared with £6,166 million in 2011. Excluding the past service pension credit in 2012, staff costs were £467 million, or 8 per cent lower at £5,699 million compared with £6,166 million in 2011 due to the ongoing impact of headcount reductions, more than offsetting the effect of annual pay rises. Premises and equipment costs were £102 million, or 10 per cent, lower at £949 million compared with £1,051 million in 2011. Other expenses (excluding the charges in respect of payment protection insurance and other regulatory provisions of £4,175 million from 2012 and £175 million from 2011) were £186 million, or 5 per cent, lower at £3,232 million in 2012 compared with £3,418 million in 2011 as increased technology-related spend was more than offset by reductions in advertising spend and in other costs. Depreciation and amortisation costs were £49 million, or 2 per cent lower at £2,126 million in

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2012 compared to £2,175 million in 2011. In 2011 there had been a charge of £65 million in relation to the impairment of tangible fixed assets; there was no such charge in 2012.

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

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

In 2012, the Group recorded a tax charge of £773 million compared to a tax charge of £36 million in 2011. The tax charge of £773 million in 2012 arose on a loss before tax of £570 million. This tax charge reflects a policyholder tax charge arising from the revaluation of policyholder tax credits in light of current economic forecasts and recent changes to the taxation of life insurance companies and the impact of the UK corporation tax rate reduction to 23 per cent on the net deferred tax asset.

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

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

2011 COMPARED WITH 2010

For the year ended 31 December 2011, the Group recorded a loss before tax of £342 million compared with a loss before tax in 2010 of £2,919 million, which had been driven by the £3,200 million payment protection insurance provision (see page F-74) although this had been partly offset by a pension curtailment gain in the same year of £910 million.

Total income decreased by £17,113 million to £26,843 million in 2011 compared with £43,956 million in 2010, comprising a £17,265 million reduction in other income only marginally offset by an increase of £152 million in net interest income.

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

Other income was £17,265 million, or 55 per cent, lower at £14,145 million in 2011 compared to £31,410 million in 2010. Fee and commission income was £57 million, or 1 per cent, lower at £4,935 million compared to £4,992 million in 2010. Fee and commission expense decreased by £291 million or 17 per cent to £1,391 million compared with £1,682 million in 2010. Net trading income decreased by £16,092 million to a deficit of £368 million in 2011 compared to a surplus of £15,724 million in 2010; this decrease included a reduction of £14,267 million in gains on policyholder investments held within the insurance business, offset by a similar decrease in the related claims expense, see below. Insurance premium income was largely unchanged at £8,170 million in 2011 compared with £8,148 million in 2010; an increase of £22 million. During 2011 the Group exchanged certain existing subordinated debt securities for new securities; these exchanges resulted in a gain on extinguishment of the existing securities of £599 million, being the difference between the carrying amount of the securities extinguished and the fair value of the new securities issued together with related fees and costs; this gain was £176 million, or 42 per cent higher than the liability management gains recognised in 2010. Excluding the liability management gains, other operating income was £1,605 million, or 42 per cent, lower at £2,200 million in 2011 compared to £3,805 million in 2010; this largely reflected an adverse variance of £1,411 million in the income arising from the movement in value of in-force insurance business.

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

Operating expenses decreased by £3,420 million, or 21 per cent to £13,050 million in 2011 compared with £16,470 million in 2010; the main reasons for the reduction being the £3,200 million payment protection insurance provision and the £500 million customer goodwill payments provision, raised in 2010, partly offset by a pension curtailment gain of £910 million in the same year. Staff costs were £544 million, or 10 per cent higher at £6,166 million in 2011 compared with £5,622 million in 2010. However, excluding the pension curtailment gain in 2010, staff costs were £366 million, or 6 per cent lower at £6,166 million compared with £6,532 million in 2010. Premises and equipment costs were £126 million, or 11 per cent, lower at £1,051 million compared with £1,177 million in 2010. Other expenses were £81 million, or 2 per cent higher, at £3,418 million in 2011 compared with £3,337 million in 2010. Depreciation and amortisation costs were £257 million, or 11 per cent lower at £2,175 million in 2011 compared to £2,432 million in 2010. In 2011 there was a charge of £65 million in relation to the impairment of tangible fixed assets which was £137 million, or 68 per cent lower than the charge of £202 million in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impairment losses decreased by £2,858 million, or 26 per cent, to £8,094 million in 2011 compared with £10,952 million in 2010. Impairment losses in respect of loans and advances to customers were £2,707 million, or 25 per cent, lower at £8,020 million compared with £10,727 million in 2010. The lower charges were principally due to the continued application of the Group s prudent risk appetite and strong risk management controls resulting in improved portfolio and new business quality, continued low interest rates, and broadly stable UK property prices, partly offset by weakening UK economic growth and rising unemployment. In Retail there was a higher secured impairment charge, with the increase in 2010 largely reflecting a less certain outlook for house prices, together with a decrease in the unsecured impairment charge, reflecting continued improving new business quality and portfolio trends as a result of the Group s risk appetite, with a focus on lending to existing customers. In Commercial Banking there was a decrease in the impairment charge, primarily driven by lower impairment from the corporate real estate and real estate related asset portfolios and in the European and Australian corporate books partly offset by higher impairment on leveraged acquisition finance exposures. The continued low interest rate environment helped to maintain defaults at a reduced level. In Wealth, Asset Finance and International, impairment charges were also lower; the reduction predominantly reflected lower impairment charges in the Irish portfolio where the rate of impaired loan migration had slowed.

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

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

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

The Group s credit market exposures primarily related to asset-backed security exposures held in the Commercial Banking division; on the balance sheet these exposures were classified as loans and receivables, available-for-sale financial assets or trading and other financial assets at fair value through profit or loss depending on the nature of the investment. The Wholesale division s total exposure to asset-backed securities (ABS) had decreased by £19,443 million from £34,724 million at 31 December 2010 to £15,281 million at 31 December 2011 as these investment holdings continued to reduce.

At 31 December 2011, the Group s capital ratios had increased with a total capital ratio on a Basel II basis of 15.6 per cent (compared to 14.5 per cent at 31 December 2010); a tier 1 capital ratio of 12.5 per cent (compared to 11.0 per cent at 31 December 2010) and a core tier 1 ratio of 10.8 per cent (compared to 9.6 per cent at 31 December 2010). During 2011 risk-weighted assets had decreased by £54,031 million to £352,341 million at 31 December 2011 compared with £406,372 million at 31 December 2010; this decrease reflected risk-weighted asset reductions across all divisions driven by balance sheet reductions, lower lending balances and stronger management of risk, including a £6,017 million reduction in the Retail division, a £37,009 million reduction in the Commercial Banking division and a £7,943 million reduction in Wealth, Asset Finance and International.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

NET INTEREST INCOME

	2012	2011	2010
Net interest income £m	**9,075**	12,698	12,546
Average interest-earning assets £m	**709,345**	736,032	741,883
Average rates:			
Gross yield on interest-earning assets%[1]	**3.32**	3.58	3.95
Interest spread%[2]	**1.09**	1.62	1.64
Net interest margin%[3]	**1.28**	1.73	1.69

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.

2012 COMPARED WITH 2011

Net interest income was £9,075 million in 2012; a decrease of £3,623 million, or 29 per cent compared to £12,698 million in 2011. There was a small credit of £109 million in 2012 arising from liability management gains compared to a credit of £696 million in 2011 and a negative impact of £1,647 million from an increase in the amounts payable to unitholders in those Open-Ended Investment Companies included in the consolidated results of the Group. After adjusting for these items, the underlying reduction in net interest income reflected a decrease in average interest-earning assets, mainly due to the disposal of assets outside of the Group s risk appetite and subdued lending demand. It was also driven by decrease in net interest margin, which resulted from competitive deposit markets and elevated wholesale funding costs continuing into 2012, with the average cost of new funding continuing to be higher than the average cost of maturing funds. These effects were partly mitigated by the benefits of re-pricing certain lending portfolios, an improving funding mix, and the reduction in certain lower margin asset portfolios.

Average interest-earning assets were £26,687 million, or 4 per cent, lower at £709,345 million in 2012 compared to £736,032 million in 2011. This reduction reflected the continuing run-off of assets which were outside of the Group s risk appetite from the Group s balance sheet and subdued lending demand.

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

Average interest-earning assets across the rest of the Group were £15,215 million, or 4 per cent, lower at £358,672 million in 2012 compared to £373,887 million in 2011. Relationship lending and similar average interest-earning assets in Commercial Banking were £22,327 million, or 13 per cent, lower at £144,379 million in 2012 compared to £166,706 million in 2011. Balances in Wealth, Asset Finance and International were £8,327 million, or 15 per cent, lower at £48,208 million in 2012 compared to £56,535 million in 2011. The remainder of the Group s average interest-earning assets, which include certain non-relationship and treasury-related balances in the Commercial Banking division and the bank deposits held in the insurance business, were £15,439 million, or 10 per cent, higher at £166,085 million in 2012 compared to £150,646 million in 2011.

The Group s net interest margin decreased by 45 basis points to 1.28 per cent in 2012 compared to 1.73 per cent in 2011. However, net interest income in 2012 included only £109 million in relation to the revision in the carrying values of certain debt securities compared to £696 million in 2011; and there was also a charge of £1,428 million in respect of amounts payable to policyholders in consolidated Open-Ended Investment Companies compared to a credit of £219 million in 2011. Excluding these amounts net interest income was £1,389 million, or 12 per cent, lower at £10,394 million in 2012 compared to £11,783 million in 2011 and the net interest margin was 13 basis points lower at 1.47 per cent in 2012 compared to 1.60 per cent in 2011. Margins in Commercial banking reduced, as a result of increased wholesale funding costs and competition for customer deposits; margins were also lower in Wealth, Asset Finance and International as a result of the run-off of assets outside of the Group s risk appetite.

Margins in Retail, however, were stable as the impact of higher funding costs and portfolio de-risking was largely mitigated by repricing of selected lending portfolios.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

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

Average interest-earning assets were £5,851 million, or 1 per cent, lower at £736,032 million in 2011 compared to £741,883 million in 2010. This reduction reflected the run-off of assets which were outside of the Group s risk appetite from the Group s balance sheet and subdued lending demand.

Average interest-earning assets in Retail were £10,963 million, or 3 per cent, lower at £362,145 million in 2011 compared to £373,108 million in 2010. Average personal mortgage balances were £7,235 million, or 2 per cent, lower at £335,496 million in 2011 compared with £342,731 million in 2010; Retail s new mortgage lending continued to be focused on home purchase with 70 per cent of lending being for house purchase rather than re-mortgaging. Average other personal lending balances were £3,728 million, or 12 per cent, lower at £26,649 million in 2011 compared with £30,377 million in 2010 as a result of customers continuing to reduce their personal indebtedness, particularly in unsecured lending.

Average interest-earning assets across the rest of the Group were £5,112 million, or 1 per cent, higher at £373,887 million in 2011 compared to £368,775 million in 2010. Relationship lending and similar average interest-earning assets in Commercial Banking were £24,812 million, or 13 per cent, lower at £166,706 million in 2011 compared to £191,518 million in 2010, as demand for new corporate lending and refinancing of existing facilities was more than offset by maturities, reflecting a continued trend of subdued corporate demand for lending and customer deleveraging. Balances in Wealth, Asset Finance and International were £4,708 million, or 8 per cent, lower at £56,535 million in 2011 compared to £61,243 million in 2010. The remainder of the Group s average interest-earning assets, which include certain non-relationship and treasury-related balances in the Commercial Banking division and the bank deposits held in the insurance business, were £34,617 million, or 30 per cent, higher at £150,646 million in 2011 compared to £116,029 million in 2010.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OTHER INCOME

	2012 £m	2011 £m	2010 £m
Fee and commission income:			
Current account fees	**1,008**	1,053	1,086
Credit and debit card fees	**941**	877	812
Other	**2,782**	3,005	3,094
	4,731	4,935	4,992
Fee and commission expense	**(1,438)**	(1,391)	(1,682)
Net fee and commission income	**3,293**	3,544	3,310
Net trading income	**13,554**	(368)	15,724
Insurance premium income	**8,284**	8,170	8,148
Liability management	**(338)**	599	423
Other[1]	**5,038**	2,200	3,805
Other operating income	**4,700**	2,799	4,228
Total other income	**29,831**	14,145	31,410

1 As the Group s share of results of joint ventures and associates is no longer significant, this is now included within other operating income; comparatives have been re-presented on a consistent basis.

2012 COMPARED WITH 2011

Other income was £15,686 million, or 111 per cent, higher at £29,831 million in 2012 compared to £14,145 million in 2011.

Fee and commission income was £204 million, or 4 per cent, lower at £4,731 million in 2012 compared with £4,935 million in 2011. Current account fees were £45 million, or 4 per cent, lower at £1,008 million in 2012 compared to £1,053 million in 2011. An increase of £64 million, or 7 per cent, in credit and debit card fees from £877 million in 2011 to £941 million in 2012 resulted from increased customer activity and merchanting charges. Other fees and commissions were £223 million, or 7 per cent, lower at £2,782 million in 2012 compared with £3,005 million in 2011.

Fee and commission expense was £47 million, or 3 per cent, higher at £1,438 million in 2012 compared to £1,391 million in 2011.

Net trading income was £13,922 million higher at £13,554 million in 2012 compared with a deficit of £368 million in 2011. Net trading income within the insurance businesses was £13,506 million in 2012 compared to a deficit of £518 million in 2011, which reflects the improved market performance in 2012, however this increase along with the small increase in long-term insurance premium income were largely offset by the overall increase in insurance claims expense. A gain of £249 million in 2012, compared with a loss in 2011 of £5 million, arose from the change in fair value of the embedded equity conversion feature contained in the Enhanced Capital Notes issued by the Group. Net trading income within the Group s banking activities was £356 million lower at a loss of £201 million in 2012 compared with net gains of £155 million in 2011.

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

Other operating income was £1,901 million, or 68 per cent, higher at £4,700 million in the 2012 compared to £2,799 million in 2011. During February 2012, the Group completed the exchange of certain subordinated debt securities issued by the HBOS group for new subordinated debt securities issued by Lloyds TSB Bank plc by undertaking an exchange offer on certain securities which were eligible for call during 2012. This exchange resulted in a gain on the extinguishment of the existing securities of £59 million; additionally, during the second half of 2012 losses totalling £397 million arose on the buy-back of other debt securities. These net losses of £338 million in respect of liability management compared to gains of £599 million in 2011.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

Other income was £17,265 million, or 55 per cent, lower at £14,145 million in 2011 compared to £31,410 million in 2010.

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

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

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

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

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

Other operating income, excluding the liability management gains, was £1,605 million, or 42 per cent, lower at £2,200 million in 2011 compared with £3,805 million in 2010; this was mainly driven by a significant decline in the movement in value of in-force business from a profit of £789 million in 2010 to a loss of £622 million in 2011, particularly reflecting non-economic assumption changes and economic variance (see note 29 to the financial statements), along with lower levels of operating lease rentals receivable and lower gains on disposal of available-for-sale financial assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

OPERATING EXPENSES

	2012 £m	2011 £m	2010[1] £m
Administrative expenses:			
Staff:			
Salaries	**3,411**	3,784	3,787
Performance-based compensation	**395**	361	533
Social security costs	**383**	432	396
Pensions and other post-retirement benefit schemes:			
Past service credits and curtailment gains	**(250)**		(910)
Other	**547**	401	628
	297	401	(282)
Restructuring costs	**217**	124	119
Other staff costs	**746**	1,064	1,069
	5,449	6,166	5,622
Premises and equipment:			
Rent and rates	**488**	547	602
Hire of equipment	**17**	22	18
Repairs and maintenance	**174**	188	199
Other	**270**	294	358
	949	1,051	1,177
Other expenses:			
Communications and data processing	**1,082**	954	1,126
Advertising and promotion	**314**	398	362
Professional fees	**550**	576	742
Financial services compensation scheme levy	**175**	179	46
UK bank levy	**179**	189	
Other	**932**	1,122	1,061
	3,232	3,418	3,337
Depreciation and amortisation:			
Depreciation of tangible fixed assets	**1,431**	1,434	1,635
Amortisation of acquired value of in-force non-participating investment contracts	**79**	78	76
Amortisation of other intangible assets	**616**	663	721
	2,126	2,175	2,432
Impairment of tangible fixed assets[1]		65	202
Total operating expenses, excluding regulatory provisions	**11,756**	12,875	12,770
Regulatory provisions:			
Payment protection insurance provision	**3,575**		3,200
Other regulatory provisions[2]	**600**	175	500
	4,175	175	3,700
Total operating expenses	**15,931**	13,050	16,470
Cost: income ratio (%)[3]	**77.7**	62.7	66.2

1 In 2011 £65 million (2010: £52 million) of the impairment of tangible fixed assets related to integration activities.

2 In addition, regulatory provisions of £50 million (2011: £nil; 2010: £nil) have been charged against income.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2012 COMPARED WITH 2011

Operating expenses increased by £2,881 million, or 22 per cent, to £15,931 million in 2012 compared with £13,050 million in 2011. This increase principally reflected the £3,575 million payment protection insurance provision made in 2012.

Staff costs were £717 million, or 12 per cent, lower in 2012 at £5,449 million compared to £6,166 million in 2011; in part reflecting a past service pension credit of £250 million in 2012. Excluding the past service pension credit of £250 million in 2012, staff costs were lower by £467 million, a decrease of 8 per cent from £6,166 million in 2011. Salaries were £373 million, or 10 per cent, lower at £3,411 million in 2012 compared with £3,784 million in 2011 as the impact of annual pay rises was more than offset by staff reductions. Pension costs, excluding the past service pension credit in 2012, were £146 million, or 36 per cent, higher at £547 million in 2012 compared to £401 million in 2011, principally as a result of reduced expected returns on defined benefit scheme assets during 2012. Social security costs were £49 million, or 11 per cent, lower at £383 million in 2012 compared with £432 million in 2011 in line with the decrease in salaries. Staff restructuring costs were £93 million, or 75 per cent, higher at £217 million in 2012 compared with £124 million in 2011, and other staff costs were £318 million, or 30 per cent, lower at £746 million in 2012 compared with £1,064 million in 2011.

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

Other expenses (excluding the regulatory provisions charges of £4,175 million from 2012 and £175 million from 2011) were £186 million, or 5 per cent, lower at £3,232 million in 2012 compared with £3,418 million in 2011. Communications and data processing costs were £128 million, or 13 per cent, higher at £1,082 million in 2012 compared with £954 million in 2011 as a result of project-related spend and increased demand for technology in the business. Advertising and promotion costs were £84 million, or 21 per cent, lower at £314 million in 2012 compared with £398 million in 2011 following reduced expenditure within the integration programme and scaling-back of marketing spend; and other costs were £190 million, or 17 per cent, lower at £932 million in 2012 compared with £1,122 million in 2011.

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

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

The Group incurred a regulatory provisions charge of £4,175 million in 2012 compared to £175 million in 2011 of which £3,575 million (2011: £nil) related to payment protection insurance. For further details see note 44 to the financial statements.

2011 COMPARED WITH 2010

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

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

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

Other expenses were £81 million, or 2 per cent, higher at £3,418 million in 2011 compared with £3,337 million in 2010. In 2011 there was a charge of £189 million for the UK bank levy and a total of £179 million for Financial Services Compensation Scheme (FSCS) levies compared to only £46 million in 2010. Excluding these items, other expenses in 2011 were £241 million, or 7 per cent, lower at £3,050 million compared to £3,291 million in 2010. Communications and data processing costs were £172 million, or 15 per cent, lower at £954 million in 2011 compared with £1,126 million in 2010 as a result of increased amounts of software expenditure being suitable for capitalisation as the integration programme has progressed. Professional fees were £166 million, or 22 per cent, lower at £576 million in 2011 compared with £742 million in 2010 following reduced expenditure within the integration programme and on a number of specific projects.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRMENT

	2012 £m	2011 £m	2010 £m
Impairment losses on loans and receivables:			
Loans and advances to banks			(13)
Loans and advances to customers	**5,125**	8,020	10,727
Debt securities classified as loans and receivables	**(4)**	49	57
Total impairment losses on loans and receivables	**5,121**	8,069	10,771
Impairment of available-for-sale financial assets	**37**	80	106
Other credit risk provisions	**(9)**	(55)	75
Total impairment charged to the income statement	**5,149**	8,094	10,952

2012 COMPARED WITH 2011

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

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

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

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

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

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

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

In Wealth, Asset Finance and International, impairment charges were also lower. The reduction predominantly reflected lower impairment charges in the Irish portfolio where the rate of impaired loan migration slowed. The impairment charge as a percentage of average loans and advances to customers improved.

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

TAXATION

	2012 £m	2011 £m	2010 £m
UK corporation tax:			
Current tax on profits for the year	**(175)**	(93)	(146)
Adjustments in respect of prior years	**58**	(146)	310
	(117)	(239)	164
Double taxation relief			1
	(117)	(239)	165
Foreign tax:			
Current tax on profits for the year	**(86)**	(90)	(82)
Adjustments in respect of prior years	**(8)**	36	49
	(94)	(54)	(33)
Current tax credit (charge)	**(211)**	(293)	132
Deferred tax	**(562)**	257	193
Taxation (charge) credit	**(773)**	(36)	325

2012 COMPARED WITH 2011

The rate of tax is influenced by the geographic and business mix of profits.

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

In 2012, a tax charge of £773 million arose on the loss before tax of £570 million and in 2011 a tax charge of £36 million arose on the loss before tax of £342 million. The statutory corporation tax rates were 24.5 per cent for 2012 and 26.5 per cent for 2011.

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

Reductions in the enacted UK corporation tax rates to 23 per cent (2011 to 25 per cent) led to an additional deferred tax charge in both 2012 (£308 million) and 2011 (£420 million) on the revaluation of the Group s deferred tax asset.

2011 COMPARED WITH 2010

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LINE OF BUSINESS INFORMATION

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

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

The aggregate total of the management basis and the underlying basis segmental results constitute non-GAAP measures as defined in the United States Securities and Exchange Commission s Regulation G. Management uses the aggregated total of management profit before tax and the aggregated and segmental underlying profit before tax, all non-GAAP measures, as measures of performance and believes that they provide important information for investors because they are comparable representations of the Group s performance. Profit before tax is the comparable GAAP measure to aggregate management profit before tax and aggregate underlying profit before tax. Segmental management profit before tax is the comparable GAAP measure to segmental underlying profit before tax. The tables below set out reconciliations of each these non-GAAP measures to their comparable GAAP measure.

Following a reorganisation in the second half of 2012, the Group s activities are now organised into four financial reporting segments: Retail; Commercial Banking; Wealth, Asset Finance and International; and Insurance. The impact of this reorganisation was as follows:

The Group s existing Wholesale division and its Commercial division have been combined to form Commercial Banking.

The Asset Finance business unit, previously reported within Wholesale, is now reported within the Wealth, Asset Finance and International segment; the Asset Finance business recorded a management basis profit before tax of £319 million in the year ended 31 December 2012 (2011: £275 million; 2010: £380 million).

The Group s continental European wholesale business and the wholesale Australian business have been transferred from Wealth, Asset Finance and International to Commercial Banking; during the year ended 31 December 2012 these transferred businesses recorded a management basis loss before tax of £432 million (2011: £1,050 million; 2010: £1,327 million).

In addition, asset sales now include sales of centrally held government bonds, following an increase in activity in the first half of 2012, and are reported net of the related fair value unwind whereas this was previously included on the separate fair value unwind line.

Comparative figures have been restated accordingly for all of the above changes.

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

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

the amortisation of purchased intangible assets has been excluded; and the unwind of acquisition-related fair value adjustments is shown on one line in the management basis income statement, other than unwind related to asset sales which is included within the effects of asset sales, volatile items and liability management.

In order to better present the business performance the effects of liability management, volatile items and asset sales are shown on separate lines in the management basis consolidated income statement and underlying profit is profit before taking into account these items and fair value unwind. Comparatives have been restated accordingly.

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

integration, simplification and EC mandated retail business disposal costs;

volatility arising in insurance businesses;

insurance gross-up;

the payment protection insurance provision;

other regulatory provisions;

certain past service pensions credits and curtailment gains in respect of the Group s defined benefit pension schemes; and

the loss on disposal of businesses in 2010.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

Underlying basis

	2012	2011	2010
	£m	£m	£m
Retail	**3,188**	2,749	2,881
Commercial Banking	**(324)**	(812)	(1,782)
Wealth, Asset Finance and International	**(929)**	(2,785)	(3,652)
Insurance	**1,107**	1,465	1,354
Group Operations and Central items:			
Group Operations	**(51)**	(56)	(52)
Central items	**(384)**	77	350
	(435)	21	298
Underlying profit (loss) before tax	**2,607**	638	(901)

Management basis

	2012	2011	2010
	£m	£m	£m
Retail	**3,670**	3,636	3,986
Commercial Banking	**238**	75	1,098
Wealth, Asset Finance and International	**(1,176)**	(2,684)	(3,243)
Insurance	**1,065**	1,422	1,326
Group Operations and Central items:			
Group Operations	**(51)**	(56)	(52)
Central items	**1,081**	292	(903)
	1,030	236	(955)
Management basis profit before tax	**4,827**	2,685	2,212

RECONCILIATION OF UNDERLYING PROFIT (LOSS) TO MANAGEMENT BASIS PROFIT AND TO STATUTORY PROFIT (LOSS) BEFORE TAX FOR THE YEAR

		2012	2011	2010
	Note	**£m**	£m	£m
Profit before tax Underlying basis		**2,607**	638	(901)
Asset sales	1	**2,547**	284	496
Volatile items	2	**(748)**	(738)	(270)
Liability management	3	**(229)**	1,295	423
Fair value unwind	4	**650**	1,206	2,464
Profit before tax Management basis		**4,827**	2,685	2,212
Integration, simplification and EC mandated retail business disposal costs	5	**(1,246)**	(1,452)	(1,653)
Volatility arising in insurance businesses	6	**306**	(838)	306
Amortisation of purchased intangibles	8	**(482)**	(562)	(629)
Payment protection insurance provision	9	**(3,575)**		(3,200)
Other regulatory provisions	10	**(650)**	(175)	(500)
Past service pension credits and curtailment gains in respect of defined benefit pension schemes	11	**250**		910
Loss on disposal of businesses	12			(365)
Loss before tax Statutory		**(570)**	(342)	(2,919)

1. Asset sales

Asset sales comprise the gains and losses on asset disposals (2012: losses of £660 million; 2011: gains of £88 million; 2010: gains of £453 million), which principally comprised assets which were outside of the Group s risk appetite, and gains on bond sales (2012: £3,207 million; 2011: £196 million; 2010: £43 million) as the Group has taken the opportunity afforded by the continuing low interest rate environment to rebalance and reduce the level of holdings of available-for-sale Government securities.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2. Volatile items
This comprises own debt volatility and other volatile items.

Own debt volatility reflects a charge of £437 million relating to the change in fair value attributable to movements in the Group s credit standing of the small proportion of the Group s wholesale funding which was designated at fair value at inception (2012: charge of £437 million; 2011: gain of £189 million; 2010: nil). Own debt volatility also includes a £249 million gain (2011: loss of £5 million; 2010: loss of £620 million) relating to the change in fair value of the equity conversion feature of the Enhanced Capital Notes.

Other volatile items include the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting. A charge of £827 million was included in 2012 (2011: charge of £204 million; 2010: credit of £392 million) and reflected the market conditions that resulted in substantial changes in interest and foreign exchange rates in the year. Also included in 2012 was a positive net derivative valuation adjustment of £267 million (2011: charge of £718 million; 2010: charge of £42 million), reflecting a reduction in the market implied credit risk associated with customer derivative balances.

3. Liability management
Liability management losses of £229 million (2011: gains of £1,295 million; 2010: gains of £423 million) arose on transactions undertaken as part of the Group s management of wholesale funding and capital, including a loss of £397 million resulting from debt repurchases and a gain of £168 million relating to the exchange of certain capital securities for other subordinated debt instruments. These liability management losses comprised a gain of £109 million (2011: £696 million; 2010: nil) recognised with net interest income and losses of £338 million (2011: gains of £599 million; 2010: gains of £423 million) recognised in other income.

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

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

5. Integration, simplification and EC mandated retail business disposal costs
The costs of the Simplification programme were £676 million in 2012 (2011: £185 million; 2010: £nil). These costs related to severance, IT and business costs of implementation. Full-time equivalent role reductions of 4,892 were announced in 2012 taking the total to 6,990 since the start of the programme. Simplification of the Group s business operations continues through reduction in management layers and increasing spans of control as well as restructuring business units. The latter includes consolidation of back office operations sites, optimisation of the IT delivery model and outsourcing of property facilities and asset management services.

No integration costs were incurred in 2012 (2011: £1,097 million; 2010: £1,653 million).

As part of the European Commission s decision approving state aid to the Group, the Group is required to dispose of a retail banking business with at least 600 branches, a 4.6 per cent share of the personal current accounts market in the UK and up to 19.2 per cent of the Group s mortgage assets, with the business to be disposed of before the end of November 2013. The Group refers to this as the Verde business. On 19 July 2012, the Group announced that it had agreed non-binding heads of terms with The Co-operative Group plc (Co-operative). The transaction is expected to complete by the end of November 2013 and to result in the disposal of 632 branches, 4.8 million customers, including 3.1 million personal current account customers, and approximately £24 billion of assets. The Co-operative will also acquire the TSB and C&G brands from the Group.

Costs incurred in relation to this disposal in the year ended 31 December 2012 totalled £570 million (2011: £170 million; 2010: nil).

The completion of the divestment is currently expected to be recognised in the Group s 2013 financial statements. The ultimate impact on the Group of this disposal can only be known once the sale and purchase agreement has been agreed and the transaction completed. The divestment is not expected to have a material effect on the ongoing future profitability of the Group.

Under the heads of terms:

- the Group will receive initial consideration of £350 million;
- the initial consideration will be funded through the sale by Co-operative of perpetual subordinated debt, underwritten by the Group;
- the Group will receive additional consideration of up to £400 million (on a present value basis) based on the performance of the Co-operative s combined banking business between completion and 2027;
- the Verde business is expected to have £1.5 billion of equity capital at completion if a standardised capital model is used. This amount may be reduced by up to £300 million if the Verde business uses an Internal Ratings Based (IRB) model; and
- the Group intends to apply for an IRB waiver prior to completion.

The Group continues to work with the Co-operative to finalise a sale and purchase agreement and is having ongoing constructive discussions on the transaction with the relevant governmental and regulatory bodies.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

6. Volatility arising in insurance businesses

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

In 2012, the Group s statutory result before tax included positive insurance and policyholder interests volatility totalling £306 million compared to negative volatility of £838 million in 2011 and positive volatility of £306 million in 2010.

Volatility comprises the following:

	2012	2011	2010
	£m	£m	£m
Insurance volatility	**183**	(557)	100
Policyholder interests volatility	**143**	(283)	216
Insurance hedging arrangements	**(20)**	2	(10)
Total	**306**	(838)	306

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

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

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

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

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:

	2012	2011	2010
United Kingdom (Sterling)	**%**	%	%
Gilt yields (gross)	**2.48**	3.99	4.45
Equity returns (gross)	**5.48**	6.99	7.45
Dividend yield	**3.00**	3.00	3.00
Property return (gross)	**5.48**	6.99	7.45
Corporate bonds in unit-linked and with-profit funds (gross)	**3.08**	4.59	5.05
Fixed interest investments backing annuity liabilities (gross)	**3.89**	4.78	5.30

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 Profit Funds, the value of the in-force business and the value of shareholders funds.

The liabilities in respect of the Group s UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and, since late 2012, illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. The illiquidity premium is estimated to be 73 basis points at 31 December 2012 (2011: 119 basis points; 2010: 75 basis points).

The positive insurance volatility of £183 million during 2012 primarily reflected the benefits of an increase in equity market values relative to the expected return and a reduction in gilt yields and a narrowing of corporate bond spreads. This was partially offset by lower cash returns compared to the long-term expectation. The negative insurance volatility of £557 million in 2011 primarily reflected the underperformance of equity markets in the second half of that year. The positive volatility of £100 million in 2010 was primarily driven by strong performance of equity and property investments relative to the expected return. During 2010, equity market values had increased by 9 per cent and property returns had reached 19 per cent; partly offsetting this were lower than expected returns on cash and fixed interest assets.

Policyholder interests volatility

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the normalised approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility.

During the year ended 31 December 2012, the statutory profit before tax included a credit to other income of £143 million which related to the policyholder interests volatility (2011: charge of £283 million in other income; 2010: credit of £216 million in other income).

Group hedging arrangements

The statutory results for the year ended 31 December 2012 also include a charge in relation to the Group s insurance hedging arrangements of £20 million (2011: credit of £2 million; 2010: charge of £10 million). To protect against further deterioration in equity market conditions, and the consequent negative impact on the value of in-force business on the Group balance sheet, the Group has been purchasing put option contracts since 2009.

7. Insurance gross-up

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

8. Amortisation of purchased intangibles

A total of £4,650 million of customer-related intangibles, brands, core deposit intangibles and purchased credit card relationships were recognised on the acquisition of HBOS in 2009 and these are being amortised over their estimated useful lives, where this has been determined to be finite. This has resulted in a charge of £482 million in the year ended 31 December 2012 (2011: £562 million; 2010: £629 million).

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

9. Payment protection insurance provision

Following the unsuccessful legal challenge by the British Bankers Association in respect of payment protection insurance (PPI), the Group entered into discussions with the FSA with a view to seeking clarity around the detailed implementation of the Policy Statement. As a result the Group concluded that there are certain circumstances where customer redress will be appropriate. Accordingly the Group made a provision in its income statement for the year ended 31 December 2010 of £3,200 million in respect of the anticipated costs of such redress, including administration expenses. During the first half of 2012 there was an increase in the volume of complaints being received and, although the level of complaints received declined during the second half of 2012 in comparison to the previous six months, they were higher than had been anticipated. As a consequence, the Group increased its provision by a further £3,575 million during the year ended 31 December 2012.

10. Other regulatory provisions

Litigation in relation to insurance branch business in Germany

As previously disclosed, CMIG has received a number of claims in the German courts, relating to policies issued by CMIG but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group has recognised a further provision of £150 million (2011: £175 million;

2010: £nil) with respect to this litigation. However, there are still a number of uncertainties as to the full impact of the FCJ s decisions, and the implications with respect to the claims facing CMIG. As a result the ultimate financial effect, which could be significantly different to the provision, will only be known once there is further clarity with respect to a range of legal issues involved in these claims and/or all relevant claims have been resolved.

Interest rate hedging products

In June 2012, a number of banks, including the Group, reached agreement with the FSA to carry out a thorough assessment of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. The Group agreed that on conclusion of this review it would provide redress to any of these customers where appropriate. Following the completion of a pilot review of IRHP sales to small and medium-sized businesses and agreement reached with the FSA on 30 January 2013 on the principles to be adopted during the course of the wider review, the Group has provided £400 million (2011: £nil; 2010: £nil) for the estimated cost of redress and related administration costs. At 31 December 2012, £20 million of the provision had been utilised. A number of uncertainties remain as to the eventual costs given the inherent difficulties in determining the number of customers within the scope of the review and the average compensation to customers.

Other regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA or other regulators in relation to a range of matters. In 2012 a provision of £100 million (2011: £nil; 2010: £nil) was made in respect of certain UK retail and other matters; however, the ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

Customer goodwill payments provision

Following discussions with the FSA regarding the application of an interest rate variation clause in certain Bank of Scotland plc variable rate mortgage contracts, Bank of Scotland plc applied for a Voluntary Variation of Permission (V VOP) in February 2011 and agreed to initiate a customer review and contact programme and to make goodwill payments to affected customers. The Group made a provision of £500 million in respect of this matter during the year ended 31 December 2010. Since that time further information has become available which has resulted in Bank of Scotland plc applying for, and being granted, an amended V VOP by the FSA in November 2011. No additional provision was required during the year ended 31 December 2011 or the year ended 31 December 2012.

11. Past service pensions credits and curtailment gains in respect of defined benefit pension schemes

Following a review of policy in respect of discretionary pension increases in relation to the Group s defined benefit pension schemes, increases in certain schemes are now linked to the Consumer Price Index rather than the Retail Price Index. The impact of this change is a reduction in the Group s defined benefit obligation of £258 million, recognised in the Group s income statement in 2012, net of a charge of £8 million in respect of one of the Group s smaller schemes.

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

12. Loss on disposal of businesses

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

DIVISIONAL RESULTS

A reconciliation from underlying profit (loss) to management profit (loss) for each division is set out below:

2012	**Retail £m**	**Commercial Banking £m**	**Wealth, Asset Finance and International £m**	**Insurance £m**	**Other £m**
Underlying profit (loss)	**3,188**	**(324)**	**(929)**	**1,107**	**(435)**
Asset sales		**(464)**	**(196)**		**3,207**
Volatile items		**138**			**(886)**
Liability management					**(229)**
Fair value unwind	**482**	**888**	**(51)**	**(42)**	**(627)**
Management profit (loss)	**3,670**	**238**	**(1,176)**	**1,065**	**1,030**

2011	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Other £m
Underlying profit (loss)	2,749	(812)	(2,785)	1,465	21
Asset sales	48	61	(21)		196
Volatile items		(736)			(2)
Liability management					1,295
Fair value unwind	839	1,562	122	(43)	(1,274)
Management profit (loss)	3,636	75	(2,684)	1,422	236

2010	Retail £m	Commercial Banking £m	Wealth, Asset Finance and International £m	Insurance £m	Other £m
Underlying profit (loss)	2,881	(1,782)	(3,652)	1,354	298
Asset sales		401	37	15	43
Volatile items		3			(273)
Liability management					423
Fair value unwind	1,105	2,476	372	(43)	(1,446)
Management profit (loss)	3,986	1,098	(3,243)	1,326	(955)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RETAIL

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

The division is focused on improving customer service and advocacy and becoming the best bank for customers. With its strong stable of brands including Lloyds TSB, Halifax, Bank of Scotland and Cheltenham & Gloucester, it serves over 30 million customers through one of the largest branch and fee free ATM networks in the UK and a comprehensive digital, telephony and mobile proposition.

In meeting the financial needs of its customers the division provides a comprehensive product range to ensure differing customer requirements can be effectively met. This includes a range of current accounts including packaged accounts and basic banking accounts. It is also the largest provider of personal loans in the UK, as well as being the UK s leading credit card issuer. Retail provides one in five new residential mortgages and provided over 55,000 mortgages to help first time buyers in 2012, making it one of the leading UK mortgage lenders. Retail is the largest private sector savings provider in the UK. It is also a major general insurance and bancassurance distributor, offering a wide range of long-term savings, investment and general insurance products.

	2012	2011[1]	2010[1]
	£m	£m	£m
Net interest income	**7,195**	7,497	8,648
Other income	**1,462**	1,660	1,624
Total underlying income	**8,657**	9,157	10,272
Operating expenses	**(4,199)**	(4,438)	(4,644)
Impairment	**(1,270)**	(1,970)	(2,747)
Underlying profit	**3,188**	2,749	2,881

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

2012 COMPARED WITH 2011

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

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

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

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

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

The impairment charge reduced by £700 million, or 36 per cent, to £1,270 million in 2012 compared to £1,970 million in 2011. Credit performance across the business continued to be strong considering the subdued economic environment. This was supported by the Group s sustainable approach to risk, a continued focus on lending to existing customers and low interest rates. The unsecured impairment charge reduced by £614 million, or 41 per cent, to £893 million in 2012 compared to £1,507 million in 2011, reflecting the impact of the sustainable approach to risk (resulting in improved new business quality), effective portfolio management and a reduction in unsecured balances. The secured impairment charge decreased by £86 million, or 19 per cent, to £377 million from £463 million in 2011, reflecting further reductions in impaired loans in the secured portfolio.

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

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

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

2011 COMPARED WITH 2010

Underlying profit for Retail in 2011 of £2,749 million was £132 million, or 5 per cent, lower than 2010, driven by higher funding costs.

Total underlying income decreased by £1,115 million, or 11 per cent, to £9,157 million. This was driven by a reduction in net interest income of £1,151 million, while other income increased by £36 million.

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

Other income increased by 2 per cent in 2011 to £1,660 million from £1,624 million largely as a result of higher bancassurance income, driven by an increase in the value of protection products sold through the branch network.

Operating expenses and other costs fell by 4 per cent compared to 2010 and the cost: income ratio was 48.5 per cent (2010: 45.2 per cent). Operating expenses benefited from integration activities, the start of the simplification programme, and other day-to-day cost management activities to offset inflation. The Group continues to invest in the Retail business to improve products and services for its customers including digital platforms and branches. During 2011 Retail completed a major milestone in the Integration programme, the consolidation of its main Retail product systems. This now creates a solid platform to deliver the simplification programme.

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL BANKING

Commercial Banking was created in the fourth quarter of 2012 bringing Small and Medium-sized Enterprises (SMEs) together with larger corporate UK and global clients to ensure consistent and effective client coverage. The Commercial division was combined with the Wholesale division and the Australian and European corporate businesses previously reported in the International segment of Wealth, International and Asset Finance.

The division continues to re-segment client coverage, driven by evolving client behaviours. For SME and Mid-Market clients, the division is strengthening the face-to-face banking proposition as well as working to improve the delivery of simple products to meet simple needs through enhanced digital capability. For larger corporate clients, the division is strengthening product capability through investment in Transaction Banking at the same time as enriching the core proposition in Financial Markets and Capital Markets to improve fee generating solutions.

The division s strategy is to be the best bank for its clients. Clients are at the centre of the business model and the division will lead the business through four coverage segments: Small and Medium-sized Enterprises, Mid-Markets, Global Corporates and Financial Institutions. The division will meet clients needs with a suite of core banking products from Lending and Transaction Banking to Financial Markets and Capital Markets, delivering the full capability of the bank to clients and serving their needs as they move up the value chain. The division s strategy is driven by three guiding principles; to be client centric, UK focused and capital efficient with a rigorous focus on executing plans according to these core principles. The business will be delivered through the formation of a simpler and leaner organisation, sharper prioritisation of resources to support core clients and focused investment in product capability to better serve clients needs.

	2012 £m	2011[1] £m	2010[1] £m
Net interest income	**2,206**	3,192	3,820
Other income	**2,932**	2,806	3,009
Total underlying income	**5,138**	5,998	6,829
Costs:			
Operating expenses	**(2,516)**	(2,600)	(2,747)
Impairment of tangible fixed assets			(150)
	(2,516)	(2,600)	(2,897)
Impairment	**(2,946)**	(4,210)	(5,714)
Underlying loss	**(324)**	(812)	(1,782)

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

2012 COMPARED WITH 2011

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

The division s underlying loss improved by £970 million, or 54 per cent, to £812 million in 2011, compared to £1,782 million in 2010. The improvement reflects an £831 million reduction in total underlying income which was more than offset by a £297 million reduction in costs and a £1,504 million decrease in impairments.

Net interest income decreased by £628 million, or 16 per cent, to £3,192 million in 2011 compared to £3,820 million in 2010. The decrease reflects a continued decrease of average lending volumes in line with the Group s targeted balance sheet and higher funding costs.

Banking net interest margin increased by 8 basis points to 1.86 per cent in 2011 compared to 1.80 per cent in 2010, reflecting client re-pricing and increased deposit margins and volumes. This is partially offset by increased wholesale funding costs.

Other income decreased by £203 million, or 7 per cent, to £2,806 million in 2011 compared to £3,009 million in 2010, mainly reflecting reduced trading revenues.

Operating expenses decreased by £147 million, or 5 per cent, to £2,600 million in 2011 compared to £2,747 million in 2010, reflecting further savings from the Integration programme, lower operating lease depreciation, lower bonus accruals and other ongoing cost management actions to mitigate the impact of inflationary increases. This was partially offset by continued investment in customer facing resources and systems.

The impairment charge decreased by £1,504 million, or 26 per cent, to £4,210 million in 2011 compared to £5,714 million in 2010, reflecting a sustained decrease since the peak in 2009. As a percentage of average loans and advances to customers, the impairment charge improved to 2.32 per cent in 2011 compared to 2.62 per cent in 2010. This reflected risk management initiatives and lower defaults from continued low interest rates despite a subdued economic environment.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

WEALTH, ASSET FINANCE AND INTERNATIONAL

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

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

Wealth UK and International Wealth businesses, Scottish Widows Investment Partnership and St James s Place.

Asset Finance UK and International Asset Finance and on-line deposit businesses.

International banking businesses in Ireland, Europe, Asia and the rest of the world (excluding businesses transferred to the Commercial Banking division in 2012).

	2012 £m	2011[1] £m	2010[1] £m
Net interest income	**799**	1,003	1,204
Other income	**2,043**	2,230	2,397
Total underlying income	**2,842**	3,233	3,601
Operating expenses	**(2,291)**	(2,414)	(2,533)
Impairment	**(1,480)**	(3,604)	(4,720)
Underlying loss	**(929)**	(2,785)	(3,652)

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

2012 COMPARED WITH 2011

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

Underlying loss reduced by £867 million, or 24 per cent, to £2,785 million in 2011 compared to £3,652 million in 2010 as a lower impairment charge, predominantly in Ireland, and lower operating expenses more than offset lower income.

Total underlying income decreased by £368 million, or 10 per cent, to £3,233 million in 2011 compared to £3,601 million in 2010.

Net interest income decreased by £201 million, or 17 per cent, to £1,003 million in 2011 compared to £1,204 million in 2010. There was a reduction of 17 per cent in constant currency terms. Higher funding costs and the increased strain of impaired assets, reflected in a reduction in net lending margins together with lower lending volumes impacting net interest income were partially offset by the impact of the stronger Australian dollar. Deposit margins increased, reflecting changing product mix predominantly as a result of continued deposit inflows in the on-line deposit business at higher margins together with improving margins across the Wealth businesses.

Other income decreased by £167 million, or 7 per cent, to £2,230 million in 2011 compared to £2,397 million in 2010 mainly due to back-book run-down in Asset Finance. Excluding the impact of foreign exchange, other income decreased by 6 per cent.

Operating expenses decreased by £119 million, or 5 per cent to £2,414 million in 2011 compared to £2,533 million in 2010, due to increased investment in the International deposit business, the impact of the stronger Australian dollar and Swiss franc and additional regulatory costs in Wealth. On a constant currency basis, operating expenses reduced by 5 per cent.

The impairment charge reduced by £1,116 million or 24 per cent, to £3,604 million in 2011 compared to £4,720 million in 2010. Following increased charges in the last quarter of 2010, driven by the significant deterioration in the economic environment in Ireland, the rate of impaired loan migration slowed in 2011.

	Impairment charges	
	2011 £m	2010 £m
Ireland	3,187	4,264
Other	152	129
International	3,339	4,393
Wealth	33	23
Asset Finance	232	304
	3,604	4,720

The International impairment charge reduced by £1,054 million, or 24 per cent, to £3,339 million due to a £1,077 million reduction in impairment charges in Ireland.

The impairment charge within Wealth increased by £10 million to £33 million in 2011 compared to £23 million in 2010 primarily due to an increased charge within private banking.

The impairment charge in Asset Finance was £72 million, or 24 per cent, lower at £232 million in 2011 compared to £304 million in 2010, reflecting an improvement in market conditions for both the retail and non-retail consumer finance businesses. The lower impairment charge was driven by a reduction in new cases entering arrears, reduced book size and improved credit quality of new business.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

INSURANCE

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

Life, Pensions and Investments

The UK Life, Pensions and Investments business provides long-term savings, protection and investment products distributed through the bancassurance, intermediary and direct channels of the Lloyds TSB, Halifax, Bank of Scotland and Scottish Widows brands. The European Life, Pensions and Investments business distributes products primarily in the German market under the Heidelberger Leben and Clerical Medical brands.

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

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

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

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

General Insurance

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

	2012 **£m**	2011[1] £m	2010[1] £m
Net interest income	**(78)**	(67)	(39)
Other income	**2,294**	2,687	2,789
Insurance claims	**(365)**	(343)	(542)
Total underlying income, net of insurance claims	**1,851**	2,277	2,208
Operating expenses	**(744)**	(812)	(854)
Underlying profit	**1,107**	1,465	1,354
Underlying profit by business unit			
Life, Pensions and Investments	**698**	968	957
General Insurance	**409**	497	397
Underlying profit	**1,107**	1,465	1,354

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

2012 COMPARED WITH 2011

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

2011 COMPARED WITH 2010

Underlying profit from Insurance was £111 million, or 8 per cent, higher at £1,465 million compared to £1,354 million in 2010. In 2010 income was reduced by a non-recurring charge of £70 million in respect of the Group s decision to cease writing new PPI business. Excluding this charge underlying profit increased by £41 million, or 3 per cent, to £1,465 million in 2011 compared to £1,424 million in 2010.

Total underlying income, net of insurance claims, increased by £69 million, or 3 per cent, to £2,277 million from £2,208 million in 2010. This was attributable to strong sales of corporate pensions through the intermediary channel and the continued change in new business mix within Life, Pensions and Investments UK (LP&I UK) towards a more profitable protection business reflecting a focus on meeting customer needs in an area where there is a general level of under provision in the UK. Improved claims experience within General Insurance which was offset by lower PPI related income was also a significant contributor to this.

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

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

LIFE, PENSIONS AND INVESTMENTS

	2012 £m	2011 £m	2010 £m
Existing business income	**760**	1,031	990
New business income:			
New Intermediary and direct income	**357**	321	335
New Bancassurance income	**162**	233	265
	519	554	600
Total underlying income	**1,279**	1,585	1,590
Total costs	**(581)**	(617)	(633)
Underlying profit	**698**	968	957
LP&I existing business profit	**380**	637	691
LP&I new business profit	**318**	331	266
Underlying profit	**698**	968	957

2012 COMPARED WITH 2011

LP&I Existing business profit reduced by £257 million, or 40 per cent, to £380 million in 2012. This was primarily attributable to the subdued economic environment. For LP&I insurance contracts, returns on existing business reflect long term economic assumptions for these policies. The subdued economic environment has resulted in the rate of return used in calculating the 2012 results being significantly lower than the comparable rate in the prior year and this was the main driver of the reduction in existing business profit.

Total new business profit decreased by £13 million, or 4 per cent, to £318 million, primarily reflecting a 3 per cent reduction in the present value of new business premiums (PVNBP) driven by lower bancassurance volumes, reflecting the impact of the economic environment on customers desire to invest and the decision to only offer investment advice for Retail customers with savings above £100,000 ahead of the implementation of the Financial Services Authority s Retail Distribution Review (RDR). High volumes of corporate pension sales through the intermediary channel partially offset this.

2011 COMPARED WITH 2010

Existing business profit decreased by £54 million, or 8 per cent, to £637 million. The decrease predominantly reflected higher interest payments following capital restructuring initiatives, a reduction in the assumed rate of return, and lower levels of shareholder net assets following capital repatriation initiatives in 2010. This was partly offset by a net beneficial impact of experience variances and assumption changes, mainly reflecting the absence of the £70 million charge taken in 2010 from the Group s decision to cease writing new PPI business.

Total new business profit increased by £65 million, or 24 per cent, to £331 million. The increase was primarily attributable to strong sales of corporate pensions through the intermediary channel, the continued growth of protection business in the bancassurance channel as the Group helped more customers and addressed the sizeable protection gap that exists in the UK and a reduction in lower margin business following the launch of the integrated bancassurance proposition in June 2010.

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 the performance of the business this is calculated as the value of single premiums plus the discounted present value of future expected regular premiums.

	2012			2011			2010		
	UK £m	**Europe £m**	**Total £m**	UK £m	Europe £m	Total £m	UK £m	Europe £m	Total £m
Corporate and other pensions	**5,427**		**5,427**	4,423		4,423	2,750		2,750
Individual pensions	**1,580**	**97**	**1,677**	1,480	144	1,624	1,606	141	1,747
Retirement income	**729**		**729**	747		747	889		889
Protection	**554**	**53**	**607**	729	53	782	644	56	700
Investments (inc. OEICs)	**1,715**	**209**	**1,924**	2,840	246	3,086	4,427	315	4,742
Total	**10,005**	**359**	**10,364**	10,219	443	10,662	10,316	512	10,828
Analysis by channel									
Intermediary	**7,053**	**359**	**7,412**	6,415	443	6,858	5,365	512	5,877
Bancassurance	**2,325**		**2,325**	3,216		3,216	4,432		4,432
Direct	**627**		**627**	588		588	519		519
Total	**10,005**	**359**	**10,364**	10,219	443	10,662	10,316	512	10,828

2012 COMPARED WITH 2011

Total sales (PVNBP) have reduced by £298 million, or 3 per cent, to £10,364 million in 2012 compared to £10,662 million in 2011. European Embedded Value new business margin reduced to 3.8 per cent in 2012 from 4.0 per cent in 2011. This reflects a change in business mix as a result of lower investments and protection volumes being partially offset by strong sales of corporate and individual pensions in LP&I UK.

Within the intermediary channel the increase in sales of £554 million or 8 per cent, mainly reflects strong sales of corporate pensions which were 23 per cent higher than 2011, ahead of the introduction of the RDR.

Sales of investment products and protection through the bancassurance channel have reduced due to subdued customer demand (reflecting the economic environment) and the withdrawal in the second half of 2012 from investment advice within the Retail business for customers with savings below £100,000.

The direct channel continues to perform well and is being developed for future growth. This channel will become even more important to the business with the introduction of RDR.

The reduction in European sales reflects an expected reduction in new business due to the strategy of focusing on the relationship with key distributors and securing value in the existing book of business.

2011 COMPARED WITH 2010

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

Despite the reduction in sales total new business profit within LP&I increased by £65 million, or 24 per cent, to £331 million.

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

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

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

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

GENERAL INSURANCE

	2012 £m	2011[1] £m	2010[1] £m
Net operating income	**937**	1,035	1,160
Claims paid on insurance contracts (net of reinsurance)	**(365)**	(343)	(542)
Underlying operating income, net of claims	**572**	692	618
Operating expenses	**(163)**	(195)	(221)
Underlying profit	**409**	497	397

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

2012 COMPARED WITH 2011

Underlying profit decreased by £88 million, or 18 per cent to £409 million compared to £497 million in 2011. The decrease was primarily due to increased weather related claims in 2012, reduced investment returns and the impact of the continued run-off of the PPI book.

Total income for home insurance was broadly in line with 2011 at £868 million and reflects the maturity and competitiveness of the market. PPI income continues to reduce as a result of the Group ceasing to write new PPI business in 2010.

Claims of £365 million were £22 million, or 6 per cent higher than £343 million in 2011, primarily reflecting £95 million of incremental adverse property claims as a result of extreme weather events. This was partly offset by lower underlying home claims reflecting the improved claims management processes resulting in reduced average claims costs as well as lower claims as a result of the reduction in the size of the PPI book.

Operating expenses decreased by £32 million, or 16 per cent, to £163 million compared to £195 million in 2011 primarily as a result of continued focus on cost management.

Despite the impact of weather related claims the combined ratio remains strong at 72 per cent.

2011 COMPARED WITH 2010

Underlying profit from General Insurance increased by £100 million, or 25 per cent to £497 million compared to £397 million in 2010. The increase was primarily due to improved PPI claims experience from the run off of this business line, the absence of severe weather related claims as experienced in 2010 and lower expenses.

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GROUP OPERATIONS

	2012 £m	2011[1,2] £m	2010[1,2] £m
Total income	**30**	42	(9)
Direct costs:			
Information technology	**(1,150)**	(1,177)	(1,354)
Operations	**(670)**	(739)	(802)
Property	**(884)**	(909)	(966)
Support functions	**(100)**	(109)	(119)
	(2,804)	(2,934)	(3,241)
Result before recharges to divisions	**(2,774)**	(2,892)	(3,250)
Total net recharges to divisions	**2,723**	2,836	3,198
Underlying loss	**(51)**	(56)	(52)

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.
2 Comparative figures have also been amended to reflect the centralisation of operations across the Group. To ensure a fair comparison of 2012 performance, 2011 and 2010 direct costs have been changed with an equivalent offsetting adjustment in recharges to divisions.

2012 COMPARED WITH 2011

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

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

Direct costs were £130 million, or 4 per cent, lower at £2,804 million in 2012 compared to £2,934 million in 2011; this reflected Simplification savings and the continued focus on cost management which more than offset inflationary issues and incremental costs from Group investment projects.

Information Technology costs decreased by 2 per cent after absorbing increased costs from delivering Group Strategic Initiatives which deliver income and cost benefits in other Divisions; Operations costs decreased by 9 per cent through the continuing rationalisation of major Operations functions. Property costs decreased by 3 per cent with the continuing consolidation of the Group s property portfolio delivering further benefits. Support functions costs were £9 million, or 8 per cent, lower at £100 million in 2012 compared to £109 million in 2011.

Recharges to divisions were £113 million lower at £2,723 million in 2012 compared to £2,836 million in 2011 reflecting the lower direct cost position.

2011 COMPARED WITH 2010

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

Total income, excluding recharges to divisions, improved by £51 million, to £42 million in 2011 compared to a deficit of £9 million in 2010.

Direct costs were £307 million, or 9 per cent, lower at £2,934 million in 2011 compared to £3,241 million in 2010; this reflected the continued focus on cost management and the delivery of integration synergy savings and Simplification benefits.

Information Technology costs decreased by 13 per cent primarily with integration savings offsetting inflationary savings; Operations costs decreased by 8 per cent through the continuing rationalisation of the major Operations functions; Group Property costs decreased by 6 per cent due to the continuing consolidation of the heritage property portfolios helping to deliver further integration benefits.

Support functions costs were £10 million, or 8 per cent, lower at £109 million in 2011 compared to £119 million in 2010.

Recharges to divisions were £362 million lower at £2,836 million in 2011 compared to £3,198 million in 2010.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CENTRAL ITEMS

	2012 £m	2011[1] £m	2010[1] £m
Total underlying income	**(132)**	339	457
Operating expenses	**(251)**	(259)	(107)
Trading surplus	**(383)**	80	350
Impairment	**(1)**	(3)	
Underlying profit (loss)	**(384)**	77	350

1 Segmental results for 2011 and 2010 have been restated as explained on page 26.

Central items are comprised of three main elements:

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

interest on the Group s equity position;

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

cost to the Group of funding wholesale and liquidity balances.

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

3 Other unallocated central items include the on-going activities of central areas including those of group corporate treasury (including the central hedge function), group internal audit, group risk, group compliance and group finance.

2012 COMPARED WITH 2011

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

Total costs were £8 million, or 3 per cent, lower at £251 million in 2012 compared to £259 million in 2011. These costs include the centrally held element of the Group s financial services compensation scheme costs, £175 million (2011: £161 million) of the Group s total charges of £175 million (2011: £179 million); the UK bank levy charge which was £10 million, or 5 per cent, lower at £179 million (2011: £189 million) in spite of an increase in the rate of the levy, as a consequence of the lower levels of wholesale funding, a reduction in the Group s balance sheet and an increase in the proportion of funding with a maturity of greater than one year; and charges in respect of annual donations to the Group s charitable foundations.

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

2011 COMPARED WITH 2010

Total underlying income decreased by £118 million, or 26 per cent, to £339 million in 2011 compared to £457 million in 2010.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

AVERAGE BALANCE SHEET AND NET INTEREST INCOME

	2012			2011			2010		
	Average balance £m	**Interest income £m**	**Yield %**	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	**110,319**	**590**	**0.53**	81,001	628	0.78	70,808	512	0.72
Loans and advances to customers	**548,350**	**21,600**	**3.94**	594,152	23,950	4.03	592,120	26,085	4.41
Debt securities	**9,080**	**433**	**4.77**	18,616	590	3.17	31,248	1,377	4.41
Available-for-sale financial assets	**31,304**	**624**	**1.99**	34,305	886	2.58	45,519	1,311	2.88
Held-to-maturity investments	**10,292**	**288**	**2.80**	7,958	262	3.29	2,188	55	2.51
Total interest-earning assets of banking book	**709,345**	**23,535**	**3.32**	736,032	26,316	3.58	741,883	29,340	3.95
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**67,357**	**2,306**	**3.42**	63,418	2,201	3.47	65,176	2,412	3.70
Total interest-earning assets	**776,702**	**25,841**	**3.33**	799,450	28,517	3.57	807,059	31,752	3.93
Allowance for impairment losses on loans and receivables	**(17,487)**			(19,548)			(17,146)		
Non-interest earning assets	**197,087**			200,939			220,098		
Total average assets and interest income	**956,302**	**25,841**	**2.70**	980,841	28,517	2.91	1,010,011	31,752	3.14

	2012			2011			2010		
	Average interest earning assets £m	**Net interest income £m**	**Net interest margin %**	Average interest earning assets £m	Net interest income £m	Net interest margin %	Average interest earning assets £m	Net interest income £m	Net interest margin %
Average interest-earning assets and net interest income:									
Banking business	**709,345**	**9,075**	**1.28**	736,032	12,698	1.73	741,883	12,546	1.69
Trading securities and other financial assets at fair value through profit or loss	**67,357**	**1,805**	**2.68**	63,418	1,722	2.72	65,176	2,172	3.33
	776,702	**10,880**	**1.40**	799,450	14,420	1.80	807,059	14,718	1.82

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	2012			2011			2010		
	Average balance £m	**Interest expense £m**	**Cost %**	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders funds									
Deposits by banks	**28,430**	**324**	**1.14**	27,748	222	0.80	40,918	319	0.78
Liabilities to banks under sale and repurchase agreements	**12,039**	**198**	**1.64**	16,536	267	1.61	20,658	513	2.48
Customer deposits	**393,820**	**6,637**	**1.69**	365,418	6,080	1.66	344,138	5,381	1.56
Liabilities to customers under sale and repurchase agreements	**4,663**	**47**	**1.01**	7,572	68	0.90	42,530	231	0.54
Debt securities in issue	**149,437**	**3,043**	**2.04**	227,497	5,045	2.22	234,107	5,833	2.49
Other interest-bearing liabilities	**19,297**	**1,428**	**7.40**	19,242	(219)	(1.14)	12,882	898	6.97
Subordinated liabilities	**37,537**	**2,783**	**7.41**	33,918	2,155	6.35	32,962	3,619	10.98
Total interest-bearing liabilities of banking book	**645,223**	**14,460**	**2.24**	697,931	13,618	1.95	728,195	16,794	2.31
Total interest-bearing liabilities of trading book	**37,533**	**501**	**1.33**	26,407	479	1.81	26,115	240	0.92
Total interest-bearing liabilities	**682,756**	**14,961**	**2.19**	724,338	14,097	1.95	754,310	17,034	2.26
Interest-free liabilities									
Non-interest bearing customer accounts	**30,039**			31,519			19,403		
Other interest-free liabilities	**197,056**			179,705			189,274		
Non-controlling interests and shareholders funds	**46,451**			45,279			47,024		
Total average liabilities and interest expense	**956,302**	**14,961**	**1.56**	980,841	14,097	1.44	1,010,011	17,034	1.69

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

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The analysis of average balances and interest for 2012, 2011 and 2010 between domestic and international offices is as follows:

	Domestic			Foreign			Total		
2012	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	**80,338**	**521**	**0.65**	**29,981**	**69**	**0.23**	**110,319**	**590**	**0.53**
Loans and advances to customers	**499,464**	**20,248**	**4.05**	**48,886**	**1,352**	**2.77**	**548,350**	**21,600**	**3.94**
Debt securities	**9,080**	**433**	**4.77**				**9,080**	**433**	**4.77**
Available-for-sale financial assets	**27,411**	**601**	**2.19**	**3,893**	**23**	**0.59**	**31,304**	**624**	**1.99**
Held-to-maturity investments	**10,292**	**288**	**2.80**				**10,292**	**288**	**2.80**
Total interest-earning assets of banking book	**626,585**	**22,091**	**3.53**	**82,760**	**1,444**	**1.74**	**709,345**	**23,535**	**3.32**
Total interest-earning trading securities and other financial assets at fair value through profit or loss	**65,182**	**2,243**	**3.44**	**2,175**	**63**	**2.90**	**67,357**	**2,306**	**3.42**
Total interest-earning assets	**691,767**	**24,334**	**3.52**	**84,935**	**1,507**	**1.77**	**776,702**	**25,841**	**3.33**
Allowance for impairment losses on loans and advances	**(5,948)**			**(11,539)**			**(17,487)**		
Non-interest earning assets	**187,089**			**9,998**			**197,087**		
Total average assets and interest income	**872,908**	**24,334**	**2.79**	**83,394**	**1,507**	**1.81**	**956,302**	**25,841**	**2.70**
Percentage of assets applicable to foreign activities (%)							**8.72**		

	Domestic			Foreign			Total		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders funds									
Deposits by banks	**16,011**	**221**	**1.38**	**12,419**	**103**	**0.83**	**28,430**	**324**	**1.14**
Liabilities to banks under sale and repurchase agreements	**11,779**	**189**	**1.60**	**260**	**9**	**3.46**	**12,039**	**198**	**1.64**
Customer deposits	**370,831**	**6,110**	**1.65**	**22,989**	**527**	**2.29**	**393,820**	**6,637**	**1.69**
Liabilities to customers under sale and repurchase agreements	**4,658**	**47**	**1.01**	**5**			**4,663**	**47**	**1.01**
Debt securities in issue	**136,842**	**2,617**	**1.91**	**12,595**	**426**	**3.38**	**149,437**	**3,043**	**2.04**
Other interest-bearing liabilities	**19,297**	**1,428**	**7.40**				**19,297**	**1,428**	**7.40**
Subordinated liabilities	**37,537**	**2,783**	**7.41**				**37,537**	**2,783**	**7.41**
Total interest-bearing liabilities of banking book	**596,955**	**13,395**	**2.24**	**48,268**	**1,065**	**2.21**	**645,223**	**14,460**	**2.24**
Total interest-bearing liabilities of trading book	**37,533**	**501**	**1.33**				**37,533**	**501**	**1.33**
Total interest-bearing liabilities	**634,488**	**13,896**	**2.19**	**48,268**	**1,065**	**2.21**	**682,756**	**14,961**	**2.19**
Interest-free liabilities									
Non-interest bearing customer accounts	**28,989**			**1,050**			**30,039**		

Other interest-free liabilities	**175,284**			**21,772**			**197,056**		
Minority interests and shareholders funds	**34,147**			**12,304**			**46,451**		
Total average liabilities and interest expense	**872,908**	**13,896**	**1.59**	**83,394**	**1,065**	**1.28**	**956,302**	**14,961**	**1.56**
Percentage of liabilities applicable to foreign activities (%)							**7.78**		

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	Domestic			Foreign			Total		
2011	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Assets									
Loans and receivables:									
Loans and advances to banks	63,572	488	0.77	17,429	140	0.80	81,001	628	0.78
Loans and advances to customers	534,384	21,657	4.05	59,768	2,293	3.84	594,152	23,950	4.03
Debt securities	17,683	578	3.27	933	12	1.29	18,616	590	3.17
Available-for-sale financial assets	29,092	848	2.91	5,213	38	0.73	34,305	886	2.58
Held-to-maturity investments	7,958	262	3.29				7,958	262	3.29
Total interest-earning assets of banking book	652,689	23,833	3.65	83,343	2,483	2.98	736,032	26,316	3.58
Total interest-earning trading securities and other financial assets at fair value through profit or loss	59,640	1,998	3.35	3,778	203	5.37	63,418	2,201	3.47
Total interest-earning assets	712,329	25,831	3.63	87,121	2,686	3.08	799,450	28,517	3.57
Allowance for impairment losses on loans and advances	(7,557)			(11,991)			(19,548)		
Non-interest earning assets	192,714			8,225			200,939		
Total average assets and interest income	897,486	25,831	2.88	83,355	2,686	3.22	980,841	28,517	2.91
Percentage of assets applicable to foreign activities (%)							8.50		

	Domestic			Foreign			Total		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Liabilities and shareholders funds									
Deposits by banks	24,751	190	0.77	2,997	32	1.07	27,748	222	0.80
Liabilities to banks under sale and repurchase agreements	16,399	261	1.59	137	6	4.38	16,536	267	1.61
Customer deposits	350,762	5,754	1.64	14,656	326	2.22	365,418	6,080	1.66
Liabilities to customers under sale and repurchase agreements	7,554	68	0.90	18			7,572	68	0.90
Debt securities in issue	203,340	4,420	2.17	24,157	625	2.59	227,497	5,045	2.22
Other interest-bearing liabilities	19,242	(219)	(1.14)				19,242	(219)	(1.14)
Subordinated liabilities	33,918	2,155	6.35				33,918	2,155	6.35
Total interest-bearing liabilities of banking book	655,966	12,629	1.93	41,965	989	2.36	697,931	13,618	1.95
Total interest-bearing liabilities of trading book	26,407	479	1.81				26,407	479	1.81
Total interest-bearing liabilities	682,373	13,108	1.92	41,965	989	2.36	724,338	14,097	1.95
Interest-free liabilities									
Non-interest bearing customer accounts	30,606			913			31,519		
Other interest-free liabilities	153,439			26,266			179,705		
Minority interests and shareholders funds	31,068			14,211			45,279		

Total average liabilities and interest expense	897,486	13,108	1.46	83,355	989	1.19	980,841	14,097	1.44
Percentage of liabilities applicable to foreign activities (%)							7.39		

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

Minority interests and shareholders funds									
Total average liabilities and interest expense	919,885	15,947	1.73	90,126	1,087	1.21	1,010,011	17,034	1.69
Percentage of liabilities applicable to foreign activities (%)							8.06		

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 2012 compared with 2011 and for 2011 compared with 2010. Where variances have arisen from both changes in volume and rate these are allocated to volume.

	2012 compared with 2011 Increase/(decrease)			2011 compared with 2010 Increase/(decrease)		
	Total change £m	**Volume £m**	**Rate £m**	Total change £m	Volume £m	Rate £m
Interest receivable and similar income						
Loans and receivables:						
Loans and advances to banks	**(38)**	**157**	**(195)**	116	79	37
Loans and advances to customers	**(2,350)**	**(1,804)**	**(546)**	(2,135)	82	(2,217)
Debt securities	**(157)**	**(455)**	**298**	(787)	(400)	(387)
Available-for-sale financial assets	**(262)**	**(60)**	**(202)**	(425)	(290)	(135)
Held-to-maturity investments	**26**	**65**	**(39)**	207	190	17
Total banking book interest receivable and similar income	**(2,781)**	**(2,097)**	**(684)**	(3,024)	(339)	(2,685)
Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss	**105**	**135**	**(30)**	(211)	(61)	(150)
Total interest receivable and similar income	**(2,676)**	**(1,962)**	**(714)**	(3,235)	(400)	(2,835)
Interest payable						
Deposits by banks	**102**	**8**	**94**	(97)	(105)	8
Liabilities to banks under sale and repurchase agreements	**(69)**	**(74)**	**5**	(246)	(67)	(179)
Customer deposits	**557**	**479**	**78**	699	354	345
Liabilities to customers under sale and repurchase agreements	**(21)**	**(29)**	**8**	(163)	(314)	151
Debt securities in issue	**(2,002)**	**(1,590)**	**(412)**	(788)	(147)	(641)
Other interest bearing liabilities	**1,647**	**4**	**1,643**	(1,117)	(72)	(1,045)
Subordinated liabilities	**628**	**268**	**360**	(1,464)	61	(1,525)
Total banking book interest payable	**842**	**(934)**	**1,776**	(3,176)	(290)	(2,886)
Total interest payable on trading and other liabilities at fair value through profit or loss	**22**	**149**	**(127)**	239	5	234
Total interest payable	**864**	**(785)**	**1,649**	(2,937)	(285)	(2,652)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK MANAGEMENT

All narrative on pages 51 to 142 is unaudited unless otherwise stated. Tables are both audited and unaudited as stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

Risk Management is at the heart of Lloyds Banking Group s strategy to become the best bank for customers, investors, shareholders and its people.

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

ACHIEVEMENTS IN 2012

Robust risk governance framework and conservative risk appetite further embedded across the Group.

Reductions in assets outside of the Group s risk appetite ahead of target and capital generative.

Sustained improvements in credit quality.

Prudent approach to underwriting and provisioning has made portfolios more resilient to future stresses.

Implementation of conduct strategy to ensure legacy issues of the past are not repeated.

PRIORITIES FOR 2013

Strategy: Continue to support delivery of the Group s customer focused strategic plan within risk appetite.

Risk infrastructure: Continue programme of investment in the Group s risk systems.

Risk culture: Maintain and strengthen the Group s strong risk culture by managing performance to ensure risk based behaviours.

Regulatory change: Deliver against new regulatory requirements.

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

THE GROUP S APPROACH TO RISK

The Group operates a strong and independent Risk Division with rigorous management controls to keep the Group safe, support sustainable business growth and minimise losses within risk appetite.

The mission of Risk Division is to maintain a robust control framework, identify and escalate emerging risks and support sustainable business growth within risk appetite through good risk reward decisioning.

RISK CULTURE

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

The Group has a conservative business model embodied by a risk culture founded on a prudent approach to managing risk. The Group refreshed its Codes of Business and Personal Responsibility in 2012 reinforcing its approach; colleagues are accountable for the risks they take and the needs of customers are paramount.

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

The Group has zero appetite for systemic unfair customer outcomes arising from product design, sales or after-sales processes.

The Group expects its leaders to have the highest integrity and values, thinking and acting for the long-term.

The Group s risk culture is embedded within the Group s risk appetites, policies, procedures, controls and reporting. For example:

The Group s risk culture is embedded within its approach to conduct risk, and is supported by frameworks to help it deliver the right outcomes for customers, and implemented through policies and standards in key areas such as product governance, responsible lending, claims and complaints handling.

The Group s risk culture is embedded within its approach to managing credit risk: Board level credit risk appetite is supported by more detailed metrics at Divisional and business level; measurement of credit risk for loans and advances to customers at counterparty level; internal systems of control such as credit policies, assurance and review, controls over rating systems, stress testing and scenario analysis; collateral; master netting agreements and support for customers in difficulty.

RISK APPETITE

The Group defines risk appetite as the amount and type of risk that the organisation is prepared to seek, accept or tolerate.

The Group s strategy operates in tandem with the Group s high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2012 which incorporated recommendations from the non-executive directors and is fully aligned with Group strategy.

Risk appetite is embedded within policies, authorities and limits across the Group.

Risk appetite will continue to evolve in tandem with Group strategy.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

GOVERNANCE AND CONTROL

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

The Group s approach to risk is founded on a robust control framework and a strong risk management culture which ensures that business units remain accountable for risk and therefore guides the way all employees approach their work, behave and make decisions.

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

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

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

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

RISK DECISION MAKING AND REPORTING

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

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

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

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

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

RISK AS A STRATEGIC DIFFERENTIATOR

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

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

Conservative approach to risk: The Group has a fully embedded conservative approach to, and prudent appetite for risk with risk culture and appetite driven top down.

Strong control framework: The Group has a strong risk control framework which is the foundation for the delivery of effective risk management. This framework ensures appropriate engagement in developing risk appetite whilst also ensuring business units operate within approved parameters.

Effective risk analysis, management and reporting: Effective risk analysis ensures the identification of opportunities as well as risks and ensures risks are managed appropriately and consistent with strategy. The Groups key risks and performance against risk appetite are monitored and reported regularly to senior management using quantitative and qualitative analysis and are subject to relevant stress testing. This ensures that the Group fully understands the risk in the business at both an individual risk type and aggregate portfolio level. The key risks to the Group are outlined below.

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

PRINCIPAL RISKS AND UNCERTAINTIES

At present the most significant risks faced by the Group are detailed below. These risks could impact the success of delivering against the Group s long-term strategic objectives and are aligned to the Group s Risk Drivers.

Further detail on the Group s Risk Drivers and how the Group manages risk can be found on page 63.

For further information on the economy see pages 12 and 13.

CREDIT RISK

DEFINITION

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

PRINCIPAL RISKS

Arising mainly in the Retail, Commercial Banking, and Wealth, Asset Finance and International divisions, reflecting the risks inherent in the Group s lending activities and, to a lesser extent in the Insurance business in respect of investment holdings and exposures to reinsurers. 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 increase the Group s write-downs and allowances for impairment losses. Credit risk can be affected by a range of macro-economic environment and other factors, including, inter alia, increased unemployment, reduced asset values, lower consumer spending, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates and/or higher tenant defaults.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Over the last five years, the global banking crisis and economic downturn has driven cyclically high bad debt charges, especially in the Group s legacy HBOS portfolios, arising from the Group s lending to both retail (including those in Wealth, Asset Finance and International division) and commercial customers (including those in Wealth, Asset Finance and International division). Group portfolios will remain strongly linked to the economic environment, with inter alia house price falls, unemployment increases, consumer over-indebtedness and rising interest rates being possible impacts to the Group s exposures. The Group has exposure to commercial customers in both the UK and internationally, including Europe and Ireland, particularly related to commercial real estate lending, where the Group has a high level of lending secured on secondary and tertiary assets. The possibility of further economic downside risk remains.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk. The Group manages its credit risk in a variety of ways such as:

- through prudent and through the cycle credit risk appetite and policies;
- clearly defined levels of authority (including, independently sanctioned and controlled credit limits for commercial customers and counterparties, sound credit scoring models and credit policies for retail customers);
- robust credit processes and controls; and
- well-established Group and Divisional committees that ensure distressed and impaired loans are identified, considered, controlled and appropriately escalated and appropriately impaired (taking account of the Group s latest view of current and expected market conditions, as well as refinancing risk).

Reviews are undertaken at least quarterly and incorporate internal and external audit review and challenge.

For further information on credit risk, see page 63.

CONDUCT RISK

DEFINITION

Conduct risk is defined as the risk of customer detriment or censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct.

PRINCIPAL RISKS

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

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

There is a risk that certain aspects of the Group s business may be determined by the FSA, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. The Group may also be liable for damages to third parties harmed by the conduct of its business.

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk; key examples include:

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

The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns. The Group develops colleagues awareness of these and other expected standards of conduct through these and other policies and standards and codes of responsibility. It also undertakes root cause analysis of complaints and makes use of technology and metrics to facilitate earlier detection and mitigation of conduct issues.

For further information on conduct risk, see page 111.

MARKET RISK

DEFINITION

Market risk is defined as the risk that unfavourable market moves (including changes in and increased volatility of interest rates, market-implied inflation rates, credit spreads and prices for bonds, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

PRINCIPAL RISKS

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

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

- Equity risk: This risk arises from movements in equity market prices. The main equity market risks arise in the Insurance business and defined benefit pension schemes.
- Credit spread risk: This risk arises when the market perception of the creditworthiness of a particular counterparty changes. The main credit spread exposure arises in the Insurance business, defined benefit pension schemes and banking businesses.

MITIGATING ACTIONS

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

High level market risk exposure is reported regularly to appropriate committees for monitoring and oversight by senior management.

A variety of risk measures are used such as:

- Sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates)
- Percentile based measures (e.g. Value at Risk)
- Scenario/stress based measures (e.g. single factor stresses, macroeconomic scenarios)

In addition, profit and loss triggers are used in the trading books in order to ensure that mitigating action is discussed if profit and loss becomes volatile.

- Interest rate risk: Exposure arising from the different repricing characteristics of the Group s non-trading assets and liabilities, and from the mismatch between interest rate insensitive assets and interest rate sensitive liabilities, is managed centrally. Matching assets and liabilities are offset against each other and interest rate swaps are also used to manage the residual exposure to within the non-traded market risk appetite. Exposure arising from the margin of interbank rates over central bank rates is monitored and managed within the non-traded market risk appetite through appropriate hedging activity.
- Equity and credit spread risk: The Group continues to liaise with defined benefit pension scheme Trustees with regard to appropriately de-risking the pension scheme portfolio.

For further information on market risk, see page 112.

OPERATIONAL RISK

DEFINITION

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

PRINCIPAL RISKS

The principal operational risks currently facing the Group are:

- IT systems and resilience: The risk of loss resulting from the failure to develop, deliver or maintain effective IT solutions. The resilience of IT in terms of its availability to customers and colleagues is of paramount importance to the Group.
- Information security: The risk of information leakage, loss or theft. The threat profile is rapidly changing; in particular increasingly sophisticated attacks by cybercrime groups.
- External fraud: The risk of loss to the Group and/or its customers resulting from an act of deception or omission.

Customer process: The risk of new issues, process weaknesses and control deficiencies within the Group s customer facing processes as the business continues to evolve.

MITIGATING ACTIONS

The Group operates a robust control environment with regular review and investment. Contingency plans are maintained for a range of potential scenarios with a regime of regular disaster recovery exercises, both Group specific and industry wide. Significant investment has been made in IT infrastructure and systems to ensure their resilience and to enhance the services they support, in recognition of the importance of the ongoing availability of the Group s services both to its customers and to the wider UK financial infrastructure. The Group continues to invest in IT and information security control environments including user access management and records management to address evolving threats.

The Group adopts a risk based approach to external fraud management, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group s technology, process and people related controls; with emphasis on preventative controls, supported by real time detective controls wherever feasible. The Group has developed a mature and robust fraud operating model with centralised accountability established, discharged via Group-wide policies and operational control frameworks. The Group s fraud awareness programme is a key component of its fraud control environment; in 2012 a Group-wide awareness campaign was launched specifically addressing the emerging cyber threats and the role that the Group s colleagues play in helping to keep its customers safe and secure.

Material operational risks are reported regularly to appropriate committees, attracting senior management visibility, and are managed via a range of strategies avoidance, mitigation, transfer (including insurance), and acceptance.

For further information on operational risk, see page 116.

PEOPLE RISK

DEFINITION

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to reductions in earnings and/ or value.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

PRINCIPAL RISKS

The Group has a strategic aim to be the best bank for customers; it is committed to addressing issues within the business that could contribute to customers receiving unfair outcomes. The Group believes the quality, effectiveness and engagement of its people are fundamental to its successful delivery of this strategy. This belief coincides with the increasing external focus on the culture which underpins the performance and behaviour of employees in the development and delivery of fair outcomes to customers.

Consequently, the Group s management of material people risks is critical to its capacity to deliver against its strategic objectives. Over the coming twelve months the Group s ability to manage people risks successfully is likely to be affected by the following factors:

The Group s continuing structural consolidation and the sale of part of its branch network under Project Verde may disrupt its ability to lead and manage its people effectively in some areas;

The developing and increasingly rigorous and intrusive regulatory environment may challenge the Group s people strategy, remuneration practices and retention; and

Negative political and media attention on banking sector culture, sales practices and ethical conduct may impact colleague engagement, investor sentiment and the Group s cost base.

MITIGATING ACTIONS

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

Focusing on strengthening the risk-based culture amongst colleagues by developing and delivering a number of initiatives that reinforce risk-based behaviours to generate the best possible outcomes for customers and colleagues;

Continuing to ensure strong management of the impact of organisational change and consolidation on colleagues;

Embedding our Codes of Personal and Business Responsibility across the Group;

Reviewing and developing incentives continually to ensure they promote colleagues behaviours that meet customer needs and regulatory expectations;

Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;

Maintaining focus on people risk management across the Group; and

Ensuring compliance with legal and regulatory requirements related to Approved Persons and the Remuneration Code, and embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities.

For further information on people risk, see page 118.

LIQUIDITY AND FUNDING RISK

DEFINITION

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

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

PRINCIPAL RISKS

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

Continued functioning of the money and capital markets.

The continuation of the Group s strategy of right-sizing the balance sheet and development of the retail deposit base which has led to a significant reduction in the wholesale funding requirement during 2012.

Limited further deterioration in the UK s and the Group s credit rating. In June 2012 the Group experienced a one notch downgrade in its long-term rating from Moody s Investors Service (Moody s), following the agency s review of 114 European banks. The impact that the Group experienced following the downgrade was not material and was consistent with the modelled outcomes based on the stress testing framework. Similarly the internal stress testing framework indicates that Moody s one notch downgrade of the UK s credit rating, announced on 22 February 2013, will not have a material impact on the Group s liquidity and funding positions; and

No significant or sudden withdrawal of customer deposits.

MITIGATING ACTIONS

Liquidity and funding risk appetite for the banking businesses is set by the Board and this statement of the Group s overall appetite for liquidity risk is reviewed and approved annually by the Board.

The Group s liquidity and funding position is underpinned by its significant customer deposit base, and has been supported by stable funding from the wholesale markets with a reduced dependence on short-term wholesale funding;

At 31 December 2012, the Group had £205 billion of highly liquid unencumbered assets in its liquidity portfolio which are available to meet cash and collateral outflows;

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Daily monitoring and control processes are in place to address regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group;

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

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.

For further information on liquidity and funding risk, see page 119.

INSURANCE RISK

DEFINITION

Insurance risk is defined as the risk of adverse developments in the timing, frequency and severity of claims for insured/underwritten events and in customer behaviour, leading to reductions in earnings and/or value.

PRINCIPAL RISKS

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

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

MITIGATING ACTIONS

The Group takes many mitigating actions with respect to this principal risk, key examples include:

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

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

Insurance risk is reported regularly to appropriate committees and boards.

For further information on insurance risk, see page 129.

State Funding and State Aid is not considered as one of the Group s Risk Drivers; however the Group does consider State Funding and State Aid to be a Principal Risk.

STATE FUNDING AND STATE AID

PRINCIPAL RISKS

HM Treasury currently holds 39.2 per cent of the Group s ordinary share capital. United Kingdom Financial Investments Limited (UKFI), as manager of HM Treasury s shareholding, continues to operate in line with the framework document between UKFI and

HM Treasury, managing the investment in the Group on a commercial basis without interference in day-to-day management decisions. There is a risk that a change in Government priorities could result in the framework agreement currently in place being replaced leading to interference in the operations of the Group.

In addition, the Group is subject to European Union State Aid obligations in line with the Restructuring Plan agreed with HM Treasury and the EU College of Commissioners in November 2009, which is designed to support the long-term viability of the Group and remedy any distortion of competition and trade in the European Union (EU) arising from the State Aid given to the Group. This has placed a number of requirements on the Group including an asset reduction target from a defined pool of assets by the end of 2014, known as Project Atlantic, and the divestment of certain portions of its Retail business by the end of November 2013, known as Project Verde. There is a risk that if the Group does not deliver its divestment commitments by November 2013, a Divesture Trustee would be appointed to dispose of the divestment, which could be sold at a negative price.

MITIGATING ACTIONS

The Group has received no indications that the Government intends to change the existing operating arrangements with regard to the role of UKFI and engagement with the Group.

The Group continues to make good progress in respect to its State Aid commitments. In line with the strengthening of the balance sheet, the Group has made excellent progress against its asset reduction commitment and reached the reduction total required in December 2012, two years ahead of the mandated completion date. The Group is currently working with the European Commission to achieve formal release from this commitment.

On 19 July 2012 the Group announced that it had agreed non-binding heads of terms with The Co-operative for the disposal of the Verde business. The Group continues to work with the Co-operative to agree a sale and purchase agreement, with completion of the divestment expected by the end of November 2013. The Group has also undertaken planning for an Initial Public Offering (IPO) of the Verde business, should this be required as a fallback option. The Verde business will be rebranded and operating on a standalone basis within Lloyds Banking Group during 2013 and available for sale to another third party as a further fallback option.

The Group continues to work closely with the FSA, EU Commission, HM Treasury and the Monitoring Trustee appointed by the EU Commission to ensure the successful implementation of the restructuring plan and mitigate customer impact.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

EMERGING RISKS

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

MACROECONOMIC ENVIRONMENT

The operating plan is challenging, with a focus on improving earnings while achieving the required regulatory improvements on capital and liquidity. Any adverse movement in interest rates or deterioration in macroeconomic environment beyond the Group s assumptions would delay improvement of the earnings and return profile.

MITIGATING ACTIONS

The Group is actively supporting sustainable growth in the UK economy through the focused range of products and services provided to business and personal customers, as well as through partnerships with industry and Government. Capital, liquidity and credit risk are managed conservatively and reductions in assets outside of the Group s appetite remain ahead of schedule ensuring the Group is better placed to address macroeconomic shocks.

CAPITAL RISK

The Group has a strong capital position but remains exposed to the risks of lower than expected profitability, significant losses in a number of stress scenarios or volatility through accounting standards and regulatory changes.

One such area of potential regulatory change relates to the Bank of England s interim Financial Policy Committee (FPC) which published its Financial Stability Report on 29 November 2012. The report recommended that the Financial Services Authority takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. The FPC met on 19 March 2013 to discuss the FSA recommendations and the Group expects to receive feedback on their conclusion before the end of March 2013.

MITIGATING ACTIONS

The Group has made significant progress and continues to deliver on its strategy of strengthening the balance sheet, including its capital position, to improve the resilience of the Group.

The Group has strong governance, processes and controls which, combined with the Group s proactive management of risk, result in an appropriate level of capital. This includes:

- Rigorous stress testing exercises where the results are shared with the FSA; and
- Prudent internal models, based on empirical data, that meet regulatory and stringent internal requirements.

REGULATORY CHANGE

The Parliamentary Commission on Banking Standards (PCBS) was asked to conduct pre-legislative scrutiny on the draft Banking Reform Bill. The PCBS published its initial report on 21 December 2012. The report contains the Commission s consideration of the Government s draft legislation which gives effect to the recommendations of the Independent Commission on Banking. The PCBS looked at Ring fencing , one of the UK Government s main proposals for increasing financial stability.

MITIGATING ACTIONS

Actions to respond to the proposals on ring fencing are being taken forward alongside planning for recovery and resolution as part of a programme of work with senior executive sponsorship and robust governance arrangements.

COMPLIANCE AND CONDUCT

Significant legacy costs beyond current provisioning could have significant impact on capital ratios and credit ratings with consequent impact on liquidity risk. There is inherent uncertainty in making estimates of provisions required.

MITIGATING ACTIONS

Prudent provisioning policy provisions for legacy conduct issues represent management s best estimate of the anticipated costs of related customer contact and/or redress, including administration expenses.

Group product governance controls potential risks are monitored through product management information, new product approvals and annual product reviews leading to identification and mitigation of risks at an early stage.

ACCOUNTING STANDARDS

A number of potential changes to accounting standards are under consultation. These standards are currently scheduled for implementation between 2015 and 2018 and have the potential to add substantial volatility to the Group s reported results and capital.

MITIGATING ACTIONS

The Group continues to monitor potential changes and where appropriate provide feedback.

Further information can be found in note 57 to the financial statements.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RISK GOVERNANCE

Lloyds Banking Group Enterprise Risk Management (ERM) framework provides a robust and consistent approach to risk management across the Group and is a core component of the Group s Internal Governance framework. Throughout 2012 the integrated governance, risk and control frameworks were further embedded continuing the use of a consistent approach to risk appetite, delegated authorities and governance committee structures.

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

Table 1.1: **Risk governance structures**

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

BOARD, EXECUTIVE AND RISK COMMITTEES

The Group s risk governance structure (see table 1.1) strengthens risk evaluation and management, while also positioning the Group to manage the changing regulatory environment in an efficient and effective manner.

The Board, assisted by the Board Risk and Audit Committees, approves the Group s overall governance, risk and control frameworks and risk appetite. The risk focus of these committees, together with other committees is described below: The roles of the Board, Board Risk and Audit Committees are further described in the Corporate Governance section on pages 166 to 178.

Table 1.2: **Board, Executive and Risk Committees**

COMMITTEES	RISK FOCUS
BOARD COMMITTEES	
Board	Assisted by Board Risk Committee and Audit Committee approves the Group s overall governance, risk and control frameworks and risk appetite. The Board also reviews the Group s aggregate risk exposures and concentrations of risk to ensure that these are consistent with the Board s agreed appetite for risk.
Board Risk Committee	Oversees and challenges the development, implementation and maintenance of the Group s risk management framework, ensuring that its strategy, principles, policies and resources are aligned internally to its risk appetite as well as externally to regulation, corporate governance and industry best practice. The Board Risk Committee regularly reviews the Group s risk exposures across the risk drivers and the detailed risk types.
Audit Committee	To monitor and review the formal arrangements established by the Board in respect of internal controls and the risk management framework. The committee also reviews the effectiveness of the systems for internal control, risk management and compliance with financial services legislation and regulations.
GROUP EXECUTIVE COMMITTEES	
Group Executive Committee	Supports the Group Chief Executive in ensuring the effectiveness of the Group s risk management framework and the clear articulation of the Group s risk policies, while also reviewing the Group s aggregate risk exposures and concentrations of risk.
THE GROUP EXECUTIVE IS SUPPORTED BY THE:	
Group Risk Committee	Reviews and recommends the Group s risk appetite and governance, risk and control frameworks, high-level Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/ reward returns.
Group Asset and Liability Committee	Responsible for the strategic management of the Group s assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
GROUP EXECUTIVE COMMITTEE MEMBERS COMMITTEES	
Group Product Governance Committee	Provides strategic and senior oversight over design, launch and management of products, including new product approval, annual product reviews and management of risk in the back book.
Group Stress Testing Committee	Responsible for reviewing, challenging and recommending to Group Executive Committee the annual stress testing of the Group s operating plan based on internal and FSA recommended scenarios, annual European Banking Authority stress tests, and other Group-wide macroeconomic stress tests.
Group Incident Executive	Sets the strategic direction for the Group s response to significant incidents which could affect its ability to continue to operate, and instigates any tactical initiatives required.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE GROUP RISK COMMITTEE IS SUPPORTED BY THE FOLLOWING COMMITTEES TO ENSURE MORE EFFECTIVE RISK MANAGEMENT, CLEARER ACCOUNTABILITIES AND MORE EFFICIENT AND SIMPLIFIED PROCESSES.	
Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group s credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee	Monitors and reviews the Group s aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Insurance Risk Committee	Monitors, reviews and makes recommendations on the risk management framework, risk strategy and appetite for the Insurance business, ensuring that the policy and oversight framework for insurance risk management is appropriate. The committee reviews and challenges relevant insurance reporting and issues arising, including: the Group s aggregate portfolio of insurance risk against approved plans and risk appetite and the need and opportunity for effecting insurance risk mitigation.
Group Operational Risk Committee	Responsible for identifying significant current and emerging operational risks or accumulation of risks and control deficiencies across the Group and reviewing associated oversight plans to ensure pre-emptive risk management action. The committee also seeks to ensure that adequate business area engagement occurs to develop, implement and maintain the Group s operational risk management framework.
Group Compliance and Conduct Risk Committee	Responsible for monitoring and challenging the Group s compliance and conduct risk management framework, aggregated compliance and conduct risk profile, and its alignment with agreed risk appetite.
Group Financial Crime Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group s risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than a small number defined as highly material to the Group, which are approved by the Group Risk Committee. This also meets FSA BIPRU requirements regarding the governance and approval for Internal Ratings Based models, including Internal Assessment models, Market Risk Value at Risk and Advanced Measurement approach models.

HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

The Enterprise Risk Management framework is implemented through a Three Lines of Defence model which defines clear responsibilities and accountabilities and ensures effective independent assurance activities take place covering key decisions.

Business Unit Managing Directors/Executives (**the first line of defence**) have primary responsibility for identifying, measuring, monitoring and controlling risks within their areas of accountability and are required to establish control frameworks for their businesses that are consistent with the Group s policies and are within the parameters set by the Board, Group Executive Committee and Risk Division.

Compliance with policies and parameters is overseen by the Board Risk Committee, the Group Risk Committee, the Group Asset and Liability Committee, and Risk Division. Risk Division (**the second line of defence**) provides oversight and independent challenge to the effectiveness of risk decisions taken at a Group level by the Group Chief Executive and Group Executive Committee and at a local level by business unit management and their management committees.

Group Audit (**the third line of defence**) provides independent, objective assurance across all areas of the Group focusing on the effectiveness of risk management, control and governance processes in line with ERM principles.

RISK MANAGEMENT IN THE BUSINESS

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

All business areas complete a control effectiveness review annually (see page 62), reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives of each business area and each Group Executive Committee member certify the accuracy of their assessment.

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

RISK MANAGEMENT OVERSIGHT

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE CHIEF RISK OFFICER

oversees and promotes the development and implementation of consistent group wide governance risk and control frameworks;

provides objective challenge to the Group s senior management with the support of the Risk directors;

provides regular briefings and guidance to the Group Executive Committee and the Board ensuring awareness of the Group s risk profile and the overarching risk management framework with a clear understanding of their accountabilities for risk and internal control.

RISK DIRECTORS

report directly to the Chief Risk Officer;

have allocated responsibility for specific risk types;

are responsible for ensuring the adequacy of the framework for their risk types as well as the oversight of the associated risk profile across the Group; and

support specific business areas to provide an enterprise-wide risk management perspective.

INDEPENDENT CHALLENGE

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

RISK MANAGEMENT FRAMEWORK

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

The framework is designed to ensure that policies and controls can be adapted to reflect adjustments to business strategy and risk appetite which are made in response to changing market conditions. By providing a structured approach to identify and assess the impact of emerging risks, agree tolerances and develop mitigating strategies the framework also supports the Group s aim of maximising shareholder value over time.

A key component of the ERM framework is the common risk language, which categorises the risks to which the Group is exposed into eleven categories which are used consistently to support risk aggregation and standardised reporting. ERM framework (table 1.3) outlines the key risk management activities undertaken consistently across the Group for all types of risk. These activities map to the components of the internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

Table 1.3: **Risk management framework**

1 The Group considers these to be principal risks. See pages 52 to 56 for further details.

Objective setting the Group s high level risk appetite is derived from its business strategy of achieving strong, stable and sustainable growth. The risk management strategy and objectives are set to support the business in operating in line with the agreed risk appetite.

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

cascaded in consultation with the Group Risk Committee and Group Asset and Liability Committee to members of the Group Executive Committee and the business.

Internal environment the Group s risk culture ensures that colleague capability is developed, individual accountabilities and limits are understood, and policies and procedures are adhered to. Colleagues are expected to be aware of, and to comply with, the policies and procedures which apply to them and their work. Line management in each business area has primary responsibility for ensuring that they do so.

Event identification incidents occurring internally or externally that could affect achievement of the Group s objectives are identified, differentiating between risks and opportunities. Group-wide risk tools and methodologies are used to help identify risks across the different risk types including external horizon scanning by Risk Division.

Risk assessment and measurement risks are defined and categorised using a common risk language (see page 63). The impact of risks and issues is determined through effective risk measurement; including modelling, stress testing and scenario analysis to assess financial, reputational and regulatory capital implications (both qualitative and quantitative).

Risk response actions to mitigate each risk are aligned to the Group s risk appetite and tolerances, managing future uncertainty and responding in a manner which reduces the likelihood of downside outcomes and increases the upside.

Information and communication risk reporting consolidates and escalates key risks and management information internally through the Group s committee structure and reports these externally to regulators. Risk reporting is reviewed by the business executive sitting as a risk committee, to ensure that senior management is satisfied with the overall risk profile, risk accountabilities and progress on any necessary action plans and tracking. Information is provided to Risk Division for review and aggregation to feed into regular reporting on risk exposures and material issues.

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

Control activities robust frameworks are established across the Group covering policies, accountabilities and governance. Proportionate control activities mitigate or transfer risk where appropriate. The outcomes of independent reviews (including internal and external audit and regulatory reviews) are reflected in risk management activities and action plans. Risk and control assessments including the annual control effectiveness review assess the effectiveness of mitigating actions and whether risk exposures are consistent with the Group s risk appetite.

Monitoring and oversight regular checks are carried out to ensure the Group s risk management approach and controls are effective with sufficient oversight in place. Risk Division oversees the effective implementation of policy, and Group Audit provides independent assurance to the Board about the effectiveness of the Group s internal control framework and adherence to policy. Monitoring processes are in place supporting the reporting and escalation of significant issues or losses to appropriate levels of management. Business areas monitor and report on their risk levels against risk appetite and their performance against relevant limits or policies.

The overall effectiveness of the risk management framework depends on the people undertaking these activities and the quality of the supporting systems and tools. The risk transformation programme is progressing significant investment in risk infrastructure to strengthen the Group s risk management capability of which the Group policy framework is a key element.

The Group policy framework has four component parts:

- Group Principles statements aligned to the Group s risk drivers which set the foundation for the Group s behaviours and decision making;
- Group Policies documents which translate a specific component of risk appetite into mandatory requirements, key measures and controls;

- Group Procedures   operational standards required to implement Policy across the Group; and

- Business Processes   activity, or set of activities, which detail how local businesses will comply with Group Policies and Procedures.

All Policy Framework documents are actively managed and maintained to ensure that they remain effective and aligned to the Group s risk appetite and changing business needs. Management of the Policy lifecycle includes:

- Policy setting   development and formal approval of Policy documents to address the Group s material risk areas;

- Policy embedding   ensuring all colleagues are aware of the Policies which impact them, and the required processes are in place in business units to implement the Policy requirements;

- Policy assurance   monitoring and oversight activity to confirm adherence to Policy requirements and ensure any non-compliance is identified and managed; and

- Policy review   review of each Policy at least once a year in light of any changes to the internal or external environment in order to identify any amendments needed to ensure effective management of the risk within the Group s appetite.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

FULL ANALYSIS OF RISK DRIVERS

The Group s risk framework covers all types of risk which affect the Group and could impact on the achievement of its strategic objectives. Following a review in 2012 the Group has moved from six to eleven risk categories to provide greater focus on significant areas of risk. A detailed description of each category is included below.

PRIMARY RISK DRIVERS

Credit risk[1]	**Conduct risk**[1]	**Market risk**[1]	**Operational risk**[1]	**People risk**[1]	**Liquidity and Funding risk**[1]	**Insurance risk**[1]	**Regulatory risk**	**Capital risk**	**Financial Reporting risk**	**Governance risk**
Page 63	Page 111	Page 112	Page 116	Page 118	Page 119	Page 129	Page 130	Page 131	Page 141	Page 142

[1] The Group considers these to be principal risks. See pages 52 to 56 for further details.

SECONDARY RISK DRIVERS

Concentration Risk	Customer Risk	Equity Risk	Regulatory	Regulatory People Risk	Funding Risk	Mortality	Prudential Risk	Capital Sufficiency	Financial and Prudential Regulatory Reporting	Governance
Counterparty Risk	Product Risk	Foreign Exchange Risk	Customer Treatment		Liquidity Risk	Longevity	Compliance Risk	Capital Efficiency	Tax	
	Product Distribution/ Advice	Interest Rate Risk	People			Morbidity	Regulatory Development Risk		Disclosure	
	Business Standards	Credit Spread	Supplier Management			Persistency				
			Customer Processes			Property				
			Financial Crime			Expenses				
			Anti-Money Laundering and Sanctions			Unemployment				
			Security							
			IT Systems							
			Change							
			Organisational Infrastructure							

CREDIT RISK

DEFINITION

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

RISK APPETITE

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

This statement of the Group s overall appetite for credit risk is reviewed and approved annually. With the support of the Group Risk Committee, the Group Chief Executive allocates this risk appetite across the Group.

EXPOSURES

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions, sovereigns and corporate clients. The credit risk exposures of the Group are set out in note 55 to the financial statements. Credit risk exposures are categorised as retail , arising primarily in the Retail and Wealth, Asset Finance and International Divisions, commercial and corporate , financial institutions or Sovereigns arising in the Commercial Banking and Wealth, Asset Finance and International Divisions.

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 18 to the financial statements shows the total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2012. 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 55 to the financial statements.

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

Note 2(H) to the financial statements provides details of the Group s approach to the impairment of financial assets.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

MEASUREMENT

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

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

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a validation process, undertaken by independent risk teams, which includes benchmarking to externally available data, where possible. The most material rating models are approved by the Group Risk Committee. Responsibility for the approval of the remaining material rating models, and the governance framework in place around all Group models, is delegated to the Group Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities (details of these rating scales are published in the Group s Pillar III disclosure). Exposures migrate between rating grades if the assessment of the counterparty probability of default changes. Each rating system is required to map to a master scale, which supports the consolidation of credit risk information across portfolios through the adoption of a common rating scale. Given the differing risk profiles and credit rating considerations, the underlying risk reporting has been split into two distinct master scales, a retail master scale and a wholesale master scale (Note 55 to the financial statements provides an analysis of the portfolio and page 69 provides details of our Credit risk portfolio).

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

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

In non-retail portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs map to a (non-retail) master scale which enables the consolidation of credit risk information, and it is this that forms the basis for the IFRS credit quality characterisation.

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

The nature, construction and calibration of retail and non-retail models are very different and so too are their respective master scales (not least in their graduality). The distribution of probabilities of default is also different, which precludes reporting on a single consolidated basis.

MITIGATION

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

INTERNAL CONTROL

Credit principles and policy: Risk Division sets out the credit principles and policy according to which credit risk is managed. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Policies, where appropriate, include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions. These policies and procedures define chosen target market and risk acceptance criteria. These have been and will continue to be fine-tuned as appropriate and include the use of early warning indicators to help anticipate future areas of concern and allow us to take early and proactive mitigating actions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group. This includes tracking portfolio performance against an agreed set of key risk indicators.

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

Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual limit guidelines. Credit policy is aligned to the Group s risk appetite and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 20 to the financial statements, provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk and single name concentrations. In addition correlated concentration risks to sectors and movement in such concentrations are monitored regularly to guide risk appetite and limit setting, identify unwanted concentrations, and provide an early warning indicator for potential excesses. 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.

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control (see *Intensive care of customers in financial difficulty* on pages 66 to 68); security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.

Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis. Events are modelled at a group wide level, at divisional and business unit level and by rating model and portfolio.

Credit risk assurance and review: Group Credit Risk Assurance, a team within Group Audit comprising experienced credit professionals, is also in place. In conjunction with Risk senior management, this team carries out independent risk based credit reviews, providing individual business unit assessment of the effectiveness of risk management practices and adherence to risk controls across the diverse range of the Group s wholesale businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical (standard) credit reviews, non-standard reviews, and bespoke assignments, including impairment adequacy reviews as required. The work of Group Credit Risk Assurance continues to provide executive and senior management (and Audit Committee) with assurance and guidance on credit quality, effectiveness of credit risk controls and Business Support Unit work out strategies as well as accuracy of impairments.

RETAIL ASSETS (LENDING TO INDIVIDUALS IN RETAIL AND WEALTH, ASSET FINANCE AND INTERNATIONAL DIVISIONS)

The Group uses a variety of lending criteria when assessing applications for mortgages and unsecured lending. The general approval process uses credit acceptance scorecards and involves a review of an applicant s previous credit history using information held by credit reference agencies (CRA). The Group also assesses the affordability of the borrowings to the borrower under stressed scenarios including increased interest rates. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

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

For UK mortgages, the Group s policy is to reject all standard applications with a loan-to-value (LTV) greater than 90 per cent. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

Table 1.4: **Loan to value analysis (unaudited)**

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

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

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

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

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

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

COMMERCIAL CUSTOMERS

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

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

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

COLLATERAL

The principal collateral types for loans and advances are:

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

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

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial assets. Collateral is generally not held against loans and advances to financial institutions, except where securities are held as part of reverse repurchase or securities borrowing transactions or where a collateral agreement has been entered into under a master netting agreement. Derivative transactions with wholesale counterparties are typically collateralised under a Credit Support Annex in conjunction with the ISDA Master Agreement.

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

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

MASTER NETTING AGREEMENTS

Where it is appropriate and likely to be effective, the Group seeks to enter into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities, 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 and credit derivative based transactions as a means of mitigating or reducing credit risk, taking into account the nature of assets and the prevailing market conditions.

MONITORING

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

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

INTENSIVE CARE OF CUSTOMERS IN FINANCIAL DIFFICULTY

The Group operates a number of schemes to assist borrowers who are experiencing financial stress. The material elements of these schemes through which the Group has granted a concession, whether temporarily or permanently, are set out below and in note 55 to the financial statements.

RETAIL CUSTOMERS

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group offers a range of tools and assistance to support retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework; controls around the execution of policy; regular review of the different treatments to confirm that they remain appropriate; monitoring of customers performance and the level of payments received; and management visibility of the nature and extent of assistance provided and the associated risk.

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

One component of the Group s relationship management approach is to contact customers showing signs of financial difficulty, discussing with them their circumstances and offering solutions to prevent their accounts falling into arrears.

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

- Reduced contractual monthly payment a temporary account change to assist customers through periods of financial difficulty where arrears do not accrue at the original contractual payments, for example capital payment breaks and payment assistance breaks. Any arrears existing at the commencement of the arrangement are retained;
- Financial distress assistance an arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay and term extensions; and
- Repair an account change used to repair a customer s position when they have emerged from financial difficulty, for example capitalisation of arrears.

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

- Income Support for Mortgage Interest This is a Government medium-term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the Government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual s eligibility and any amounts payable under the scheme rest solely with the Government. Payments are made directly to the Group by the appropriate Government department.
- Homeowner Mortgage Support Scheme This is a Government medium-term initiative that enables borrowers affected by temporary reductions in income to access reduced payments for a period of up to two years. The Government provides a partial guarantee to the Group whilst a customer participates in the plan. Decisions on eligibility, principally whether the Group expects the borrower s earnings to recover fully, initially rest with the Group and must be made on the basis of detailed information received from an independent fee-free advisor. After a year, the customer must undergo a further full assessment made by the advice agency. The customer must pay at least 30 per cent of the interest due. Any shortfall in payments made during the period covered by the scheme is collected through increased payments over the remaining term. The scheme was closed to new customer applications in April 2011 by the Department of Communities and Local Government.
- Mortgage Rescue Scheme This is a Government short-term initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full.

COMMERCIAL CUSTOMERS

Wholesale credit facilities are reviewed on a regular basis and more frequently where required. When financial stress is exhibited, the customer would be transferred at an early stage to one of the Group s specialist Business Support Units (BSUs) or Customer Support teams.

In order to support commercial customers that encounter difficulties during the current economic downturn, the Group increased the size of its dedicated Business Support Unit (BSU) to cover all its UK and International portfolios.

The over-arching aim of BSU is to work with each customer to try and resolve the issues, to restore the business to a financially viable position and facilitate a business turnaround. This could be through a number of channels, including providing advice on how to develop and implement turnaround strategies, and considering potential restructuring of debt and forbearance.

BSU Relationship Managers are highly experienced and operate in a closely controlled and monitored environment, including regular oversight and ongoing close scrutiny by senior management. Exposure is minimised through a combination of appropriate forbearance, asset sales, restructuring and work-out strategies.

The determination of cash flows for cases in the BSUs is undertaken by a specialist risk team who gather a range of information from various sources including the customer, professional advisers and the Group s own credit teams to fully understand and appraise the customer s business and circumstances. A more detailed assessment is undertaken to assist in reducing risk exposure and highlighting potential strategic options. This often involves the Group, in addition to using its own internal experts, engaging professional advisers to perform Independent Business Reviews and, where relevant, independently value collateral held. In more complex cases, such as those involving work-out strategies, the review may also involve:

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

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

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Customer Support provides intensive care and support to smaller Commercial SME customers in difficulty. Whilst the customer relationship remains with the Relationship Manager, they are supported by a Customer Support Manager to oversee and manage identified risk.

It is Group policy that where forbearance has been granted for a commercial customer it must be managed either within the Group s good book watchlist Credit Risk Classification framework or within a BSU. Whilst the Group treats all impaired assets to commercial customers as having been granted some form of forbearance in the past, granting forbearance does not necessarily mean that it is expected that future cash flows will fall, or that the asset is impaired. Depending on circumstances and within robust parameters and controls, the Group believes forbearance can help support the customer in the medium term.

Multiple types of forbearance concessions may occur and each case is treated depending on its own specific circumstances, as the Group s strategy and offer of forbearance is largely dependent on the individual situation. Early identification, control and monitoring are key in order to support the customer and protect the Group.

The Group s forbearance actions for its commercial customers experiencing financial difficulties fall into the following three main categories:

- Amendments Waiver or amendment of covenants or interest rate to a level considered outside of market or the Group s risk appetite;
- Extensions Extension/alteration of repayment terms to a level outside of market or the Group s risk appetite due to the customer s inability to make existing contractual repayment terms; and
- Forgiveness Debt for equity swaps or partial debt forgiveness. This type of forbearance will always give rise to impairment.

Following a forbearance event, should the customer show a sustained period of stabilisation on their new terms and conditions or where the forbearance has reversed or cured, the customer would likely be returned to the mainstream good classification, at which point they may no longer be considered forborne. Such a decision can be made only by the independent Risk Division.

The Group recognises that forbearance alone is not necessarily an indicator of impairment but is a trigger point for it to review the customer s credit profile.

One of the components of the approach to forbearance and early identification of issues used for commercial customers is the Group s Credit Risk Classification Policy. This complements the Group s risk rating tools and is designed to identify and highlight portfolio levels of asset quality as well as individual problem credits. This policy includes the Group s good book/mainstream early warning watchlist process identifying Special Mention and Sub Standard cases. This process seeks to ensure that Relationship Managers act promptly to identify, and highlight to senior management, customers that have the possibility to become higher risk in the future. Customers classified as Special Mention/Sub Standard are subject to additional controls and regular monitoring routines, including oversight by BSU and the independent risk function.

Concessions granted under forbearance would be classified in the Group s Credit Risk Classification system according to the severity of the customer s financial distress. Management information is produced which gives a high level view of asset quality, with clearly defined parameters and features. Trends and warning signs are reported and advised to senior management promptly, which include issues not yet identified by rating models. A robust review and challenge process is applied to each credit if asset quality declines, initiating an appropriate and measured response. As the financial stress of a credit deteriorates the Credit Risk Classification helps to determine the route and management of the customer. Repeat transgressions of forbearance would be reflected in the strategy to manage the customer and an objective reassessment of any impairment will be undertaken on a regular basis. This is subject to independent review and sanctioning.

The Group s accounting policy for loan renegotiations and forbearance is set out in note 2(H) to the financial statements.

In addition, the Group, through its banking businesses, participates in a number of initiatives designed to assist small and medium-sized enterprises. These include:

- The Lending Code: A voluntary code of practice covering its subscribers dealings with consumers, micro-enterprises and charities with an income of less than £1 million, in respect of current account overdrafts, loans, credit cards and lending. It sets standards for financial institutions to follow in order to ensure that firms act fairly and reasonably in all dealings with UK customers. In addition to providing protection for customers, it also gives guidance as to how firms should treat them on both a day to day basis, and when they suffer times of financial difficulty.

- Business Finance Taskforce: The Group, through its banking businesses, has taken a leading role in the Business Finance Taskforce, which committed to a number of key actions in three broad areas: (i) improving customer relationships; (ii) ensuring better access to finance (for example, through regular in-depth surveys of SME customers, including Ethnic Minority Businesses and Female Led Businesses); and (iii) providing better information and promoting customer understanding (including sponsorship of the Enterprise Research Centre).

- The lending appeals process: If a lending application is declined, customers have the right to appeal that decision. The Group has committed to go beyond industry agreed standards in this area and has pledged to respond to 90 per cent of appeals with a decision within 15 working days. In addition to this, customers will receive a goodwill payment for each overturned decline. The appeals process is overseen by the Independent External Reviewer of Appeals.

- Business mentoring: Businesses may benefit from the support of a business mentor. A free online service, offered by mentorsme that enables businesses to locate local independent mentoring organisations that suit their specific business needs. The Group has committed to having 400 trained mentors across the UK available to businesses free of charge through a network of not for profit mentoring agencies. The Group also partners several mentoring initiatives to support SME including the EDA (Enterprise Diversity Alliance), young enterprise through the Group s Enterprise Awards and social enterprise through work with Business in the Community and the School of Social Entrepreneurs.

- The Government s National Loan Guarantee Scheme (NLGS) through which the Group will provide discounted funding to SMEs with a turnover of up to £250 million over the next five years. The Group issued its full allocation of funding for the scheme and is continuing to market these facilities in order to ensure that the full benefit of the scheme is passed on to SME customers.

- 2013 SME Charter: The 2013 SME Charter details the Group s commitment to supporting UK business and, amongst others, includes pledges that:

  - The Group will deliver net lending that is positive and ahead of the industry as a whole.

  - As part of its participation in the Funding for Lending Scheme (FLS), the Group will continue to offer interest rate reductions of 1 per cent on all approved business loan, commercial mortgage and hire purchase applications for the whole life of these loans.

  - The Group will do everything possible to support business customers that are facing financial difficulties through its customer support specialists.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

THE GROUP CREDIT RISK PORTFOLIO IN 2012

OVERVIEW

The Group s impairment charge decreased by 42 per cent to £5,697 million in 2012, due to significant portfolio reductions and an improving overall credit quality.

The lower charges were supported by the continued application of the Group s prudent risk appetite and strong risk management controls. The portfolio also benefited from continued low interest rates, and broadly stable UK retail property prices, partly offset by subdued UK and global economic growth, high unemployment and a weak commercial real estate market.

The Group s exposures which are higher risk are being successfully managed by the Business and Customer Support Units in Commercial Banking and Ireland wholesale and Collection and Recovery Units in Retail.

The Group continues to proactively manage down sovereign as well as banking and trading book exposure to selected Eurozone countries.

The Group s divestment strategy remains focused on reducing assets outside of the Group s risk appetite and on the disposal of higher risk positions.

Table 1.5: **Impairment charge by Division (audited)**

	2012 £m	2011 £m	Change %
Retail	**1,270**	1,970	36
Commercial Banking	**2,946**	4,210	30
Wealth, Asset Finance and International	**1,480**	3,604	59
Central items	**1**	3	67
Total impairment charge	**5,697**	9,787	42
Impairment charge as a % of average advances	**1.02%**	1.62%	(60)bp

Total impairment charge comprises

Table 1.6: **Total impairment charge (audited)**

	2012 £m	2011 £m	Change %
Loans and advances to customers	**5,654**	9,712	42
Debt securities classified as loans and receivables	**15**	49	69
Available-for-sale financial assets	**37**	81	54
Other credit risk provisions	**(9)**	(55)	(84)
Total impairment charge	**5,697**	9,787	42

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.7: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2012					
Retail	**346,560**	**8,320**	**2.4**	**2,335**	**32.5**
Commercial Banking	**144,770**	**23,965**	**16.6**	**9,984**	**41.7**
Wealth, Asset Finance and International	**42,927**	**14,008**	**32.6**	**9,453**	**67.5**
Reverse repos and other items	**5,814**				
	540,071	**46,293**	**8.6**	**21,772**	**48.2**
Impairment provisions	**(21,772)**				
Fair value adjustments[3]	**(1,074)**				
Total Group	**517,225**				
At 31 December 2011					
Retail	356,907	8,822	2.5	2,718	35.4
Commercial Banking	169,964	33,117	19.5	13,693	41.3
Wealth, Asset Finance and International	51,506	18,330	35.6	11,307	61.7
Reverse repos and other items	17,066				
	595,443	60,269	10.1	27,718	46.9
Impairment provisions	(27,718)				
Fair value adjustments[3]	(2,087)				
Total Group	565,638				

1 Includes collective unimpaired provisions.

2 Provisions as a percentage of impaired loans are calculated excluding Retail unsecured loans in recoveries (2012: £1,129 million; 2011: £1,137 million).

3 The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group s consolidated financial records at their fair value and took into account both the expected future impairment losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires significant management judgement to determine its timing which includes an assessment of whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated useful lives of the related assets (until 2014 for wholesale loans and 2018 for retail loans) although if an asset is written off or suffers previously unexpected impairment then this element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £868 million for 2012 (2011: £1,693 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, and loans are repaid or written off, and will reduce to zero over time.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK RETAIL

Overview

The Retail impairment charge was £1,270 million in 2012, a decrease of 36 per cent, against 2011 primarily driven by the unsecured portfolio as a result of the Group s sustainable risk appetite and ongoing effective portfolio management.

The Retail impairment charge, as an annualised percentage of average loans and advances to customers decreased to 0.36 per cent in 2012 from 0.54 per cent in 2011.

The overall value of assets entering arrears in 2012 was lower in both unsecured and secured lending compared to 2011.

Approximately 8 per cent of total Retail assets at 31 December 2012 are outside of the Group s risk appetite; primarily specialist mortgages which is closed to new business and has been in run-off since 2009.

Table 1.8: **Retail impairment charge**

(audited)	**2012 £m**	2011 £m	Change %
Secured	**377**	463	19
Unsecured	**893**	1,507	41
Total impairment charge	**1,270**	1,970	36
(unaudited)			
Impairment charge as a % of average advances	**0.36%**	0.54%	(18)bp

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Impaired loans and provisions

Retail impaired loans decreased by £502 million to £8,320 million compared with 31 December 2011 and, as a percentage of closing loans and advances to customers, decreased to 2.4 per cent from 2.5 per cent at 31 December 2011. Impairment provisions as a percentage of impaired loans (excluding unsecured loans in recoveries) decreased to 32.5 per cent from 35.4 per cent at 31 December 2011 driven by the reduction in unsecured impaired loans.

Table 1.9: **Impairments on Retail loans and advances (audited)**

	Loans and advances to customers £m	**Impaired loans £m**	**Impaired loans as a % of closing advances %**	**Impairment provisions[1] £m**	**Impairment provisions as a % of impaired loans[3] %**
At 31 December 2012					
Secured	**323,862**	**6,321**	**2.0**	**1,616**	**25.6**
Unsecured:					
Collections		**870**		**719**	**82.6**
Recoveries[2]		**1,129**			
	22,698	**1,999**	**8.8**	**719**	
Total gross lending	**346,560**	**8,320**	**2.4**	**2,335**	**32.5**
Impairment provisions	**(2,335)**				
Fair value adjustments	**(915)**				
Total	**343,310**				
At 31 December 2011					
Secured	332,143	6,452	1.9	1,651	25.6
Unsecured:					
Collections		1,233		1,067	86.5
Recoveries[2]		1,137			
	24,764	2,370	9.6	1,067	
Total gross lending	356,907	8,822	2.5	2,718	35.4
Impairment provisions	(2,718)				
Fair value adjustments	(1,377)				
Total	352,812				

1 Impairment provisions include collective unimpaired provisions.

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

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

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

Table 1.10: **Retail loans and advances to customers (audited)**

	2012 £m	2011 £m
Secured:		
Mainstream	**248,735**	256,518
Buy to let	**49,568**	48,276
Specialist	**25,559**	27,349
	323,862	332,143
Unsecured:		
Credit cards	**9,465**	10,192
Personal loans	**10,523**	11,970
Bank accounts	**2,710**	2,602
	22,698	24,764

Total gross lending	**346,560**	356,907

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Secured

The secured impairment charge decreased to £377 million from £463 million in 2011 reflecting further reductions in impaired loans. The annualised impairment charge, as a percentage of average loans and advances to customers, decreased to 0.12 per cent in 2012 from 0.14 per cent in 2011. Provision coverage has remained stable at 25.6 per cent compared to 31 December 2011.

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

The value of mortgages greater than three months in arrears (excluding repossessions) increased to £9,637 million at 31 December 2012 compared to £9,560 million at 31 December 2011. The value of mortgages subject to forbearance (reduced contractual monthly payment treatment) reduced from £3,923 million (1.2 per cent) at 31 December 2011 to £2,706 million (0.8 per cent) at 31 December 2012.

The number of customers entering into arrears was 7 per cent lower in 2012 in comparison with 2011.

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

	Number of cases		**Total mortgage accounts %**		**Value of debt[1]**		**Total mortgage balances %**	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	Cases	Cases	**%**	%	**£m**	£m	**%**	%
At 31 December 2012								
Mainstream	**55,905**	53,734	**2.2**	2.0	**6,287**	5,988	**2.5**	2.3
Buy to let	**7,306**	7,805	**1.6**	1.8	**1,033**	1,145	**2.1**	2.4
Specialist	**13,262**	13,677	**7.6**	7.5	**2,317**	2,427	**9.1**	8.9
Total	**76,473**	75,216	**2.4**	2.3	**9,637**	9,560	**3.0**	2.9

1 Value of debt represents total book value of mortgages in arrears.

The stock of repossessions decreased to 2,438 cases at 31 December 2012 compared to 3,054 cases at 31 December 2011.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Secured loan to value analysis

The average indexed LTV on the mortgage portfolio at 31 December 2012 increased to 56.4 per cent compared with 55.9 per cent at 31 December 2011. The average LTV for new mortgages and further advances written in 2012 was 62.6 per cent compared with 62.1 per cent for 2011.

The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 11.7 per cent (£37,811 million) at 31 December 2012, compared with 12.0 per cent (£39,729 million) at 31 December 2011. The tables below show LTVs across the principal mortgage portfolios.

Table 1.12: **Actual and average LTVs across the Retail mortgage portfolios (audited)**

	Mainstream %	**Buy to let** %	**Specialist**[1] %	**Total** %
At 31 December 2012				
Less than 60%	**31.9**	**12.8**	**14.7**	**27.6**
60% to 70%	**12.8**	**12.9**	**9.7**	**12.6**
70% to 80%	**18.3**	**26.2**	**17.2**	**19.4**
80% to 90%	**16.6**	**16.5**	**19.1**	**16.8**
90% to 100%	**10.5**	**15.4**	**18.5**	**11.9**
Greater than 100%	**9.9**	**16.2**	**20.8**	**11.7**
Total	**100.0**	**100.0**	**100.0**	**100.0**
Average loan to value:[2]				
Stock of residential mortgages	**52.7**	**73.6**	**72.6**	**56.4**
New residential lending	**62.3**	**64.5**	**n/a**	**62.6**
Impaired mortgages	**72.2**	**99.3**	**88.1**	**78.3**
At 31 December 2011				
Less than 60%	32.5	12.7	14.6	28.1
60% to 70%	12.7	13.0	10.1	12.5
70% to 80%	17.2	24.1	17.2	18.2
80% to 90%	16.0	17.3	19.3	16.5
90% to 100%	11.2	17.1	19.0	12.7
Greater than 100%	10.4	15.8	19.8	12.0
Total	100.0	100.0	100.0	100.0
Average loan to value:[2]				
Stock of residential mortgages	52.2	74.0	72.6	55.9
New residential lending	61.4	65.8	n/a	62.1
Impaired mortgages	72.0	99.8	88.0	78.4

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

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

UNSECURED

The impairment charge on unsecured loans and advances to customers reduced by £614 million in 2012 to £893 million compared with 2011. The impairment charge as a percentage of annualised average loans and advances to customers decreased to 3.74 per cent in 2012 from 5.65 per cent in 2011.

A combination of reduced demand from customers for new unsecured borrowing and existing customers continuing to reduce their personal indebtedness contributed to loans and advances to customers reducing by £2,066 million since 31 December 2011 to £22,698 million at 31 December 2012.

Impaired loans decreased by £371 million since 31 December 2011 to £1,999 million at 31 December 2012 which represented 8.8 per cent of closing loans and advances to customers, compared with 9.6 per cent at 31 December 2011. The reduction in impaired loans is a result of the Group s sustainable risk appetite and ongoing effective portfolio management. Retail s exposure to revolving credit products has been actively managed to ensure that it is appropriate to customers changing financial circumstances.

Impairment provisions decreased by £348 million, compared with 31 December 2011. This reduction was driven by fewer assets entering arrears and recoveries assets being written down to the present value of future expected cash flows. Impairment provisions as a percentage of impaired loans in collections decreased to 82.6 per cent at 31 December 2012 from 86.5 per cent at 31 December 2011.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK COMMERCIAL BANKING

Overview

Impairment charges were £2,946 million in 2012, down from £4,210 million in 2011. The decrease in the underlying impairment charge was primarily driven by lower charges in Australasia and in Acquisition Finance. The reduction was partly offset by further deterioration in the Shipping portfolio as a result of weak markets.

The fall in the impairment charge reflects generally stable obligor credit quality overall, with the low interest rate environment helping to maintain defaults at a lower level, despite weaker consumer confidence in a number of sectors. The credit risk appetite approach is through the cycle helping to ensure that new business written is of good quality.

Forbearance is well controlled and managed, and any such cases are quickly identified and managed appropriately under the Group s Credit Risk Classification Framework. The value of assets transferring into the BSU has reduced by 37 per cent during 2012.

Table 1.13: **Commercial Banking impairment charge (unaudited)**

	2012 **£m**	2011 £m	Change during 2012
Total impairment charge	**2,946**	4,210	30%
Impairment charge as a % of average advances	**1.85%**	2.32%	(47)bp

Impairment charges have decreased 30 per cent compared with 2011 driven by lower charges in Australasia and leveraged lending in Acquisition Finance, which was partly offset by further deterioration in the Shipping portfolio as a result of weak markets. The low interest rate environment is helping to maintain defaults at a lower level.

Impaired loans and provisions

The overall quality of the Commercial Banking portfolio continues to improve. Despite a reducing portfolio, as a percentage of closing loans and advances to customers, impaired loans decreased to 16.6 per cent from 19.5 per cent at 31 December 2011.

Commercial Banking s impaired loans reduced by £9,152 million to £23,965 million compared with 31 December 2011. The reduction is due to write-offs on irrecoverable assets, the sale of previously impaired assets, net repayments and transfers out of Business Support Unit more than offsetting the flow of newly impaired assets into Business Support Unit. Furthermore, the flow of assets into impaired status was lower during 2012 compared to 2011.

Impairment provisions as a percentage of impaired loans increased to 41.7 per cent from 41.3 per cent at 31 December 2011 as Business Support Unit was successful in selling a number of impaired assets which generally had lower coverage levels. The Business Support Unit portfolio continues to reduce as a result of robust and proactive risk management.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.14: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Commercial[2]	**29,357**	**2,680**	**9.1**	**814**	**30.4**
Wholesale[2]	**75,510**	**3,227**	**4.3**	**2,052**	**63.6**
Lending outside of the Group s risk appetite:					
Corporate Real Estate BSU[3]	**15,701**	**12,060**	**76.8**	**4,424**	**36.7**
Specialised Lending	**15,018**	**2,679**	**17.8**	**1,135**	**42.4**
Other	**9,184**	**3,319**	**36.1**	**1,559**	**47.0**
	39,903	**18,058**	**45.3**	**7,118**	**39.4**
Total Commercial Banking	**144,770**	**23,965**	**16.6**	**9,984**	**41.7**
Reverse repos	**5,087**				
Impairment provisions	**(9,984)**				
Fair value adjustments	**(131)**				
Total	**139,742**				
Loans and advances to banks	**7,580**				
Debt securities	**5,261**				
Available-for-sale financial assets	**4,345**				
At 31 December 2011					
Commercial[2]	28,289	2,885	10.2	858	29.7
Wholesale[2]	81,520	3,829	4.7	2,317	60.5
Lending outside of the Group s risk appetite:					
Corporate Real Estate BSU[3]	21,055	15,069	71.6	5,579	37.0
Specialised Lending	20,387	4,822	23.7	1,615	33.5
Other	18,713	6,512	34.8	3,324	51.0
	60,155	26,403	43.9	10,518	39.8
Total Commercial Banking	169,964	33,117	19.5	13,693	41.3
Reverse repos	16,836				
Impairment provisions	(13,693)				
Fair value adjustments	(668)				
Total	172,439				
Loans and advances to banks	8,461				
Debt securities	12,490				
Available-for-sale financial assets	12,554				

1 Includes collective unimpaired provisions of £894 million (2011: £1,213 million).

2 Excludes lending which is outside of the Group s risk appetite.

3 Corporate Real Estate BSU includes direct real estate and other real estate related sectors (such as hotels, care homes and housebuilders).

Gross customers loans and advances which are outside of the Group s risk appetite totals £39,903 million (2011: £60,155 million). This figure comprises gross loans and advances of £1,086 million (2011: £1,392 million) within Commercial Banking s Commercial sub-segment and gross loans and advances of £38,817 million (2011: £58,736 million) within Commercial Banking s Wholesale sub-segment.

Lending outside of the Group s risk appetite which is detailed above consist of businesses which deliver below-hurdle returns, which are outside of the Group s risk appetite or may be distressed, are subscale or have unclear value proposition, or have a poor fit with the Group s customer strategy.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LENDING WHICH IS WITHIN THE GROUP S RISK APPETITE

Commercial

The Commercial portfolio credit quality remains stable and impairment charges have fallen over the last 12 months to £252 million in 2012 from £296 million in 2011. The decrease reflects the continued benefits of the low interest rate environment, which has helped to maintain defaults at a lower level, and the continued application of the Group s prudent risk appetite and through the cycle credit policy that has proven itself appropriate for both customers and the Group.

Supporting its clients through the cycle remains a key aim and the Group continues to operate control and monitoring activities which play an important role in identifying customers showing early signs of financial stress and bringing them into the Group s support model so prompt and supporting actions can be taken.

Wholesale

Overall obligor quality remains stable, and impairment charges reduced over the last 12 months to £452 million in 2012 from £759 million in 2011.

The £75,510 million of gross loans and advances to customers in the Wholesale portfolio is structured across a number of different coverage segments delivered via a suite of core banking products from Lending and Transaction Banking to Financial Markets and Capital Markets. These include:

Mid-Markets The businesses are predominantly UK focused and several sectors have continued to face challenging trading conditions in the face of domestic economic performance, weak consumer sentiment and public sector austerity measures. The Retail, Leisure, Construction and Care sectors have shown the most evident stress, although there is wide disparity between the performance of the stronger and weaker businesses in each of these areas. The Group s through the cycle risk appetite has helped ensure that the portfolio quality has remained relatively stable.

Global Corporates This portfolio continues to be predominantly investment grade focused, the overall portfolio asset quality remains strong and Major Corporate balance sheets continue to de-lever. This year has seen a limited number of mergers and acquisitions. These are being selectively targeted by Corporates, with conservative structuring approaches being adopted, and subsequent focus on rapid de-leveraging. The Group continues to see softness in sectors such as Media, Retail, Leisure and Construction across the UK and Continental Europe. Public sector austerity continues to impact on recovery prospects, although the long lead-in times to these cuts have allowed Corporates to adjust their own structures and cost bases.

Financial Institutions (FIs) Commercial Banking maintains relationships with many major financial institutions throughout the world. These relationships are either client focused or held to support the Group s funding, liquidity and general hedging requirements. Trading exposures continue to be predominantly short-term and/or collateralised with inter bank activity mainly undertaken with strong investment grade counterparties. The Eurozone crisis continued during 2012 and continues to require very close portfolio scrutiny and oversight. Detailed contingency plans are in place and continuously refined, whilst exposures to FIs domiciled in peripheral Eurozone countries in particular have been further reduced and are being managed within tight risk parameters.

Acquisition Finance (leveraged lending) The Group s Acquisition Finance portfolio that is within its risk appetite is performing in line with expectations given the economic environment. Many customers are prepaying facilities ahead of schedule. The portfolio is predominantly within the good book business and all such loans are performing. The Group continues to write new business within its through the cycle credit risk appetite parameters.

Project Finance Principally focuses on lending to large scale UK Infrastructure. The good book accounts for over 95 per cent of the portfolio which is representative of the quasi government cash flow or monopolistic nature of the assets. Good book assets are performing well and have shown resilience to economic cyclicality.

Sales and Trading Acts as the link between the wholesale markets and the Group s balance sheet management activities providing pricing and risk management solutions to both internal and external clients. The portfolio comprises £5.8 billion of loans and advances to banks, £1.7 billion of available-for-sale debt securities and £2.8 billion of loans and advances to customers (excluding reverse repos). Sales and Trading actively manages the government bond portfolio which is now almost solely AAA/AA rated. Exposure to the weaker Eurozone sovereigns has been managed down to a de minimis level given continued concerns over market conditions across the Eurozone.

The majority of Sales and Trading s funding and risk management activity is transacted with investment grade counterparties including Sovereign central banks and much of it is on a collateralised basis, such as repos facing a Central Counterparty (CCP). Derivative transactions with FI counterparties are typically collateralised under a credit support annex in conjunction with the International Swaps and Derivatives Association Master Agreement. During 2012 the Group continued to consolidate its counterparty risk via CCP s as part of an ongoing move to reduce counterparty risk by clearing standardised derivative contracts.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

LENDING WHICH IS OUTSIDE OF THE GROUP S RISK APPETITE

Corporate Real Estate Business Support Unit (BSU)

Strong progress has been maintained in reducing this element of the Corporate Real Estate BSU portfolio with the reduction in gross loans and advances falling to £15.7 billion (2011: £21.1 billion). This is primarily due to the momentum on asset disposals which totalled around £4 billion (net cash proceeds) in the year despite the declining volume of transactions in the regional markets. There has been a material reduction in the level of gross loans and advances through disposals (including write-offs) since 30 June 2009. The full year Corporate Real Estate BSU impairment charge for loans and advances outside of the Group s risk appetite has continued its downward trend to £1.2 billion (2011: £1.3 billion) despite the difficult market conditions.

Over 75 per cent of the Corporate Real Estate BSU portfolio that is outside of the group s risk appetite consists of distressed or sub standard direct real estate loans. The remainder relates to loans to other real estate related sectors, supported by trading activities (such as housebuilders, hotels and care homes), with assets managed by specialist teams.

The portfolio remains regionally focused with real estate asset quality that is largely secondary and tertiary in nature. However, these assets have been the subject of significant and frequent review, and have been impaired to appropriate levels.

The profile of the Group s portfolio allows the Group flexibility to consider asset disposal, loan sales or repayments through the Group s embedded property asset management platforms and has allowed the Group to attract liquidity from different counterparties in a demanding environment. Over the last three years Corporate Real Estate BSU has reduced its gross exposure to loans outside the Group s risk appetite by approximately £21 billion. In 2012, disposals outside London accounted for over 70 per cent of Corporate Real Estate BSU s disposals by value and over 90 per cent by number. This is higher than the general market experience.

Corporate Real Estate BSU has continued to execute its active asset management programme of this complex portfolio making strong progress in a difficult real estate market. The principal aim is to minimise losses for the Group and to support the Group s clients through difficult periods. This activity can involve the restructuring of loans, seeking deleverage through asset sales and other sale initiatives. A consensual route with its clients is always the Group s preferred option.

Values in the Commercial Real Estate market have trended downwards over the last 12 months, falling on average by 4.2 per cent on the same period last year. Investment volumes have by and large been steady, though investor appetite has been concentrated on London. Although values in London continue to climb and are 39 per cent above their 2009 trough, non-London asset values are struggling and are now only 5 per cent above their 2009 trough. With a continuing high level of loan maturities due over the next few years, refinancing risk remains a market wide risk, although loans in BSU are predominantly bilateral. In assessing the Group s impairment provisions, allowance is taken for the Group s greater proportion of secondary real estate assets. Consequently a steeper fall in real estate prices, compared to the general market index expectations, is used to calculate impairment provisions.

SPECIALISED LENDING

Loans and advances to customers of £15.0 billion largely comprise balances in the Structured Corporate Finance portfolio, which includes the portion of the Acquisition Finance (leveraged lending) portfolio and the Asset Based Finance portfolios (Ship Finance, Aircraft Finance and Rail Capital) which are outside of the Group s risk appetite. While the effects of subdued UK economic conditions and refinancing risk continues to be felt in this portion of the Acquisition Finance portfolio, the portfolio of assets which are outside of the Group s risk appetite is now smaller in size and has a generally lower risk profile than in previous reporting periods which led to a significantly lower impairment charge during 2012 compared to 2011.

The Acquisition Finance portfolio that is outside of the Group s risk appetite is approximately 75 per cent managed in Business Support Unit reflecting its relatively high risk parameters, with significant loan maturities due in the next few years. In Ship Finance, the tankers, dry bulk and containers sectors remained challenging in 2012. The Group has completed projects to accelerate exits within its Ship Finance portfolio when deemed in the best interest of the Group with further planning at an advanced stage to facilitate early exits where opportunities arise during 2013. In December 2012, the Group sold its Rail Finance rolling stock operating lease businesses and made a managed disposal of some of its US aircraft exposure.

Specialised Lending also includes a small equity business and a significantly reduced Treasury Assets portfolio, both of which are outside of the Group s risk appetite. Following a number of disposals during 2012, at 31 December 2012 the drawn assets representing equity risk only totals £0.7 billion. The Treasury Asset legacy investment portfolio mainly encompasses a portfolio of asset-backed securities and financial institution Covered Bond positions. This portfolio size continues to be actively reduced through asset sales and from bond maturities. Further details of Commercial Banking s asset-backed securities portfolio is provided in note 55 to the financial statements.

OTHER

Loans and advances to customers of £9.2 billion largely comprise balances in Australian Corporate (£2.3 billion), Wholesale Europe (£2.2 billion) and Entrepreneurs (£2.0 billion) businesses. The Group significantly reduced its exposure and impaired assets in its Australasian business by £3.4 billion and £2.2 billion respectively during 2012, largely due to asset sales including the successful disposal of a £0.8 billion portfolio of impaired Australasian real estate loans. At 31 December 2012, net Corporate Real Estate exposure in Australia totals £0.1 billion (2011: £1.3 billion). The Group was also successful in reducing the Wholesale Europe exposure which is outside of its risk appetite during 2012, with disposals of £0.4 billion in the period.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

SECURED LOAN TO VALUE ANALYSIS FOR UK DIRECT REAL ESTATE LENDING IN COMMERCIAL BANKING

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

UK Direct Real Estate in the good book The Group s good book exposure totalled £18.0 billion at 31 December 2012. Approximately three quarters related to commercial real estate with the remainder mostly residential real estate. A large element of the residential exposure is to professional landlords in the Group s SME business, where performance has been good. The entire good book portfolio has been fully reviewed and is performing acceptably. The Group s risk appetite requires it to look first at the underlying cash flows as part of credit assessment, alongside key requirements for good quality counterparties and a well spread tenant profile. The Group considers the value in security taken as a secondary repayment source, although its origination parameters for LTVs are considered through the cycle.

UK Direct Real Estate in Business Support Units The Group s Business Support Unit portfolios consist of £12.7 billion gross (£8.8 billion net of impairment) of UK Direct Real Estate loan exposure at 31 December 2012.

Loan to value ratios (indexed or actual if within last 12 months) for the Group s largest transactions (over £5 million) are detailed in the table below.

The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each transaction, and the value of the collateral held. In the case of impaired UK Direct Real Estate exposures (over £5 million) there is a net property collateral shortfall of approximately £0.2 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. For the good book, unsecured and over 100 per cent LTV lending mainly comprises lending supported by either the strength of the obligors balance sheet or a strong parent. The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indexes, models and subject matter expert judgement.

Table 1.15: **LTV UK Direct Real Estate (unaudited)**

	Good book Loans and advances (gross)		**Business Support Loans and advances (gross)**	
	2012	**2012**	**2012**	**2012**
	£m	**%**	**£m**	**%**
Exposures > £5 million:				
Less than 60%	**3,536**	**42**	**402**	**4**
61% to 70%	**1,891**	**22**	**308**	**3**
71% to 80%	**1,738**	**21**	**495**	**5**
81% to 100%	**351**	**4**	**2,690**	**26**
101% to 125%	**229**	**3**	**1,546**	**15**
More than 125%	**23**		**4,362**	**43**
Unsecured	**677**	**8**	**431**	**4**
	8,445	**100**	**10,234**	**100**
Exposures < £5 million	**9,591**		**2,474**	
Total	**18,036**		**12,708**	

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

CREDIT RISK WEALTH, ASSET FINANCE AND INTERNATIONAL

OVERVIEW

In 2012 Wealth, Asset Finance and International impairment charges fell significantly compared to 2011 predominantly reflecting reductions in the Ireland (wholesale and retail) portfolio.

In the Irish wholesale portfolio, 85.2 per cent (2011: 84.3 per cent) is now impaired with a coverage ratio of 68.0 per cent (2011: 61.1 per cent), primarily reflecting continued deterioration in the Irish commercial property market. Net exposure in Ireland wholesale has reduced to £5.4 billion (2011: £8.6 billion).

In the Irish retail mortgage portfolio, impairment provisions as a percentage of impaired loans increased to 71.2 per cent (2011: 70.4 per cent).

Table 1.16: **Impairment charge (audited)**

	2012	2011	Change
	£m	£m	%
Wealth	**23**	33	30
International:			
Ireland retail	**108**	511	79
Ireland wholesale	**1,137**	2,676	58
Spain retail	**51**	59	14
Netherlands retail	**23**	21	(10)
Asia retail	**35**	7	
Latin America and Middle East	**(33)**	65	
	1,321	3,339	60
Asset Finance:			
United Kingdom	**121**	200	40
Australia	**15**	32	53
	136	232	41
Total impairment charge	**1,480**	3,604	59
Impairment charge as a % of average advances	**3.12%**	6.48%	(3.36)pp

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

IMPAIRED LOANS AND PROVISIONS

Total impaired loans decreased by £4,322 million to £14,008 million compared with £18,330 million at 31 December 2011 and as a percentage of closing loans and advances to customers decreased to 32.6 per cent from 35.6 per cent at 31 December 2011. This is primarily driven by reductions in Ireland wholesale.

Impairment provisions as a percentage of impaired loans increased to 67.5 per cent from 61.7 per cent at 31 December 2011. The increase was driven by the International portfolios.

Table 1.17: **Impairments on loans and advances (audited)**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2012					
Wealth	**4,325**	**284**	**6.6**	**73**	**25.7**
International:					
Ireland retail	**6,656**	**1,534**	**23.0**	**1,111**	**72.4**
Ireland wholesale	**12,875**	**10,967**	**85.2**	**7,463**	**68.0**
Spain retail	**1,458**	**104**	**7.1**	**94**	**90.4**
Netherlands retail	**5,689**	**79**	**1.4**	**41**	**51.9**
Asia retail	**1,978**	**80**	**4.0**	**46**	**57.5**
Latin America and Middle East	**46**	**36**	**78.3**	**31**	**86.1**
	28,702	**12,800**	**44.6**	**8,786**	**68.6**
Asset Finance:					
United Kingdom	**5,848**	**885**	**15.1**	**541**	**61.1**
Australia	**4,052**	**39**	**1.0**	**53**	
	9,900	**924**	**9.3**	**594**	**64.3**
	42,927	**14,008**	**32.6**	**9,453**	**67.5**
Impairment provisions	**(9,453)**				
Fair value adjustments	**(28)**				
Total	**33,446**				
At 31 December 2011					
Wealth	4,865	231	4.7	74	32.0
International:					
Ireland retail	7,036	1,415	20.1	1,034	73.1
Ireland wholesale	17,737	14,945	84.3	9,133	61.1
Spain retail	1,604	99	6.2	63	63.6
Netherlands retail	6,259	62	1.0	30	48.4
Asia retail	2,180	55	2.5	18	32.7
Latin America and Middle East	612	211	34.5	144	68.2
	35,428	16,787	47.4	10,422	62.1
Asset Finance:					
United Kingdom	7,162	1,217	17.0	746	61.3
Australia	4,051	95	2.3	65	68.4
	11,213	1,312	11.7	811	61.8
	51,506	18,330	35.6	11,307	61.7
Impairment provisions	(11,307)				
Fair value adjustments	(42)				
Total	40,157				

1 Impairment provisions include collective unimpaired provisions.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Wealth

Total impaired loans increased by £53 million to £284 million compared with £231 million at 31 December 2011. Impairment provisions as a percentage of impaired loans and advances decreased to 25.7 per cent from 32.0 per cent at 31 December 2011. The impairment charge for 2012 was £23 million. The impairment charge, as an annualised percentage of average loans and advances to customers, decreased to 0.51 per cent compared with 0.67 per cent in 2011.

International

Ireland

Total impaired loans decreased by £3,859 million, or 24 per cent to £12,501 million compared with £16,360 million at 31 December 2011. The reduction is driven primarily by commercial real estate and corporate loans. Impaired loans as a percentage of closing loans and advances decreased to 64.0 per cent from 66.0 per cent at 31 December 2011. Continuing weakness in the Irish real estate markets resulted in a further increase in Ireland wholesale coverage in 2012 to 68.0 per cent from 61.1 per cent.

Impairment charges decreased by £1,942 million to £1,245 million compared to 2011 as the rate of increase in newly impaired loans fell during 2012. Impairment charges as an annualised percentage of average loans and advances to customers decreased to 5.53 per cent from 11.93 per cent in 2011.

Table 1.18: **Impairments on Ireland loans and advances (audited)**

		2012			2011	
	Loans and advances to customers £m	**Impaired loans £m**	**Provisions £m**	Loans and advances to customers £m	Impaired loans £m	Provisions £m
Commercial Real Estate	**7,408**	**6,720**	**4,695**	10,872	9,807	6,194
Corporate	**5,467**	**4,247**	**2,768**	6,865	5,138	2,939
Retail	**6,656**	**1,534**	**1,111**	7,036	1,415	1,034
Total Ireland	**19,531**	**12,501**	**8,574**	24,773	16,360	10,167

The most significant contribution to impairment in Ireland is the Commercial Real Estate portfolio. Within the Commercial Real Estate portfolio, 90.7 per cent of the portfolio is now impaired (compared to 90.2 per cent at 31 December 2011). The average impairment coverage ratio has increased in the year to 69.9 per cent (63.2 per cent at 31 December 2011) reflecting the continued deterioration in the Irish commercial property market. Mortgage lending at 31 December 2012 comprised 99.5 per cent of the retail portfolio with impairment coverage on the mortgage portfolio at 71.2 per cent (2011: 70.4 per cent). Impaired loans on the retail portfolio increased by £119 million in 2012 compared to a £545 million increase in 2011. The reduction in growth of impaired loans is primarily due to a less uncertain economic environment.

The Group continued to reduce its exposure to Ireland. Gross loans and advances reduced by £5,242 million during 2012 mainly due to write-offs of £2.5 billion, disposals of £1.4 billion and net repayments of £0.7 billion.

£1,413 million of gross wholesale lending within the Commercial Real Estate and Corporate portfolios relates to sterling loans secured on UK property.

SECURED LOAN-TO-VALUE ANALYSIS FOR COMMERCIAL REAL ESTATE LENDING IN IRELAND WHOLESALE

Loan-to-value ratios (indexed or actual if within the last 18 months) for the Group s largest transactions (over 5 million) are detailed in the table below:

The Group considers this portfolio to be appropriately provided for after taking into account the provisions held for each transaction, and the value of the collateral held. In the case of impaired Ireland commercial real estate exposures (over 5 million) there is a net property collateral shortfall of approximately £0.3 billion. This figure excludes benefits of credit mitigants such as cross collateralisation and cross guarantees. As a result of the market environment, market-based information on valuations is limited.

The Group therefore makes use of a variety of methodologies to assess the value of property collateral. These include use of market indexes, models and subject matter expert judgement.

Table 1.19: **LTV Ireland Wholesale Commercial Real Estate**

	Loans and advances (gross)	
	2012	**2012**
	£m	**%**
Exposures > 5 million:		
Less than 60%	**119**	**2.0**
61% to 70%	**20**	
71% to 80%	**27**	
81% to 100%	**165**	**3.0**
101% to 125%	**182**	**3.0**
More than 125%	**4,927**	**81.0**
Unsecured	**674**	**11.0**
	6,114	**100**
Exposures < 5 million	**1,294**	
Total	**7,408**	

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Other International

Total impaired loans decreased by £128 million to £299 million compared with £427 million at 31 December 2011 and as a percentage of closing loans and advances decreased to 3.3 per cent from 4.0 per cent at 31 December 2011. The reduction in impaired loans is driven by Latin America and Middle East. Impairment provisions as a percentage of impaired loans have increased in Spain Retail, Netherland Retail and Asia Retail, against a backdrop of falling residential property prices.

Asset Finance

United Kingdom   the UK Asset Finance impairment charge reduced by 40 per cent to £121 million (of which 100 per cent related to assets which are outside of the Group s risk appetite) driven by strong credit management and improving credit quality. The retail portfolio saw more customers meeting their payment arrangements resulting in a lower proportion of people falling into arrears. The retail impairments also benefited from debt sale activity during the course of the year. The number of defaults in all areas of the commercial and corporate lending book was low relative to the last three years, reflecting effective previous and ongoing credit risk management actions.

Australia   Impaired loans decreased by £56 million to £39 million compared with £95 million at 31 December 2011 and as a percentage of closing loans and advances decreased to 1.0 per cent from 2.3 per cent at 31 December 2011. The impairment charge has also reduced materially by 53 per cent to £15 million. The Asset Finance business continues to benefit from strong credit management and improving credit quality supported by a resilient Australian economy.

EXPOSURES TO EUROZONE COUNTRIES

The following section summarises the Group s direct exposure to Eurozone countries at 31 December 2012. The exposures comprise on-balance sheet exposures based on their balance sheet carrying values and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

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

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

The Group Financial Stability Forum has been established in order to monitor developments within the Eurozone, carry out stress testing through detailed scenario analysis and complete appropriate due diligence on the Group s exposures.

The Group Financial Stability Forum has carried out a number of scenario analyses and rehearsals to test the Group s resilience in the event of further instability in certain Eurozone countries. The Group has developed and refined pre-determined action plans that would be executed in such scenarios. The plans set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications, suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

The Group has included certain amounts on a net basis to better reflect the overall risk to which the Group is exposed. The gross IFRS reported values for the exposures to Ireland, Spain, Portugal, Greece and Italy are detailed in the following tables. Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level and net of cash collateral in line with legal agreements. Exposures in respect of reverse repurchase agreements are included on a gross IFRS basis and are disclosed based on the counterparty rather than the collateral (repos and stock lending are excluded); reverse repurchase exposures are not, therefore, reduced as a result of collateral held. Exposures to central clearing counterparties are shown net.

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

During the year, the Group drew 13.5 billion (the sterling equivalent of which at the date of drawdown was £11.2 billion) under the European Central Bank s Long-Term Refinancing Operation facility for an initial term of three years, to part fund a pool of euro denominated assets.

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Exposures to Ireland, Spain, Portugal, Greece and Italy
The Group continues to have minimal exposure, in aggregate, which could be considered to be direct recourse to the sovereign risk of the selected countries.

Table 1.20: **Eurozone exposures (unaudited)**

	Sovereign debt								
			Financial Institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total (net) £m
31 December 2012									
Ireland			**115**	**644**	**305**	**5,972**	**5,559**	**111**	**12,706**
Spain	**5**								