

# Lloyds TSB Bank plc

Report and Accounts  
**2010**

Member of Lloyds Banking Group



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## Results

The consolidated income statement on page 12 shows a loss attributable to equity shareholders for the year ended 31 December 2010 of £155 million.

## Principal activities

Lloyds TSB Bank plc (the Bank) and its subsidiaries (the Group) provide a wide range of banking and financial services through branches and offices in the UK and overseas.

The Group's revenue is earned through interest and fees on a broad range of financial services products including current and savings accounts, personal loans, credit cards and mortgages within the retail market; loans and capital market products to commercial, corporate and asset finance customers; life, pensions and investment products; general insurance; and private banking and asset management.

## Business review

The results for the year reflect the transfer to the Bank of 100 per cent of the ordinary share capital of HBOS plc (HBOS) on 1 January 2010 as part of an internal reorganisation within the Lloyds Banking Group. The results of HBOS were therefore included within the consolidated results of the Bank from 1 January 2010 onwards.

Profit before tax increased by £5,103 million, to a profit of £725 million compared to a loss of £4,378 million in 2009. This was due to the £12,094 million improvement in trading surplus arising from increased net interest income and the non-recurrence of both the £2,500 million Government Asset Protection Scheme (GAPS) fee and the £3,000 million subvention payment paid in 2009, together with the impact of the transfer of HBOS, which resulted in net interest income and operating expenses increasing.

Net interest income increased by £7,387 million, or 139 per cent, from £5,299 million to £12,686 million, in line with the large increase in loans and advances to customers arising from the transfer of HBOS, which increased from £245 billion to £611 billion.

Other income increased by £14,301 million, or 85 per cent, from £16,890 million to £31,191 million. The largest drivers of this increase were a £3,920 million increase in insurance premium income and £8,953 million increase in net trading income.

Operating expenses, excluding the GAPS fee and subvention payment, increased from £7,023 million to £13,236 million, reflecting additional operating expenses arising from the transfer of HBOS and a customer goodwill payments provision of £500 million, offset by the pension curtailment gain of £910 million.

Impairment losses increased by £6,536 million, or 148 per cent, from £4,416 million to £10,952 million, as improved credit quality experience in Retail and Wholesale lending was more than offset by the substantial impairment losses incurred by the HBOS international businesses.

A loss of £365 million arose on disposal of businesses in 2010 (2009: £nil).

Loans and advances to customers increased by £365,863 million, or 149 per cent, from £245,226 million to £611,089 million. Customer deposits increased by £223,231 million, or 116 per cent, from £193,045 million to £416,276 million resulting in an increase in the ratio of customer loans to customer deposits from 127 per cent at 31 December 2009 to 147 per cent at 31 December 2010.

Debt securities in issue increased by £107,598 million, or 89 per cent, from £120,719 million to £228,317 million.

Shareholders' equity increased by £33,471 million from £13,420 million to £46,891 million mainly due to £21,394 million from the issuance of shares on the transfer of HBOS from Lloyds Banking Group plc together with the credit to merger reserves of £6,348 million arising on consolidation of HBOS.

At the end of December 2010, the Group's capital ratios increased with a total capital ratio on a Basel II basis of 14.0 per cent (compared to 11.8 per cent at 31 December 2009) and a tier 1 ratio of 12.1 per cent (compared to 10.4 per cent at 31 December 2009). During 2010, risk-weighted assets increased by £234,491 million to £408,963 million compared to £174,472 million at 31 December 2009; this increase reflects the impact of the transfer of HBOS.

## Financial risk management objectives and policies

Information regarding the financial risk management objectives and policies of the Group, in relation to the use of financial instruments, is given in note 55. A discussion of the principal risks and uncertainties faced by the Group is set out on pages 6 to 9.

## Directors' report

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### Group structure

Following a reorganisation of the Lloyds Banking Group on 1 January 2010, the Bank acquired 100 per cent of the issued ordinary share capital of HBOS from Lloyds Banking Group plc; the consideration for this transfer was the issue of 21.4 million shares to Lloyds Banking Group plc for a total value of £21,394 million.

### Directors

The names of the directors of the Bank are shown on page 5. Changes to the composition of the board since 1 January 2010 are shown below:

Dr W C G Berndt retired from the board on 6 May 2010.

Three directors joined the board during the year as follows: Mr G R Moreno (1 March 2010), Mr D L Roberts (1 March 2010) and Ms A M Frew (1 December 2010).

Mr A Horta-Osório joined the board on 17 January 2011. Mr J E Daniels will retire from the board on 28 February 2011 and will be succeeded as group chief executive by Mr A Horta-Osório on 1 March 2011.

### Directors' interests

The directors are also directors of Lloyds Banking Group plc and their interests in shares in Lloyds Banking Group plc are shown in the report and accounts of that company.

### Directors' conflicts of interest

The board, as permitted by the Bank's articles of association, has authorised all potential conflicts of interest declared by individual directors. Decisions regarding these conflicts of interest could only be taken by directors who had no interest in the matter. In taking the decision, the directors acted in a way they considered, in good faith, would be most likely to promote the Bank's success. The directors had the ability to impose conditions, if thought appropriate, when granting authorisation. Any authorities given will be reviewed at least every 15 months. No director is permitted to vote on any resolution or matter where he or she has an actual or potential conflict of interest. The board confirms that it did not authorise any material conflicts during the year.

### Directors' indemnities

The directors, including the former director who retired during the year, have entered into individual deeds of indemnity with Lloyds Banking Group plc which constituted 'qualifying third party indemnity provisions' and 'qualifying pension scheme indemnity provisions' for the purposes of the Companies Act 2006. These deeds were in force during the whole of the financial year or from the date of appointment in respect of the directors who joined the board in 2010 and 2011. The indemnities remain in force for the duration of a director's period of office. Deeds for existing directors are available for inspection at the Bank's registered office.

### Share capital

Information about share capital is shown in note 46 on page 77.

### Statement of directors' responsibilities

The directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the group and parent company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Bank and of the profit or loss of the Group and the Bank for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent; and
- state whether applicable IFRSs as adopted by the European Union have been followed.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank and the Group and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Bank and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the financial statements is placed on the website [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com). The directors are responsible for the maintenance and integrity in relation to the Bank on that website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

## Directors' report

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Each of the current directors, whose names are shown on page 5 of this annual report, confirms that, to the best of his or her knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities and financial position of the Bank and Group and the profit or loss of the Group;
- the business review includes a fair review of the development and performance of the business and the position of the Bank and Group; and
- the principal risks and uncertainties faced by the Bank and the Group are set out on pages 6 to 9.

### **Going concern**

The going concern of the Bank and the Group, is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies as discussed in note 1 and additionally have considered projections for the Group's capital and funding position. Having considered these, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

### **Employees**

The Bank, as part of Lloyds Banking Group, is committed to providing employment practices and policies which recognise the diversity of our workforce and ensure equality for employees regardless of sex, race, disability, age, sexual orientation or religious belief. In the UK, Lloyds Banking Group belongs to the major employer groups campaigning for equality for the above groups of staff, including Employers' Forum on Disability, Employers' Forum on Age, Stonewall and the Race for Opportunity. Our involvement with these organisations enables us to identify and implement best practice for our staff.

Employees are kept closely involved in major changes affecting them through measures such as: team meetings, briefings, internal communications and opinion surveys. There are well established procedures, including regular meetings with recognised unions, to ensure that the views of employees are taken into account in reaching decisions.

Schemes offering share options or the acquisition of shares are available for most staff, to encourage their financial involvement in Lloyds Banking Group plc.

Lloyds Banking Group is committed to providing employees with comprehensive coverage of the economic and financial issues affecting the Group. We have established a full suite of communication channels, including an extensive face-to-face briefing programme which allows us to update our employees on our performance and any financial issues throughout the year.

### **Policy and practice on payment of creditors**

The Bank has signed up to the 'Prompt Payment Code' published by the Department for Business Innovation and Skills ('BIS'), regarding the making of payments to suppliers. Information about the 'Prompt Payment Code' may be obtained by visiting [www.promptpaymentcode.org.uk](http://www.promptpaymentcode.org.uk).

The Bank's policy is to agree terms of payment with suppliers and these normally provide for settlement within 30 days after the date of the invoice, except where other arrangements have been negotiated. It is the policy of the Bank to abide by the agreed terms of payment, provided the supplier performs according to the terms of the contract.

The number of days required to be shown in this report, to comply with the provisions of the Companies Act 2006, is 32. This bears the same proportion to the number of days in the year as the aggregate of the amounts owed to trade creditors at 31 December 2010 bears to the aggregate of the amounts invoiced by suppliers during the year.

### **Auditors and audit information**

Each person who is a director at the date of approval of this report confirms that, so far as the director is aware, there is no relevant audit information of which the Bank's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director to make himself or herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

A resolution will be proposed at the 2011 annual general meeting to reappoint PricewaterhouseCoopers LLP as auditors. The Bank's audit committee is satisfied that the external auditors remain independent and effective.

On behalf of the board

### **Harry F Baines**

Company Secretary

24 February 2011

Company Number 2065

## Directors

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Sir Winfried Bischoff *Chairman*

J E Daniels *Group Chief Executive* (to 28 February 2011)

A Horta-Osório *Group Chief Executive* (from 1 March 2011)

T J W Tookey *Group Finance Director*

A M Frew

Sir Julian Horn-Smith

A G Kane

Lord Leitch

G R Moreno

D L Roberts

T T Ryan, Jr

M A Scicluna

G T Tate

A Watson CBE

H A Weir CBE

## Principal risks and uncertainties

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At present the most significant risks faced by the Group are:

### **Credit**

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

*Features:* Arising in the retail, wholesale and wealth and international operations, reflecting the risks inherent in the Group's lending activities and to a much lesser extent in the insurance operations in respect of investment of own funds. Adverse changes in the credit quality of the Group's UK and/or international borrowers and counterparties, or in their behaviour, would be expected to reduce the value of the Group's assets and materially increase the Group's write-downs and allowances for impairment losses. Credit risk can be affected by a range of factors, including, inter alia, increased unemployment, reduced asset values, increased personal or corporate insolvency levels, reduced corporate profits, increased interest rates or higher tenant defaults. Over the last three years, the global banking crisis and economic downturn has driven cyclically high bad debt charges. These have arisen from the Group's lending to:

- Wholesale customers (including those in wealth and international operations): where companies continue to face difficult business conditions, resulting in elevated corporate default levels, illiquid commercial property markets and heightened impairment charges. The Group has high levels of exposure in both the UK and internationally, including Ireland, USA and Australia. There are particular concentrations to financial institutions and commercial real estate including secondary and tertiary locations.
- Retail customers: this portfolio will remain strongly linked to the economic environment, with inter alia house prices falls, unemployment increases, consumer over-indebtedness and rising interest rates all likely to impact both secured and unsecured retail exposures.

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

### **Legal and regulatory**

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

*Features:* Legal and regulatory exposure is driven by the significant volume of current legislation and regulation within the UK and overseas with which the Group has to comply, along with new or proposed legislation and regulation which needs to be reviewed, assessed and embedded into day-to-day operational and business practices across the Group as a whole. This is particularly the case in the current market environment, which is witnessing increased levels of government and regulatory intervention in the banking sector.

Lloyds Banking Group continues to face political and regulatory scrutiny as a result of the Group's perceived systemic importance following the acquisition of HBOS. At the time of the acquisition of HBOS plc by Lloyds Banking Group the Office of Fair Trading (OFT) identified some competition concerns in the UK personal current accounts and mortgages markets and for SME banking in Scotland. The OFT reiterated that it would keep these under review and consider whether to refer any banking markets to the Competition Commission if it identifies any prevention, restriction or distortion of competition.

The UK Government appointed an Independent Commission on Banking to review possible structural measures to reform the banking system and promote stability and competition. That commission will publish its final report by the end of September 2011. The Treasury Select Committee is conducting an examination of competition in retail banking. It is too early to quantify the potential impact of these developments on the Group.

From April 2011, lead regulation and supervision of the Group's activities will begin transitioning from the FSA to the new Financial Conduct Authority for conduct of business supervision and the Prudential Regulatory Authority for capital and liquidity supervision. In addition, from 2011, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority as new EU Supervisory Authorities are likely to have greater influence on regulatory approaches across the EU. These could lead to changes in how the Group is regulated and supervised on a day-to-day basis.

Evolving capital and liquidity requirements continue to be a priority for the Group. In September 2010 and further clarified in December 2010, the Basel Committee on Banking Supervision put forward proposals for a reform package which changes the



## Principal risks and uncertainties

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regulatory capital and liquidity standards, the definition of 'capital', introduces new definitions for the calculation of counterparty credit risk and leverage ratios, additional capital buffers and development of a global liquidity standard. Implementation of these changes is expected to be phased in between 2012 and 2018.

Lloyds Banking Group is currently assessing the impacts of these regulatory developments and will participate in the consultation and calibration processes to be undertaken by the various regulatory bodies during 2011. The Insurance division is progressing their plans to achieve Solvency II compliance. Lloyds Banking Group continues to work closely with the regulatory authorities and industry associations to ensure that it is able to identify and respond to proposed regulatory changes and mitigate against risks to the Group and its stakeholders.

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

### **Liquidity and funding**

*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.

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

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

Additionally, the Lloyds Banking Group has entered into a number of EU state aid related obligations to achieve reductions in certain parts of its balance sheet by the end of 2014. The requirement to meet this deadline may result in the Group having to provide funding to support these asset reductions and/or disposals and may also result in a lower price being achieved.

Liquidity and funding risks are managed within a board approved framework using a range of metrics to monitor the Group's profile against its stated appetite and potential market conditions.

### **Market Risk**

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

*Features:* 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.

The principal market risks are as follows:

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

The main equity market risks arise in the life assurance companies and staff pension schemes. Credit spread risk arises in the life assurance companies, pension schemes and banking businesses. Equity market movements and changes in credit spreads impact the Group's results.

## Principal risks and uncertainties

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Continuing concerns about the scale of deficits in Ireland and southern European countries resulted in increased credit spreads in the areas affected, and fears of contagion affected the Euro and widened spreads between central bank and interbank rates.

The Group's trading activity is small relative to its peers and is not considered to be a principal risk.

### Insurance Risk

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

*Features:* The major sources of insurance risk are within the insurance businesses and the staff 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 prime insurance risk carried by the Group's defined benefit pension schemes is related to longevity.

Insurance risks typically, and longevity in particular, may crystallise gradually over time. Actuarial assumption setting for financial reporting and liability management requires expert judgement as to when evidence of an emerging trend is sufficient to require an alteration to long-run assumptions.

### Customer treatment

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

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

The FSA continues to drive focus on conduct of business activities and has established a new approach to supervision of Conduct Risk, replacing the previous 'Treating Customers Fairly' initiative for retail customers. Under this new regime the FSA has indicated that it will seek to place greater emphasis on product governance and contract terms in general, and will seek to intervene much earlier in the product lifecycle to prevent customer detriment. The FSA also continues to carry out thematic reviews on a variety of issues across the industry as a whole, for example complaints handling. Lloyds Banking Group actively engages with the regulatory authorities and other stakeholders on these key customer treatment challenges, which includes for example, PPI (see note 53 of the financial statements).

The Group has policies, procedures and governance arrangements in place to facilitate the fair treatment of customers. Since the acquisition of HBOS, the Group has made significant progress in aligning its approach to Treating Customers Fairly across both heritages. In addition the Group has aligned its Treating Customers Fairly governance and management information arrangements, with customer impact being a key factor in assessing every integration proposition. The Group regularly reviews its product range to ensure that it meets regulatory requirements and is competitive in the market place.

### People

*Definition:* The risk of reductions in earnings and/or value, through financial or reputational loss, from inappropriate colleague actions and behaviour, industrial action, legal action in relation to people, or health and safety issues. Loss can also be incurred through failure to recruit, retain, train, reward and incentivise appropriately skilled staff to achieve business objectives and through failure to take appropriate action as a result of staff underperformance.

*Features:* The Group aims to attract, retain, and develop high calibre talent. Failure to do so presents a significant risk to delivering the Group's overall strategy and is affected by a range of factors including:

- Ongoing regulatory and public interest in remuneration practices
- Delivery of Lloyds Banking Group's integration commitments, and
- Uncertainty about EU state aid requirements and the Independent Commission on Banking's proposals for banking reform.

The Group's remuneration arrangements encourage compliant and appropriate behaviour from colleagues, in line with group policies, values and short and long term people risk priorities. The Group has continued to work closely with regulators to seek to

## Principal risks and uncertainties

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ensure compliance with our obligations. However, there is recognition that international consensus must be achieved to avoid UK institutions being significantly disadvantaged in attracting and retaining the highest calibre talent.

The Group continues to manage union relationships actively and the majority of colleagues are now on harmonised Terms and Conditions. There is strong ongoing commitment to support and retain colleagues throughout a period of significant integration and organisational change. Active monitoring of the Colleague Engagement Survey, allows the Group to understand engagement levels. These continue to increase and are now exceeding industry benchmarking for high performing organisations.

The Lloyds Banking Group is closely engaged with the UK Government and regulators on reform proposals, and with the EU on disposal arrangements, to influence and manage colleague uncertainty.

### **Integration**

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

*Features:* The integration of the two heritage organisations continues to be one of the largest integration challenges that has been seen in the UK financial services industry. While there continue to be delivery risks to the programme, not least the risk of new regulatory requirements which may have an effect on resourcing, the Group is now two years into the integration programme and has a fully developed and functioning governance framework to manage these risks. There is a clear understanding of the phased deliverables to ensure effective delivery through to 2012.

## **INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF LLOYDS TSB BANK PLC**

We have audited the Group and the Bank financial statements (the 'financial statements') of Lloyds TSB Bank plc for the year ended 31 December 2010 which comprise the Consolidated income statement, the Group and Bank statements of comprehensive income, the Group and Bank balance sheets, the Group and Bank statements of changes in equity, the Group and Bank cash flow statements and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the Bank financial statements, as applied in accordance with the provisions of the Companies Act 2006.

### **Respective responsibilities of directors and auditors**

As explained more fully in the Statement of directors' responsibilities on pages 3 and 4, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Bank's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

### **Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Bank's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

### **Opinion on financial statements**

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2010 and of the Group's loss and Group's and Bank's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Bank financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

### **Opinion on other matter prescribed by the Companies Act 2006**

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

## Independent auditors' report

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### **Matters on which we are required to report by exception**

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the Bank, or returns adequate for our audit have not been received from branches not visited by us; or
- the Bank financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of the directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Ian Rankin (Senior Statutory Auditor)  
for and on behalf of PricewaterhouseCoopers LLP  
Chartered Accountants and Statutory Auditors  
Edinburgh  
24 February 2011

- a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the Group directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.
- b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Consolidated income statement  
for the year ended 31 December 2010

	Note	2010 £ million	2009 £ million
Interest and similar income		29,682	11,575
Interest and similar expense		(16,996)	(6,276)
<b>Net interest income</b>	5	<b>12,686</b>	5,299
Fee and commission income		4,415	2,821
Fee and commission expense		(1,682)	(680)
Net fee and commission income	6	2,733	2,141
Net trading income	7	16,167	7,214
Insurance premium income	8	8,148	4,228
Other operating income	9	4,143	3,307
<b>Other income</b>		<b>31,191</b>	16,890
<b>Total income</b>		<b>43,877</b>	22,189
Insurance claims	10	(18,511)	(9,630)
<b>Total income, net of insurance claims</b>		<b>25,366</b>	12,559
Subvention payment		–	(3,000)
Government Asset Protection Scheme fee		–	(2,500)
Other operating expenses		(13,236)	(7,023)
Total operating expenses	11	(13,236)	(12,523)
<b>Trading surplus</b>		<b>12,130</b>	36
Impairment	12	(10,952)	(4,416)
Share of results of joint ventures and associates	13	(88)	2
Loss on disposal of businesses	14	(365)	–
<b>Profit (loss) before tax</b>		<b>725</b>	(4,378)
Taxation	15	(818)	1,605
<b>Loss for the year</b>		<b>(93)</b>	(2,773)
Profit attributable to non-controlling interests		62	24
Loss attributable to equity shareholders		(155)	(2,797)
<b>Loss for the year</b>		<b>(93)</b>	(2,773)

The accompanying notes are an integral part of the financial statements.

Statements of comprehensive income  
for the year ended 31 December 2010

	2010 £ million	2009 £ million
<b>The Group</b>		
<b>Loss for the year</b>	<b>(93)</b>	(2,773)
<b>Other comprehensive income</b>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	1,231	1,430
Income statement transfers in respect of disposals	(399)	(1)
Income statement transfers in respect of impairment	114	44
Other income statement transfers	(110)	(29)
Taxation	(343)	(228)
	<b>493</b>	1,216
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	(1,062)	(4)
Net income statement transfers	932	(17)
Taxation	35	6
	<b>(95)</b>	(15)
Currency translation differences:		
Currency translation differences, before tax	(137)	313
Taxation	-	(182)
	<b>(137)</b>	131
<b>Other comprehensive income for the year, net of tax</b>	<b>261</b>	1,332
<b>Total comprehensive income for the year</b>	<b>168</b>	(1,441)
Total comprehensive income attributable to non-controlling interests	57	5
Total comprehensive income attributable to equity shareholders	111	(1,446)
<b>Total comprehensive income for the year</b>	<b>168</b>	(1,441)
<b>The Bank</b>	2010 £ million	2009 £ million
<b>Loss for the year</b>	<b>(280)</b>	(1,909)
<b>Other comprehensive income:</b>		
Movements in revaluation reserve in respect of available-for-sale financial assets:		
Change in fair value	924	(41)
Income statement transfers in respect of disposals	6	(1)
Income statement transfers in respect of impairment	21	15
Other income statement transfers	(44)	(58)
Taxation	(249)	30
	<b>658</b>	(55)
Movements in cash flow hedging reserve:		
Effective portion of changes in fair value taken to other comprehensive income	(13)	(4)
Net income statement transfers	41	(17)
Taxation	(8)	6
	<b>20</b>	(15)
Currency translation differences:		
Currency translation differences, before tax	17	(11)
Taxation	-	-
	<b>17</b>	(11)
<b>Other comprehensive income for the year, net of tax</b>	<b>695</b>	(81)
<b>Total comprehensive income for the year</b>	<b>415</b>	(1,990)

Lloyds TSB Bank plc  
**Balance sheets**  
at 31 December 2010

	Note	The Group		The Bank	
		2010 £ million	2009 £ million	2010 £ million	2009 £ million
<b>Assets</b>					
Cash and balances at central banks		<b>38,115</b>	36,089	<b>35,585</b>	35,964
Items in the course of collection from banks		<b>1,368</b>	1,045	<b>997</b>	1,004
Trading and other financial assets at fair value through profit or loss	16	<b>156,276</b>	48,894	<b>4,587</b>	2,633
Derivative financial instruments	17	<b>49,600</b>	18,797	<b>21,322</b>	17,937
Loans and receivables:					
Loans and advances to banks	18	<b>30,272</b>	175,554	<b>152,596</b>	176,556
Loans and advances to customers	19	<b>611,089</b>	245,226	<b>251,173</b>	253,111
Debt securities	22	<b>25,735</b>	2,636	<b>1,479</b>	2,830
		<b>667,096</b>	423,416	<b>405,248</b>	432,497
Available-for-sale financial assets	24	<b>42,955</b>	26,089	<b>24,951</b>	13,514
Held-to-maturity investments	25	<b>7,905</b>	–	<b>7,905</b>	–
Investment properties	26	<b>5,997</b>	2,340	–	–
Investments in joint ventures and associates	13	<b>429</b>	56	<b>6</b>	61
Goodwill	27	<b>2,016</b>	2,016	–	–
Value of in-force business	28	<b>7,367</b>	2,403	–	–
Other intangible assets	29	<b>3,496</b>	205	<b>118</b>	111
Tangible fixed assets	30	<b>8,190</b>	4,125	<b>1,531</b>	1,374
Current tax recoverable		<b>550</b>	85	<b>828</b>	886
Deferred tax assets	43	<b>4,204</b>	2,438	<b>2,796</b>	2,672
Investment in subsidiary undertakings	31	–	–	<b>40,155</b>	15,960
Retirement benefit assets	42	<b>736</b>	–	<b>530</b>	–
Other assets	32	<b>12,432</b>	4,982	<b>1,243</b>	816
		<b><u>1,008,732</u></b>	<u>572,980</u>	<b><u>547,802</u></b>	<u>525,429</u>

The accompanying notes are an integral part of the financial statements.

The directors approved the financial statements on 24 February 2011.

**Sir Winfried Bischoff**  
Chairman

**J Eric Daniels**  
Chief Executive

**Tim J W Tookey**  
Finance Director



Lloyds TSB Bank plc  
**Balance sheets**  
at 31 December 2010

	Note	The Group		The Bank	
		2010 £ million	2009 <sup>1</sup> £ million	2010 £ million	2009 <sup>1</sup> £ million
<b>Equity and liabilities</b>					
<b>Liabilities</b>					
Deposits from banks	33	<b>50,363</b>	139,557	<b>118,337</b>	160,428
Customer deposits	34	<b>416,276</b>	193,045	<b>223,812</b>	201,053
Items in course of transmission to banks		<b>802</b>	542	<b>506</b>	492
Trading and other financial liabilities at fair value through profit or loss	35	<b>26,762</b>	6,362	<b>11,268</b>	6,362
Derivative financial instruments	17	<b>42,645</b>	16,733	<b>20,260</b>	16,829
Notes in circulation		<b>1,074</b>	–	–	–
Debt securities in issue	36	<b>228,317</b>	120,719	<b>115,122</b>	109,870
Liabilities arising from insurance contracts and participating investment contracts	37	<b>80,749</b>	36,960	–	–
Liabilities arising from non-participating investment contracts	39	<b>51,363</b>	15,734	–	–
Unallocated surplus within insurance businesses	40	<b>643</b>	310	–	–
Other liabilities	41	<b>30,046</b>	12,263	<b>3,800</b>	3,437
Retirement benefit obligations	42	<b>423</b>	474	<b>292</b>	131
Current tax liabilities		<b>149</b>	22	<b>19</b>	15
Deferred tax liabilities	43	<b>247</b>	–	–	–
Other provisions	44	<b>1,532</b>	547	<b>569</b>	533
Subordinated liabilities	45	<b>29,609</b>	15,999	<b>15,574</b>	15,456
<b>Total liabilities</b>		<b>961,000</b>	559,267	<b>509,559</b>	514,606
<b>Equity</b>					
Share capital	46	<b>1,574</b>	1,547	<b>1,574</b>	1,547
Share premium account	47	<b>35,533</b>	8,555	<b>35,533</b>	8,555
Other reserves	48	<b>5,272</b>	(1,342)	<b>365</b>	(330)
Retained profits	49	<b>4,512</b>	4,660	<b>771</b>	1,051
<b>Shareholders' equity</b>		<b>46,891</b>	13,420	<b>38,243</b>	10,823
Non-controlling interests		<b>841</b>	293	–	–
<b>Total equity</b>		<b>47,732</b>	13,713	<b>38,243</b>	10,823
<b>Total equity and liabilities</b>		<b>1,008,732</b>	572,980	<b>547,802</b>	525,429

<sup>1</sup>Restated – see note 1.

The accompanying notes are an integral part of the financial statements.

## Statements of changes in equity

	Attributable to equity shareholders					Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Non- controlling interests £ million	
<b>The Group</b>						
Balance at 1 January 2009:						
As previously stated	4,502	(2,824)	7,588	9,266	306	9,572
Prior year adjustment <sup>1</sup>	–	131	(131)	–	–	–
Restated	4,502	(2,693)	7,457	9,266	306	9,572
<b>Comprehensive income</b>						
(Loss) profit for the year	–	–	(2,797)	(2,797)	24	(2,773)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,235	–	1,235	(19)	1,216
Movements in cash flow hedging reserve, net of tax	–	(15)	–	(15)	–	(15)
Currency translation differences, net of tax	–	131	–	131	–	131
Total other comprehensive income	–	1,351	–	1,351	(19)	1,332
Total comprehensive income	–	1,351	(2,797)	(1,446)	5	(1,441)
<b>Transactions with owners</b>						
Dividends	–	–	–	–	(18)	(18)
Capital injection	5,600	–	–	5,600	–	5,600
Total transactions with owners	5,600	–	–	5,600	(18)	5,582
Balance at 31 December 2009 <sup>1</sup>	10,102	(1,342)	4,660	13,420	293	13,713
<b>Comprehensive income</b>						
(Loss) profit for the year	–	–	(155)	(155)	62	(93)
<i>Other comprehensive income</i>						
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	498	–	498	(5)	493
Movements in cash flow hedging reserve, net of tax	–	(95)	–	(95)	–	(95)
Currency translation differences, net of tax	–	(137)	–	(137)	–	(137)
Total other comprehensive income	–	266	–	266	(5)	261
<b>Total comprehensive income</b>	–	266	(155)	111	57	168
<b>Transactions with owners</b>						
Dividends	–	–	–	–	(47)	(47)
Issue of ordinary shares:						
On transfer of HBOS	21,394	–	–	21,394	–	21,394
Other	5,611	–	–	5,611	–	5,611
Reserve arising on transfer of HBOS	–	6,348	–	6,348	–	6,348
Employee share option schemes – value of employees services	–	–	7	7	–	7
Adjustment on acquisition	–	–	–	–	1,271	1,271
Extinguishment of non-controlling interests	–	–	–	–	(735)	(735)
Change in non-controlling interests	–	–	–	–	2	2
<b>Total transactions with owners</b>	<b>27,005</b>	<b>6,348</b>	<b>7</b>	<b>33,360</b>	<b>491</b>	<b>33,851</b>
<b>Balance at 31 December 2010</b>	<b>37,107</b>	<b>5,272</b>	<b>4,512</b>	<b>46,891</b>	<b>841</b>	<b>47,732</b>

<sup>1</sup>Restated – see note 1.

## Statements of changes in equity

	Attributable to equity shareholders			Total £ million
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	
<b>The Bank</b>				
Balance at 1 January 2009	4,502	(249)	2,960	7,213
<b>Comprehensive income</b>				
Loss for the year	–	–	(1,909)	(1,909)
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(55)	–	(55)
Movements in cash flow hedging reserve, net of tax	–	(15)	–	(15)
Currency translation differences, net of tax	–	(11)	–	(11)
Total other comprehensive income	–	(81)	–	(81)
Total comprehensive income	–	(81)	(1,909)	(1,990)
<b>Transactions with owners – capital injection</b>	5,600	–	–	5,600
Balance at 31 December 2009 <sup>1</sup>	10,102	(330)	1,051	10,823
<b>Comprehensive income</b>				
Loss for the year	–	–	(280)	(280)
<i>Other comprehensive income</i>				
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	658	–	658
Movements in cash flow hedging reserve, net of tax	–	20	–	20
Currency translation differences, net of tax	–	17	–	17
Total other comprehensive income	–	695	–	695
<b>Total comprehensive income</b>	–	695	(280)	415
<b>Transactions with owners</b>				
Issue of ordinary shares:				
On transfer of HBOS	21,394	–	–	21,394
Other	5,611	–	–	5,611
<b>Total transactions with owners</b>	27,005	–	–	27,005
<b>Balance at 31 December 2010</b>	<b>37,107</b>	<b>365</b>	<b>771</b>	<b>38,243</b>

<sup>1</sup>Restated – see note 1.

## Cash flow statements

for the year ended 31 December 2010

	Note	The Group		The Bank	
		2010 £ million	2009 £ million	2010 £ million	2009 £ million
<b>Profit (loss) before tax</b>		<b>725</b>	(4,378)	<b>(566)</b>	(3,570)
Adjustments for:					
Change in operating assets	57a	<b>31,872</b>	(142,905)	<b>21,003</b>	(143,910)
Change in operating liabilities	57b	<b>(45,561)</b>	132,435	<b>(6,604)</b>	136,658
Non-cash and other items	57c	<b>10,498</b>	4,683	<b>929</b>	(447)
Tax received (paid)		<b>209</b>	83	<b>(32)</b>	16
<b>Net cash (used in) provided by operating activities</b>		<b>(2,257)</b>	(10,082)	<b>14,730</b>	(11,253)
<b>Cash flows from investing activities</b>					
Purchase of available-for-sale financial assets		<b>(42,662)</b>	(445,140)	<b>(28,411)</b>	(420,748)
Proceeds from sale and maturity of available-for-sale financial assets		<b>45,999</b>	474,173	<b>14,831</b>	446,249
Purchase of held-to-maturity investments		<b>(4,228)</b>	–	<b>(4,228)</b>	–
Purchase of fixed assets		<b>(3,205)</b>	(1,310)	<b>(575)</b>	(435)
Proceeds from sale of fixed assets		<b>1,353</b>	491	<b>7</b>	19
Additional capital injections to subsidiaries		–	–	<b>(219)</b>	(1)
Acquisition of businesses, net of cash acquired	57f	<b>9,011</b>	(35)	–	–
Disposal of businesses, net of cash disposed	57g	<b>428</b>	–	<b>18</b>	33
<b>Net cash provided by (used in) investing activities</b>		<b>6,696</b>	28,179	<b>(18,577)</b>	25,117
<b>Cash flows from financing activities</b>					
Dividends paid to non-controlling interests	57e	<b>(47)</b>	(18)	–	–
Interest paid on subordinated liabilities		<b>(1,732)</b>	(968)	<b>(872)</b>	(939)
Proceeds from issue of subordinated liabilities	57e	<b>3,237</b>	3,187	<b>3,237</b>	3,187
Proceeds from issue of ordinary shares		–	5,600	–	5,600
Repayment of subordinated liabilities	57e	<b>(684)</b>	(1,842)	<b>(353)</b>	(1,842)
Change in non-controlling shareholders	57e	<b>2</b>	–	–	–
<b>Net cash provided by financing activities</b>		<b>776</b>	5,959	<b>2,012</b>	6,006
Effect of exchange rate changes on cash and cash equivalents		<b>479</b>	(210)	<b>17</b>	(87)
Change in cash and cash equivalents		<b>5,694</b>	23,846	<b>(1,818)</b>	19,783
Cash and cash equivalents at beginning of year		<b>56,606</b>	32,760	<b>42,207</b>	22,424
<b>Cash and cash equivalents at end of year</b>	57d	<b>62,300</b>	56,606	<b>40,389</b>	42,207

The accompanying notes are an integral part of the financial statements.

## 1 Basis of preparation

The financial statements of Lloyds TSB Bank plc have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union (EU) as applied in accordance with the provisions of the Companies Act 2006. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Group has not taken advantage of this relaxation, and therefore there is no difference in application to the Group between IFRS as adopted by the EU and IFRS as issued by the IASB. The financial information has been prepared under the historical cost convention, as modified by the revaluation of investment properties, available-for-sale financial assets, trading securities and certain other financial assets and liabilities at fair value through profit or loss and all derivative contracts.

The going concern of the Bank and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Bank and the Group have adequate resources to continue to operate for the foreseeable future, the directors have considered a number of key dependencies which are set out in the Principal risks and uncertainties section under Liquidity and funding on page 7 and additionally have considered projections for the Group's capital and funding position. Taking all of these factors into account, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the accounts.

As explained in note 31, Lloyds Banking Group plc transferred its investment in HBOS plc to Lloyds TSB Bank plc on 1 January 2010. In accordance with the accounting treatment available under IFRS 3 (Revised) for business combinations involving entities under common control, Lloyds TSB Bank plc was not required to fair value the acquired business at the date of transfer. Instead, the assets and liabilities were incorporated at the amounts at which they were recorded within Lloyds Banking Group at that date. The difference between the consolidated net asset value of HBOS plc at the date of transfer and the consideration paid, which was equal to Lloyds Banking Group plc's original cost of investment, has been credited to a merger reserve. Lloyds TSB Bank plc has not taken advantage of the option available under IFRS 3 (Revised) to treat HBOS plc as if it had been owned throughout the prior year and, accordingly, no comparatives have been restated as a result of the transfer.

During 2010, the International Financial Reporting Interpretations Committee clarified the treatment of amounts previously recognised in equity in respect of assets that were transferred from the available-for-sale category to the loans and receivables category. When an impairment loss is recognised in respect of such transferred financial assets, the unamortised balance of any available-for-sale revaluation reserve that remains in equity should be transferred to the income statement and recorded as part of the impairment loss. The Group has changed its accounting policy to reflect this clarification. Under the Group's previous accounting policy, when such a transferred financial asset became impaired, not all of the unamortised amounts previously transferred to equity were recycled to the income statement and therefore continued to be accreted over the expected remaining life of the financial asset. This change is applied retrospectively and the effect has been to reduce retained profits and increase available-for-sale revaluation reserves by £131 million at 1 January 2009; shareholders' equity is unchanged. There was no material effect on the Group's income statement during 2009.

Also during 2010, the Group has classified assets as held-to-maturity for the first time. Purchases of government debt securities of £4,228 million made in the second half of 2010 were classified as held-to-maturity on acquisition, were initially recognised at fair value including direct and incremental transaction costs and are being measured subsequently at amortised cost, using the effective interest method. Further, on 1 November 2010, government debt securities with a carrying value of £3,601 million, previously classified as available-for-sale, were reclassified to held-to-maturity. Unrealised gains on the transferred securities of £223 million previously taken to equity continue to be held in the available-for-sale revaluation reserve and will be amortised to the income statement over the remaining lives of the securities using the effective interest method or until the assets become impaired.

The Group has adopted the following new standards and amendments to standards which became effective for financial years beginning on or after 1 January 2010. None of these standards or amendments have had a material impact on these financial statements.

- (i) IFRS 3 *Business Combinations*. This revised standard applies prospectively to business combinations from 1 January 2010. The revised standard continues to require the use of the acquisition method of accounting for business combinations. All payments to purchase a business are to be recorded at fair value at the acquisition date, some contingent payments are subsequently remeasured at fair value through income, goodwill may be calculated based on the parent's share of net assets or it may include goodwill related to the non-controlling interest, and all transaction costs are expensed (other than those in relation to the issuance of debt instruments or share capital).
- (ii) IAS 27 *Consolidated and Separate Financial Statements*. Requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control; any remaining interest in an investee is remeasured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.
- (iii) IFRIC 17 *Distributions of Non-cash Assets to Owners*. Provides accounting guidance for non-reciprocal distributions of non-cash assets to owners (and those in which owners may elect to receive a cash alternative).
- (iv) Amendment to IAS 39 *Financial Instruments: Recognition and Measurement* – 'Eligible Hedged Items'. Clarifies how the principles underlying hedge accounting should be applied in particular situations.
- (v) *Improvements to IFRSs* (issued April 2009). Sets out minor amendments to IFRS standards as part of the annual improvements process.

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2010 and which have not been applied in preparing these financial statements are given in note 58.

## 2 Accounting policies

The accounting policies are set out below.

### a Consolidation

The assets, liabilities and results of Group undertakings (including special purpose entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures.

#### (1) Subsidiaries

Subsidiaries include entities over which the Group has the power to govern the financial and operating policies which generally accompanies a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases. Details of the principal subsidiaries are given in note 31.

Investment vehicles, such as Open Ended Investment Companies (OEICs), where the Group has control, typically through acting as fund manager and the life funds having a beneficial interest greater than 50 per cent, are consolidated. The non-controlling unitholders' interest is reported in other liabilities.

Special purpose entities (SPEs) are consolidated if, in substance, the Group controls the entity. A key indicator of such control, amongst others, is where the Group is exposed to the risks and benefits of the SPE.

The treatment of transactions with non-controlling interests depends on whether, as a result of the transaction, the Group loses control of the subsidiary. Change in the parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions; any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent entity. Where the group loses control of the subsidiary, at the date when control is lost the amount of any non-controlling interest in that former subsidiary is derecognised and any investment retained in the former subsidiary is remeasured to its fair value; the gain or loss that is recognised in profit or loss on the partial disposal of the subsidiary includes the gain or loss on the remeasurement of the retained interest.

Intercompany transactions, balances and unrealised gains and losses on transactions between Group companies are eliminated.

The acquisition method of accounting is used to account for business combinations by the Group. The consideration for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed as incurred except those relating to the issuance of debt instruments (see 2e(5)) or share capital (see 2r(1)). Identifiable assets acquired and liabilities assumed in a business combination are measured initially at their fair value at the acquisition date.

#### (2) Joint ventures and associates

Joint ventures are entities over which the Group has joint control under a contractual arrangement with other parties. Associates are entities over which the Group has significant influence, but not control or joint control, over the financial and operating policies. Significant influence is the power to participate in the financial and operating policy decisions of the entity and is normally achieved through holding between 20 per cent and 50 per cent of the voting share capital of the entity.

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting and are initially recorded at cost and adjusted each year to reflect the Group's share of the post-acquisition results of the joint venture or associate based on audited accounts which are coterminous with the Group or made up to a date which is not more than three months before the Group's reporting date. The share of any losses is restricted to a level that reflects an obligation to fund such losses.

### b Goodwill

Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates; goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities acquired. Where the fair value of the Group's share of the identifiable assets, liabilities and contingent liabilities of the acquired entity is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. Goodwill arising on acquisitions of associates and joint ventures is included in the Group's investment in joint ventures and associates. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal except where it has been written off directly to reserves in the past.

### c Other intangible assets

Other intangible assets include brands, core deposit intangibles, purchased credit card relationships, customer-related intangibles and capitalised software enhancements. Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows:

Capitalised software enhancements	up to 5 years
Brands (which have been assessed as having finite lives)	10-15 years
Customer-related intangibles	up to 10 years
Core deposit intangibles	up to 8 years
Purchased credit card relationships	5 years

Intangible assets with finite useful lives are reviewed at each reporting date to assess whether there is any indication that they are impaired. If any such indication exists the recoverable amount of the asset is determined and in the event that the asset's carrying amount is greater than its recoverable amount, it is written down immediately. Certain brands have been determined to have an indefinite useful life and are not amortised. Such intangible assets are reassessed annually to reconfirm that an indefinite useful life remains appropriate. In the event that an indefinite life is inappropriate a finite life is determined and an impairment review is performed on the asset.

## 2 Accounting policies (continued)

### d Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

The effective interest rate is calculated on initial recognition of the financial asset or liability by estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts expected to be paid or received by the Group including expected early redemption fees and related penalties and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account in the calculation. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss (see h below).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility. Loan syndication fees are recognised as revenue when the syndication has been completed and the Group retains no part of the loan package for itself or retains a part at the same effective interest rate for all interest-bearing financial instruments, including loans and advances, as for the other participants.

Dividend income is recognised when the right to receive payment is established.

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see o below).

### e Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. Purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

#### (1) Financial instruments at fair value through profit or loss

Financial instruments are classified at fair value through profit or loss where they are trading securities or where they are designated at fair value through profit or loss by management. Derivatives are carried at fair value (see f below).

Trading securities are debt securities and equity shares acquired principally for the purpose of selling in the short term or which are part of a portfolio which is managed for short-term gains. Such securities are classified as trading securities and recognised in the balance sheet at their fair value. Gains and losses arising from changes in their fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur.

Other financial assets and liabilities at fair value through profit or loss are designated as such by management upon initial recognition. Such assets and liabilities are carried in the balance sheet at their fair value and gains and losses arising from changes in fair value together with interest coupons and dividend income are recognised in the income statement within net trading income in the period in which they occur. Financial assets and liabilities are designated at fair value through profit or loss on acquisition in the following circumstances:

- it eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets and liabilities or recognising gains or losses on different bases. The main type of financial assets designated by the Group at fair value through profit or loss are assets backing insurance contracts and investment contracts issued by the Group's life insurance businesses. Fair value designation allows changes in the fair value of these assets to be recorded in the income statement along with the changes in the value of the associated liabilities, thereby significantly reducing the measurement inconsistency had the assets been classified as available-for-sale financial assets.
- the assets and liabilities are part of a group which is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, with management information also prepared on this basis. As noted in a(2) above, certain of the Group's investments are managed as venture capital investments and evaluated on the basis of their fair value and these assets are designated at fair value through profit or loss.
- where the assets and liabilities contain one or more embedded derivatives that significantly modify the cash flows arising under the contract and would otherwise need to be separately accounted for.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 54(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

The Group is permitted to reclassify, at fair value at the date of transfer, non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the trading category if they are no longer held for the purpose of being sold or repurchased in the near term, as follows:

- if the financial assets would have met the definition of loans and receivables (but for the fact that they had to be classified as held for trading at initial recognition), they may be reclassified into loans and receivables where the Group has the intention and ability to hold the assets for the foreseeable future or until maturity;
- if the financial assets would not have met the definition of loans and receivables, they may be reclassified out of the held for trading category into available-for-sale financial assets in 'rare circumstances'.

## 2 Accounting policies (continued)

### (2) Available-for-sale financial assets

Debt securities and equity shares that are not classified as trading securities, at fair value through profit or loss, held-to-maturity investments or as loans and receivables are classified as available-for-sale financial assets and are recognised in the balance sheet at their fair value, inclusive of transaction costs. Available-for-sale financial assets are those intended to be held for an indeterminate period of time and may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available-for-sale are recognised directly in other comprehensive income, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in the income statement. Interest calculated using the effective interest method and foreign exchange gains and losses on debt securities denominated in foreign currencies are recognised in the income statement.

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would have met the definition of loans and receivables at the time of reclassification (if the financial asset had not been designated as available-for-sale) and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity.

Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

When an impairment loss is recognised in respect of available-for-sale assets transferred, the unamortised balance of any available-for-sale reserve that remains in equity is transferred to the income statement and recorded as part of the impairment loss.

### (3) Loans and receivables

Loans and receivables include loans and advances to banks and customers and eligible assets including those transferred into this category out of the fair value through profit or loss or available-for-sale financial assets categories. Loans and receivables are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs or, for eligible assets transferred into this category, their fair value at the date of transfer. Financial assets classified as loans and receivables are accounted for at amortised cost using the effective interest method (see d above) less provision for impairment (see h below).

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. These loans and advances to customers continue to be recognised by the Group, together with a corresponding liability for the funding.

### (4) Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity other than:

- (a) those that the Group designates upon initial recognition as at fair value through profit or loss;
- (b) those that the Group designates as available-for-sale; and
- (c) those that meet the definition of loans and receivables.

These are initially recognised at fair value including direct and incremental transaction costs and measured subsequently at amortised cost, using the effective interest method, less any provision for impairment.

### (5) Borrowings

Borrowings (which include deposits from banks, customer deposits, debt securities in issue and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. These instruments are subsequently stated at amortised cost using the effective interest method.

Preference shares and other instruments which carry a mandatory coupon or are redeemable on a specific date are classified as financial liabilities. The coupon on these instruments is recognised in the income statement as interest expense.

An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

When a financial liability is exchanged for an equity instrument, the new equity instrument is recognised at fair value and any difference between the original carrying value of the liability and the fair value of the new equity is recognised in the profit or loss together with any related costs or fees incurred.

### (6) Sale and repurchase agreements

Securities sold subject to repurchase agreements (repos) continue to be recognised on the balance sheet where substantially all of the risks and rewards are retained. Funds received under these arrangements are included in deposits from banks, customer deposits, or trading liabilities. Conversely, securities purchased under agreements to resell (reverse repos), where the Group does not acquire substantially all of the risks and rewards of ownership, are recorded as loans and receivables or trading securities. The difference between sale and repurchase price is treated as interest and accrued over the life of the agreements using the effective interest method.

Securities lent to counterparties are retained in the financial statements. Securities borrowed are not recognised in the financial statements, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability.



## 2 Accounting policies (continued)

### *(7) Derecognition of financial assets and liabilities*

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either:

- substantially all of the risks and rewards of ownership have been transferred; or
- the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

Financial liabilities are derecognised when they are extinguished (ie when the obligation is discharged), cancelled or expire.

### **f Derivative financial instruments and hedge accounting**

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow and option pricing models, as appropriate. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 3 (Critical accounting estimates and judgements: Fair value of financial instruments) and note 53(3) (Financial instruments: Fair values of financial assets and liabilities) for details of valuation techniques and significant inputs to valuation models.

Changes in the fair value of any derivative instrument that is not part of a hedging relationship are recognised immediately in the income statement.

Derivatives embedded in financial instruments and insurance contracts (unless the embedded derivative is itself an insurance contract) are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement. In accordance with IFRS 4 Insurance Contracts, a policyholder's option to surrender an insurance contract for a fixed amount is not treated as an embedded derivative.

The method of recognising the movements in the fair value of derivatives depends on whether they are designated as hedging instruments and, if so, the nature of the item being hedged. Hedge accounting allows one financial instrument, generally a derivative such as a swap, to be designated as a hedge of another financial instrument such as a loan or deposit or a portfolio of the same. At the inception of the hedge relationship, formal documentation is drawn up specifying the hedging strategy, the hedged item and the hedging instrument and the methodology that will be used to measure the effectiveness of the hedge relationship in offsetting changes in the fair value or cash flow of the hedged risk. The effectiveness of the hedging relationship is tested both at inception and throughout its life and if at any point it is concluded that it is no longer highly effective in achieving its documented objective, hedge accounting is discontinued.

The Group designates certain derivatives as either: (1) hedges of the fair value of the particular risks inherent in recognised assets or liabilities (fair value hedges); (2) hedges of highly probable future cash flows attributable to recognised assets or liabilities (cash flow hedges); or (3) hedges of net investments in foreign operations (net investment hedges). These are accounted for as follows:

#### *(1) Fair value hedges*

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk; this also applies if the hedged asset is classified as an available-for-sale financial asset. If the hedge no longer meets the criteria for hedge accounting, changes in the fair value of the hedged item attributable to the hedged risk are no longer recognised in the income statement. The cumulative adjustment that has been made to the carrying amount of the hedged item is amortised to the income statement using the effective interest method over the period to maturity.

#### *(2) Cash flow hedges*

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the cash flow hedge reserve. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts accumulated in equity are reclassified to the income statement in the periods in which the hedged item affects profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised in the income statement when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

#### *(3) Net investment hedges*

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in other comprehensive income, the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of. The hedging instruments used in net investment hedges may include non-derivative liabilities as well as derivative financial instruments.

### **g Offset**

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously. In certain situations, even though master netting agreements exist, the lack of management intention to settle on a net basis results in the financial assets and liabilities being reported gross on the balance sheet.

### **h Impairment of financial assets**

#### *(1) Assets accounted for at amortised cost*

At each balance sheet date the Group assesses whether, as a result of one or more events occurring after initial recognition of the financial asset and prior to the balance sheet date, there is objective evidence that a financial asset or group of financial assets has become impaired.

Where such an event has had an impact on the estimated future cash flows of the financial asset or group of financial assets, an impairment allowance is recognised. The amount of impairment allowance is the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If the asset has a variable rate of interest, the discount rate used for measuring the impairment allowance is the current effective interest rate.

Subsequent to the recognition of an impairment loss on a financial asset or a group of financial assets, interest income continues to be recognised on an effective interest rate basis, on the asset's carrying value net of impairment provisions. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

## 2 Accounting policies (continued)

Impairment allowances are assessed individually for financial assets that are individually significant. Such individual assessment is used primarily for the Group's wholesale lending portfolios in the Wholesale and Wealth and International divisions. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances in the Group's retail portfolios in both the Retail and Wealth and International divisions that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

### *Individual assessment*

In respect of individually significant financial assets in the Group's wholesale lending portfolios, assets are reviewed on a regular basis and those showing potential or actual vulnerability are placed on a watch list where greater monitoring is undertaken and any adverse or potentially adverse impact on ability to repay is used in assessing whether an asset should be transferred to a dedicated Business Support Unit. Specific examples of trigger events that would lead to the initial recognition of impairment allowances against lending to corporate borrowers (or the recognition of additional impairment allowances) include (i) trading losses, loss of business or major customer of a borrower, (ii) material breaches of the terms and conditions of a loan facility, including non-payment of interest or principal, or a fall in the value of security such that it is no longer considered adequate, (iii) disappearance of an active market because of financial difficulties, or (iv) restructuring a facility with preferential terms to aid recovery of the lending (such as a debt for equity swap).

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable.

For impaired debt instruments which are held at amortised cost, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows. A reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment.

### *Collective assessment*

In respect of portfolios of smaller balance, homogenous loans, or otherwise where there is no objective evidence of individual impairment, the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors, such as the type of asset, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Generally, the impairment trigger used within the impairment calculation for a loan, or group of loans, is when they reach a pre-defined level of delinquency or where the customer is bankrupt. Loans where the Group provides arrangements that forgive a portion of interest or principal are also deemed to be impaired and loans that are originated to refinance currently impaired assets are also defined as impaired.

In respect of the Group's secured mortgage portfolios, the impairment allowance is calculated based on a definition of impaired loans which are those six months or more in arrears (or where the borrower is bankrupt or is in possession). The estimated cash flows are calculated based on historical experience and are dependent on estimates of the expected value of collateral which takes into account expected future movements in house prices, less costs to sell.

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics noted above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience.

The collective provision also includes provision for inherent losses, that is loan losses that have been incurred but have not been identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. An assessment is made, based on statistical techniques, of the likelihood of each account becoming recognised as impaired within an emergence period, with the economic loss that each portfolio is likely to generate were it to become impaired. The emergence period is the time between the loss event and the date the impairment is recognised. The emergence period is determined by local management for each portfolio. In general the periods used across the Group vary between one month and twelve months based on historical experience.

### *Loan renegotiations and forbearance*

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. There are a number of different types of loan renegotiation, including the capitalisation of arrears, payment holidays, interest rate adjustments and extensions of the due date of payment. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, this results in the asset continuing to be reported as past due and it is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. In other cases, renegotiation may lead to a new agreement, which is treated as a new loan.

### *Write offs*

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

### *Debt for equity exchanges*

Equity securities acquired in exchange for loans in order to achieve an orderly realisation are accounted for as a disposal of the loan and an acquisition of equity securities. Where control is obtained over an entity as a result of the transaction, the entity is consolidated; where the Group has significant influence over an entity as a result of the transaction, the investment is accounted for by the equity method of accounting (see (A) above). Any subsequent impairment of the assets or business acquired is treated as an impairment of the relevant asset or business and not as an impairment of the original instrument.

## 2 Accounting policies (continued)

### (2) Available-for-sale financial assets

The Group assesses, at each balance sheet date, whether there is objective evidence that an available-for-sale financial asset is impaired. In addition to the criteria for financial assets accounted for at amortised cost set out above, this assessment involves reviewing the current financial circumstances (including creditworthiness) and future prospects of the issuer assessing the future cash flows expected to be realised and, in the case of equity shares, considering whether there has been a significant or prolonged decline in the fair value of the asset below its cost. If an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is reclassified from equity to the income statement. For impaired debt instruments, impairment losses are recognised in subsequent periods when it is determined that there has been a further negative impact on expected future cash flows; a reduction in fair value caused by general widening of credit spreads would not, of itself, result in additional impairment. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, an amount not greater than the original impairment loss is credited to the income statement; any excess is taken to other comprehensive income. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

### i Investment property

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital appreciation or both. The Group's investment property primarily relates to property held for long-term rental yields and capital appreciation within the life insurance funds. Investment property is carried in the balance sheet at fair value, being the open market value as determined in accordance with the guidance published by the Royal Institution of Chartered Surveyors. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices. These valuations are reviewed at least annually by an independent valuation expert. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be measured at fair value. Changes in fair value are recognised in the income statement as net trading income.

### j Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Premises (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years and the remaining period of the lease
- Leasehold improvements: shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease

Equipment:

- Fixtures and furnishings: 10-20 years
- Other equipment and motor vehicles: 2-8 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

### k Leases

#### (1) As lessee

The leases entered into by the Group are primarily operating leases. Operating lease rentals payable are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

#### (2) As lessor

Assets leased to customers are classified as finance leases if the lease agreements transfer substantially all the risks and rewards of ownership to the lessee but not necessarily legal title. All other leases are classified as operating leases. When assets are subject to finance leases, the present value of the lease payments, together with any unguaranteed residual value, is recognised as a receivable, net of provisions, within loans and advances to banks and customers. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance lease income. Finance lease income is recognised in interest income over the term of the lease using the net investment method (before tax) so as to give a constant rate of return on the net investment in the leases. Unguaranteed residual values are reviewed regularly to identify any impairment.

Operating lease assets are included within tangible fixed assets at cost and depreciated over their estimated useful lives, which equates to the lives of the leases, after taking into account anticipated residual values. Operating lease rental income is recognised on a straight-line basis over the life of the lease.

The Group evaluates non-lease arrangements such as outsourcing and similar contracts to determine if they contain a lease which is then accounted for separately.

### l Pensions and other post-retirement benefits

The Group operates a number of post-retirement benefit schemes for its employees including both defined benefit and defined contribution pension plans. A defined benefit scheme is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, dependent on one or more factors such as age, years of service and salary. A defined contribution plan is a pension plan into which the Group pays fixed contributions; there is no legal or constructive obligation to pay further contributions.

Full actuarial valuations of the Group's principal defined benefit schemes are carried out every three years with interim reviews in the intervening years; these valuations are updated to 31 December each year by qualified independent actuaries, or in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows. For the purposes of these annual updates scheme assets are included at their fair value and scheme liabilities are

## 2 Accounting policies (continued)

measured on an actuarial basis using the projected unit credit method adjusted for unrecognised actuarial gains and losses. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

The Group's income statement charge includes the current service cost of providing pension benefits, the expected return on the schemes' assets, net of expected administration costs, and the interest cost on the schemes' liabilities. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are not recognised unless the cumulative unrecognised gain or loss at the end of the previous reporting period exceeds the greater of 10 per cent of the scheme assets or liabilities ('the corridor approach'). In these circumstances the excess is charged or credited to the income statement over the employees' expected average remaining working lives. Past service costs are charged immediately to the income statement, unless the charges are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date adjusted for any cumulative unrecognised actuarial gains or losses. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes.

The Group recognises the effect of material changes to the terms of its defined benefit pension plans which reduce future benefits as curtailments; gains and losses are recognised in the income statement when the curtailments occur.

The costs of the Group's defined contribution plans are charged to the income statement in the period in which they fall due.

### m Share-based compensation

Lloyds Banking Group operates a number of equity-settled, share-based compensation plans in respect of services received from certain of its employees. The value of the employee services received in exchange for equity instruments granted under these plans is recognised as an expense over the vesting period of the instruments. This expense is determined by reference to the fair value of the number of equity instruments that are expected to vest. The fair value of equity instruments granted is based on market prices, if available, at the date of grant. In the absence of market prices, the fair value of the instruments at the date of grant is estimated using an appropriate valuation technique, such as a Black-Scholes option pricing model. The determination of fair values excludes the impact of any non-market vesting conditions, which are included in the assumptions used to estimate the number of options that are expected to vest. At each balance sheet date, this estimate is reassessed and if necessary revised. Any revision of the original estimate is recognised in the income statement over the remaining vesting period, together with a corresponding adjustment to equity. Cancellations by employees of contributions to the Group's Save As You Earn plans are treated as non-vesting conditions and in accordance with IFRS 2 (Revised) the Group recognises, in the year of cancellation, the amount of the expense that would have otherwise been recognised over the remainder of the vesting period. Modifications are assessed at the date of modification and any incremental charges are charged to the income statement over any remaining vesting period.

### n Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise.

For the Group's long-term insurance businesses, the tax charge is analysed between tax that is payable in respect of policyholders' returns and tax that is payable on equity holders' returns. This allocation is based on an assessment of the rates of tax which will be applied to the returns under current UK tax rules.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date which are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised. Income tax payable on profits is recognised as an expense in the period in which those profits arise. The tax effects of losses available for carry forward are recognised as an asset when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred and current tax related to gains and losses on the fair value re-measurement of available-for-sale investments and cash flow hedges, where these gains and losses are recognised in other comprehensive income, is also recognised in other comprehensive income. Such tax is subsequently transferred to the income statement together with the gain or loss.

Deferred and current tax assets and liabilities are offset when they arise in the same tax reporting group and where there is both a legal right of offset and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

### o Insurance

The Group undertakes both life insurance and general insurance business.

Products sold by the life insurance business are classified into three categories:

Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.

Investment contracts containing a discretionary participation feature ('participating investment contracts') – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional discretionary benefits or bonuses that are likely to be a significant proportion of the total contractual benefits and the amount and timing of which is at the discretion of the Group, within the constraints of the terms and conditions of the instrument and based upon the performance of specified assets.

Non-participating investment contracts – these contracts do not transfer significant insurance risk or contain a discretionary participation feature.

The general insurance business issues only insurance contracts.

## 2 Accounting policies (continued)

### (1) Life insurance business

#### (i) Accounting for insurance and participating investment contracts

##### Premiums and claims

Premiums received in respect of insurance and participating investment contracts are recognised as revenue when due except for unit-linked contracts on which premiums are recognised as revenue when received. Claims are recorded as an expense on the earlier of the maturity date or the date on which the claim is notified.

##### Liabilities

###### – Insurance and participating investment contracts in the Group's with-profit funds

Liabilities of the Group's with-profit funds, including guarantees and options embedded within products written by these funds, are stated at their realistic values in accordance with the Financial Services Authority's realistic capital regime, except that projected transfers out of the funds into other Group funds are recorded in the unallocated surplus (see below). Changes in the value of these liabilities are recognised through insurance claims.

###### – Insurance and participating investment contracts which are not unit-linked or in the Group's with-profit funds

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. The liability is calculated by estimating the future cash flows over the duration of in-force policies and discounting them back to the valuation date allowing for probabilities of occurrence. The liability will vary with movements in interest rates and with the cost of life insurance and annuity benefits where future mortality is uncertain.

Assumptions are made in respect of all material factors affecting future cash flows, including future interest rates, mortality and costs.

Changes in the value of these liabilities are recognised in the income statement through insurance claims.

###### – Insurance and participating investment contracts which are unit-linked

Liabilities for unit-linked insurance contracts and participating investment contracts are stated at the bid value of units plus an additional allowance where appropriate (such as for any excess of future expenses over charges). The liability is increased or reduced by the change in the unit prices and is reduced by policy administration fees, mortality and surrender charges and any withdrawals. Changes in the value of the liability are recognised in the income statement through insurance claims. Benefit claims in excess of the account balances incurred in the period are also charged through insurance claims. Revenue consists of fees deducted for mortality, policy administration and surrender charges.

##### Unallocated surplus

Any amounts in the with-profit funds not yet determined as being due to policyholders or shareholders are recognised as an unallocated surplus which is shown separately from liabilities arising from insurance contracts and participating investment contracts.

#### (ii) Accounting for non-participating investment contracts

The Group's non-participating investment contracts are primarily unit-linked. These contracts are accounted for as financial liabilities whose value is contractually linked to the fair values of financial assets within the Group's unitised investment funds. The value of the unit-linked financial liabilities is determined using current unit prices multiplied by the number of units attributed to the contract holders at the balance sheet date. Their value is never less than the amount payable on surrender, discounted for the required notice period where applicable. Investment returns (including movements in fair value and investment income) allocated to those contracts are recognised in insurance claims.

Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the non-participating investment contract liability.

The Group receives investment management fees in the form of an initial adjustment or charge to the amount invested. These fees are in respect of services rendered in conjunction with the issue and management of investment contracts where the Group actively manages the consideration received from its customers to fund a return that is based on the investment profile that the customer selected on origination of the contract. These services comprise an indeterminate number of acts over the lives of the individual contracts and, therefore, the Group defers these fees and recognises them over the estimated lives of the contracts, in line with the provision of investment management services.

Costs which are directly attributable and incremental to securing new non-participating investment contracts are deferred. This asset is subsequently amortised over the period of the provision of investment management services and is reviewed for impairment in circumstances where its carrying amount may not be recoverable. If the asset is greater than its recoverable amount it is written down immediately through fee and commission expense in the income statement. All other costs are recognised as expenses when incurred.

#### (iii) Value of in-force business

The Group recognises as an asset the value of in-force business in respect of insurance contracts and participating investment contracts. The asset represents the present value of the shareholders' interest in the profits expected to emerge from those contracts written at the balance sheet date. This is determined after making appropriate assumptions about future economic and operating conditions such as future mortality and persistency rates and includes allowances for both non-market risk and for the realistic value of financial options and guarantees. Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. The asset in the consolidated balance sheet is presented gross of attributable tax and movements in the asset are reflected within other operating income in the income statement.

The Group's contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers are measured at fair value at the date of acquisition. The resulting asset is amortised over the estimated lives of the contracts. At each reporting date an assessment is made to determine if there is any indication of impairment. Where impairment exists, the carrying value of the asset is reduced to its recoverable amount and the impairment loss recognised in the income statement.

### (2) General insurance business

The Group both underwrites and acts as intermediary in the sale of general insurance products. Underwriting premiums are included in insurance premium income, net of refunds, in the period in which insurance cover is provided to the customer; premiums received relating to future periods are deferred in the balance sheet within liabilities arising from insurance contracts and participating investment contracts and only credited to the income statement when earned. Broking commission is recognised when the underwriter accepts the risk of providing insurance cover to the customer. Where appropriate, provision is made for the effect of future policy terminations based upon past experience.

## 2 Accounting policies (continued)

The underwriting business makes provision for the estimated cost of claims notified but not settled and claims incurred but not reported at the balance sheet date. The provision for the cost of claims notified but not settled is based upon a best estimate of the cost of settling the outstanding claims after taking into account all known facts. In those cases where there is insufficient information to determine the required provision, statistical techniques are used which take into account the cost of claims that have recently been settled and make assumptions about the future development of the outstanding cases. Similar statistical techniques are used to determine the provision for claims incurred but not reported at the balance sheet date. Claims liabilities are not discounted.

### (3) Liability adequacy test

At each balance sheet date liability adequacy tests are performed to ensure the adequacy of insurance and participating investment contract liabilities net of related deferred cost assets and value of in-force business. In performing these tests current best estimates of discounted future contractual cash flows and claims handling and policy administration expenses, as well as investment income from the assets backing such liabilities, are used. Any deficiency is immediately charged to the income statement, initially by writing off the relevant assets and subsequently by establishing a provision for losses arising from liability adequacy tests.

### (4) Reinsurance

Contracts entered into by the Group with reinsurers under which the Group is compensated for losses on one or more contracts issued by the Group and that meet the classification requirements for insurance contracts are classified as reinsurance contracts held.

The benefits to which the Group is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers as well as longer term receivables that are dependent on the expected claims and benefits arising under the related reinsured contracts. Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

## p Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in sterling, which is the Company's functional and presentation currency.

Foreign currency transactions are translated into the appropriate functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when recognised in other comprehensive income as qualifying cash flow or net investment hedges. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on equities and similar non-monetary items held at fair value through profit and loss are recognised in profit or loss as part of the fair value gain or loss. Translation differences on available-for-sale non-monetary financial assets, such as equity shares, are included in the fair value reserve in equity unless the asset is a hedged item in a fair value hedge.

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date.
- The income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

Foreign exchange differences arising on the translation of a foreign operation are recognised in other comprehensive income and accumulated in a separate component of equity together with exchange differences arising from the translation of borrowings and other currency instruments designated as hedges of such investments (see f(3) above). On disposal of a foreign operation, the cumulative amount of exchange differences relating to that foreign operation are reclassified from equity and included in determining the profit or loss arising on disposal.

## q Provisions and contingent liabilities

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

The Group recognises provisions in respect of vacant leasehold property where the unavoidable costs of the present obligations exceed anticipated rental income.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

## r Share capital

### (1) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds.

### (2) Dividends

Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

## s Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with a maturity of less than three months.

## t Investment in subsidiaries

Investments in subsidiaries are carried at historical cost, less any provisions for impairment.

### 3 Critical accounting estimates and judgements

The preparation of the Group's financial statements in accordance with IFRS requires management to make judgements, estimates and assumptions in applying the accounting policies that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty in these financial statements, which together are deemed critical to the Group's results and financial position, are as follows.

The estimates and judgements applied to these areas in the preparation of the Group's financial statements are summarised below.

#### **Allowance for impairment losses on loans and receivables**

At 31 December 2010 gross loans and receivables totalled £686,047 million (2009: £428,623 million) against which impairment allowances of £18,951 million (2009: £5,207 million) had been made (see note 23). The Group's accounting policy for losses arising on financial assets classified as loans and receivables is described in note 2h; this note also provides an overview of the methodologies applied.

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. Impairment allowances are made up of two components, those determined individually and those determined collectively.

Individual impairment allowances are generally established against the Group's wholesale lending portfolios. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. In particular, significant judgement is required by management in the current economic environment in assessing the borrower's cash flows and debt servicing capability together with the realisable value of real estate collateral. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

Collective impairment allowances are generally established for smaller balance homogenous portfolios. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

Given the relative size of the mortgage portfolio, a key variable is UK house prices which determine the collateral value supporting loans in such portfolios. The value of this collateral is estimated by applying changes in house price indices to the original assessed value of the property. If average house prices were 10 per cent lower than those estimated at 31 December 2010, the Retail division's impairment charge would increase by approximately £250 million.

In addition, a collective unimpaired provision is made for loan losses that have been incurred but have not been separately identified at the balance sheet date. This provision is sensitive to changes in the time between the loss event and the date the impairment is specifically identified. This period is known as the loss emergence period. In the Group's wholesale business, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unimpaired provisions would result in an increase in the collective unimpaired provision of approximately £333 million.

#### **Unwind of HBOS acquisition fair value adjustments**

The acquisition of HBOS in January 2009 required the Lloyds Banking Group to recognise the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. The overall effect was to increase the book value of HBOS's net assets by £1,241 million primarily reflecting a reduction in the value of HBOS's debt securities and subordinated liabilities of £15,439 million, partially offset by a reduction in the carrying value of HBOS's loans and receivables of £14,880 million, including loans and advances to customers of £13,512 million.

In the periods subsequent to the acquisition and following the transfer of HBOS to the Group, many of the fair value adjustments unwind and are recognised in the Group's income statement. The fair value adjustments made to debt securities and subordinated liabilities unwind over the expected remaining life of the related securities except in the event that the liability is extinguished, in which case the remaining unamortised fair value adjustments are recognised in the income statement immediately. The fair value adjustment relating to loans and receivables broadly comprises two elements; an element reflecting expected future impairment losses at the date of acquisition and an element reflecting market liquidity. The element relating to market liquidity unwinds to the income statement over the estimated useful lives of the related assets. However, significant management judgement is required to determine the timing of the unwind of the element relating to future credit losses. This includes the identification of losses which were expected at the date of acquisition and assessing whether anticipated losses will still be incurred. In 2010, a net credit of £3,118 million to the income statement relates to the unwind of HBOS acquisition fair value adjustments. Of that amount, £2,229 million relates to impairment losses incurred which were expected at the date of acquisition and £845 million relates to a reassessment of future credit losses.

#### **Fair value of financial instruments**

In accordance with IFRS 7, the Group categorises financial instruments carried on the balance sheet at fair value using a three level hierarchy. Financial instruments categorised as level 1 are valued using quoted market prices and therefore there is minimal judgement applied in determining fair value. However, the fair value of financial instruments categorised as level 2 and, in particular, level 3 is determined using valuation techniques including discounted cash flow analysis and valuation models. These require management judgement and contain significant estimation uncertainty.

In particular, significant judgement is required by management in determining appropriate assumptions to be used for level 3 financial instruments. At 31 December 2010, the Group classified £6,292 million of financial assets and £257 million of financial liabilities as level 3. The effect of applying reasonably possible alternative assumptions in determining the fair value of the Group's level 3 financial assets is set out in note 54.

#### **Recoverability of deferred tax assets**

At 31 December 2010 the Group carried deferred tax assets on its balance sheet of £4,204 million (2009: £2,438 million) and deferred tax liabilities of £247 million (2009: £nil) (note 43). This presentation takes into account the ability of the Group to net deferred tax assets and liabilities only where there is a legally enforceable right of offset. Note 43 presents the Group's deferred tax assets and liabilities by type. The largest category of deferred tax asset relates to tax losses carried forward. At 31 December 2010, the Group recognised a deferred tax asset of £6,596 million (2009 £2,316 million) in respect of tax losses carried forward.

### 3 Critical accounting estimates and judgements (continued)

The recognition of a deferred tax asset in respect of tax losses is permitted only to the extent that it is probable that future taxable profits will be available to utilise the tax losses carried forward. The assessment of future taxable profits involves significant estimation uncertainty, principally relating to management's projections of future taxable income which are based on business plans. These projections include assumptions about the future strategy of the Group, the economic and regulatory environment in which the Group operates, future tax legislation, customer behaviour, and the ability of the Group to deliver expected integration benefits, amongst other variables. At 31 December 2010, management has concluded that future taxable profits generated by the Group companies with tax losses carried forward are expected to be sufficient to utilise the tax losses carried forward in full.

#### Retirement benefit obligations

The net asset recognised in the balance sheet at 31 December 2010 in respect of the Group's retirement benefit obligations was £313 million (comprising an asset of £736 million and a liability of £423 million; 2009: a liability of £474 million) of which an asset of £479 million (2009: a liability of £360 million) related to defined benefit pension schemes. As explained in note 21, the Group adopts the corridor approach to the recognition of actuarial gains and losses in respect of its pension schemes and as a consequence has not recognised actuarial losses of £959 million (2009: £2,361 million). The defined benefit pension schemes' gross deficit totalled £480 million (2009: £2,721 million) representing the difference between the schemes' liabilities and the fair value of the related assets at the balance sheet date.

The value of the Group's defined benefit pension schemes' liabilities requires significant management judgement in determining the appropriate assumptions to be used. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The size of the deficit is sensitive to changes in the discount rate, which is affected by market conditions and therefore potentially subject to significant variation. The cost of the benefits payable by the schemes will also depend upon the longevity of the members. Assumptions are made regarding the expected lifetime of scheme members based upon recent experience, however given the rate of advance in medical science and increasing levels of obesity, it is uncertain whether they will ultimately reflect actual experience. Assumptions used by management reflect recent longevity experience and extrapolate the improving trend.

The effect on the gross defined benefit pension scheme asset or liability and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions are set out in note 42.

#### Valuation of assets and liabilities arising from life insurance business

At 31 December 2010, the Group recognised a value of in-force business asset of £5,898 million (2009: £2,403 million) and an acquired value of in-force business asset of £1,469 million (2009: £nil). The value of in-force business asset represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The acquired value of in-force business asset represents the contractual rights to benefits from providing investment management services in relation to non-participating investment contracts acquired in business combinations and portfolio transfers. The methodology used to value these assets is set out in note 20(1). The valuation or recoverability of these assets requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to these assets. The key assumptions that have been made in determining the carrying value of the value of in-force business assets at 31 December 2010 are set out in note 28.

At 31 December 2010, the Group carried liabilities arising from insurance contracts and participating investment contracts of £80,749 million (2009: £36,960 million). The methodology used to value these liabilities is described in note 20(1). Elements of the liability valuations require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The key assumptions that have been made in determining the carrying value of these liabilities are set out in note 37.

The effect on the Group's profit before tax and shareholders' equity of changes in key assumptions used in determining the life insurance assets and liabilities is set out in note 38.



#### 4 Segmental analysis

The Lloyds TSB Bank Group provides a wide range of banking and financial services in the UK and in certain locations overseas.

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

Following the transfer of HBOS to the Group on 1 January 2010, all of the trading activities of the Lloyds Banking Group are carried out within the Group and, as a result, the chief operating decision maker reviews the Group's performance by considering that of the Lloyds Banking Group. The Lloyds Banking Group's activities are organised into four financial reporting segments: Retail, Wholesale, Wealth and International and Insurance. The segmental results and comparatives are presented on the basis reviewed by the chief operating decision maker and therefore include the results of HBOS for the period from 1 January 2009 to 16 January 2009, prior to its acquisition by the Lloyds Banking Group.

Retail offers a broad range of retail financial service products in the UK, including current accounts, savings, personal loans, credit cards and mortgages. It is also a major general insurer and bancassurance distributor, selling a wide range of long-term savings, investment and general insurance products.

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

Wealth and International was created in 2009 to give increased focus and momentum to the Lloyds Banking Group's private banking and asset management activities and to closely co-ordinate the management of its international businesses. Wealth comprises the Group's private banking, wealth and asset management businesses in the UK and overseas. International comprises corporate, commercial, asset finance and retail businesses, principally in Australia and Continental Europe.

The Insurance division provides long-term savings, investment and protection products distributed through the retail branch network, intermediary and direct channels in the UK. It is also a distributor of home insurance in the UK with products sold through the retail branch network, direct channels and strategic corporate partners. The division consists of three business units: Life, Pensions and Investments UK; Life, Pensions and Investments Europe; and General Insurance.

Other includes the results of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and procurement services, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions, including hedge ineffectiveness and certain capital and wholesale liquidity funding costs.

Inter-segment services are generally recharged at cost, with the exception of the internal commission arrangements between the UK branch and other distribution networks and the insurance product manufacturing businesses within the Group, where a profit margin is also charged. Inter-segment lending and deposits are generally entered into at market rates, except that non-interest bearing balances are priced at a rate that reflects the external yield that could be earned on such funds.

For those derivative contracts entered into by business units for risk management purposes, the business unit retains the amount that would have been recognised on an accrual accounting basis (an amount equal to the interest element of the next payment on the swap) and transfers the remainder of the fair value of the swap to the central group segment where the resulting accounting volatility is managed through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the swap and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and records volatility in the central group segment where it is managed.

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4 Segmental analysis (continued)

	Retail £m	Wholesale £m	Wealth and International £m	Insurance £m	Group Operations and Central items £m	Reported basis total £m
<b>2010</b>						
Net interest income	9,378	4,426	1,176	(263)	(895)	13,822
Other income	1,607	4,136	1,160	2,814	447	10,164
<b>Total income</b>	<b>10,985</b>	<b>8,562</b>	<b>2,336</b>	<b>2,551</b>	<b>(448)</b>	<b>23,986</b>
Insurance claims	–	–	–	(542)	–	(542)
<b>Total income, net of insurance claims</b>	<b>10,985</b>	<b>8,562</b>	<b>2,336</b>	<b>2,009</b>	<b>(448)</b>	<b>23,444</b>
Costs:						
Operating expenses	(4,644)	(3,744)	(1,536)	(854)	(150)	(10,928)
Impairment of tangible fixed assets	–	(150)	–	–	–	(150)
	<b>(4,644)</b>	<b>(3,894)</b>	<b>(1,536)</b>	<b>(854)</b>	<b>(150)</b>	<b>(11,078)</b>
<b>Trading surplus</b>	<b>6,341</b>	<b>4,668</b>	<b>800</b>	<b>1,155</b>	<b>(598)</b>	<b>12,366</b>
Impairment	(2,747)	(4,446)	(5,988)	–	–	(13,181)
Share of results of joint ventures and associates	17	(95)	(8)	(10)	5	(91)
<b>Profit (loss) before tax and fair value unwind</b>	<b>3,611</b>	<b>127</b>	<b>(5,196)</b>	<b>1,145</b>	<b>(593)</b>	<b>(906)</b>
Fair value unwind	1,105	3,130	372	(43)	(1,446)	3,118
<b>Profit (loss) before tax</b>	<b>4,716</b>	<b>3,257</b>	<b>(4,824)</b>	<b>1,102</b>	<b>(2,039)</b>	<b>2,212</b>
	Retail £m	Wholesale £m	Wealth and International £m	Insurance £m	Other £m	Reported basis total £m
<b>2010</b>						
External revenue	13,603	3,969	3,000	3,180	234	23,986
Inter-segment revenue	(2,618)	4,593	(664)	(629)	(682)	–
Segment revenue	10,985	8,562	2,336	2,551	(448)	23,986
Segment external assets	370,708	355,582	85,158	144,540	35,586	991,574
Segment customer deposits	235,591	124,262	32,784	–	996	393,633
Other segment items reflected in income statement above:						
Depreciation and amortisation	384	1,133	87	135	64	1,803
Movement in value of in-force business	–	–	2	787	–	789
Defined benefit scheme charges	176	93	39	32	115	455
Other segment items:						
Additions to tangible fixed assets	126	1,748	(20)	585	777	3,216
Investments in joint ventures and associates at end of year	139	127	158	(1)	6	429
	Retail £m	Wholesale £m	Wealth and International £m	Insurance £m	Group Operations and Central items £m	Reported basis total £m
<b>2009</b>						
Net interest income	7,970	4,710	1,217	(287)	(884)	12,726
Other income	1,804	4,199	1,128	2,944	1,800	11,875
Total income	9,774	8,909	2,345	2,657	916	24,601
Insurance claims	–	–	–	(637)	–	(637)
Total income, net of insurance claims	9,774	8,909	2,345	2,020	916	23,964
Operating expenses	(4,566)	(4,106)	(1,544)	(974)	(419)	(11,609)
Trading surplus	5,208	4,803	801	1,046	497	12,355
Impairment	(4,227)	(15,683)	(4,078)	–	–	(23,988)
Share of results of joint ventures and associates	(6)	(720)	(21)	(22)	2	(767)
Profit (loss) before tax and fair value unwind	975	(11,600)	(3,298)	1,024	499	(12,400)
Fair value unwind	407	6,897	942	(49)	(2,097)	6,100
<b>Profit (loss) before tax</b>	<b>1,382</b>	<b>(4,703)</b>	<b>(2,356)</b>	<b>975</b>	<b>(1,598)</b>	<b>(6,300)</b>

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4 Segmental analysis (continued)

	Retail £m	Wholesale £m	International £m	Wealth and Insurance £m	Other £m	Reported basis total £m
2009						
External revenue	14,221	4,165	2,859	3,780	(424)	24,601
Inter-segment revenue	(4,447)	4,744	(514)	(1,123)	1,340	–
Segment revenue	9,774	8,909	2,345	2,657	916	24,601
Segment external assets	383,588	401,836	86,272	135,814	19,745	1,027,255
Segment customer deposits	224,149	153,389	29,037	–	166	406,741
Other segment items reflected in income statement above:						
Depreciation and amortisation	196	1,284	84	152	147	1,863
Movement in value of in-force business	–	–	(5)	1,097	–	1,092
Defined benefit scheme charges	190	112	40	39	156	537
Other segment items:						
Additions to tangible fixed assets	65	2,969	53	255	487	3,829
Investments in joint ventures and associates at end of year	30	189	123	(14)	151	479

The reported basis is the basis on which financial information is presented to the chief operating decision maker which excludes certain items included in the statutory results. The table below reconciles the statutory results to the reported basis.

	Lloyds TSB Bank Group statutory £m	Removal of:					Fair value unwind £m	Reported basis £m
		Impact of other entities in the Lloyds Banking Group <sup>1</sup> £m	Pension curtailment gain and acquisition related items <sup>2</sup> £m	Volatility arising in insurance businesses £m	Insurance gross up £m	Customer goodwill payments provision and loss on disposal of businesses £m		
<b>2010</b>								
Net interest income	12,686	(140)	–	26	949	–	301	13,822
Other income	31,191	(270)	–	(332)	(19,162)	–	(1,263)	10,164
<b>Total income</b>	<b>43,877</b>	<b>(410)</b>	<b>–</b>	<b>(306)</b>	<b>(18,213)</b>	<b>–</b>	<b>(962)</b>	<b>23,986</b>
Insurance claims	(18,511)	–	–	–	17,967	–	2	(542)
<b>Total income, net of insurance claims</b>	<b>25,366</b>	<b>(410)</b>	<b>–</b>	<b>(306)</b>	<b>(246)</b>	<b>–</b>	<b>(960)</b>	<b>23,444</b>
Costs:								
Operating expenses	(13,034)	(34)	1,320	–	246	500	74	(10,928)
Impairment of tangible fixed assets	(202)	–	52	–	–	–	–	(150)
	(13,236)	(34)	1,372	–	246	500	74	(11,078)
<b>Trading surplus</b>	<b>12,130</b>	<b>(444)</b>	<b>1,372</b>	<b>(306)</b>	<b>–</b>	<b>500</b>	<b>(886)</b>	<b>12,366</b>
Impairment	(10,952)	–	–	–	–	–	(2,229)	(13,181)
Share of results of joint ventures and associates	(88)	–	–	–	–	–	(3)	(91)
Loss on disposal of businesses	(365)	–	–	–	–	365	–	–
Fair value unwind	–	–	–	–	–	–	3,118	3,118
<b>Profit (loss) before tax</b>	<b>725</b>	<b>(444)</b>	<b>1,372</b>	<b>(306)</b>	<b>–</b>	<b>865</b>	<b>–</b>	<b>2,212</b>

<sup>1</sup>This reflects the inclusion in the results reviewed by the chief operating decision maker of the Bank's fellow subsidiary undertakings and its parent undertaking, Lloyds Banking Group plc.

<sup>2</sup>Comprises the pension curtailment gain (£910 million), integration costs (£1,653 million) and the amortisation of purchased intangibles (£629 million).

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4 Segmental analysis (continued)

	Lloyds TSB Bank Group statutory £m	Impact of other entities in the Lloyds Banking Group <sup>1</sup> £m	Removal of:					Fair value unwind £m	Reported basis £m
			Pre acquisition results of HBOS <sup>2</sup> £m	GAPS fee and acquisition related items <sup>3</sup> £m	Volatility arising in insurance businesses £m	Insurance gross up £m			
2009									
Net interest income	5,299	3,727	243	–	11	1,280	2,166	12,726	
Other income	16,890	19,381	(1,123)	–	(479)	(21,659)	(1,135)	11,875	
Total income	22,189	23,108	(880)	–	(468)	(20,379)	1,031	24,601	
Insurance claims	(9,630)	(12,389)	1,349	–	–	20,318	(285)	(637)	
Total income, net of insurance claims	12,559	10,719	469	–	(468)	(61)	746	23,964	
Operating expenses	(12,523)	(3,461)	(293)	4,589	–	61	18	(11,609)	
Trading surplus (deficit)	36	7,258	176	4,589	(468)	–	764	12,355	
Impairment	(4,416)	(12,257)	(456)	–	–	–	(6,859)	(23,988)	
Share of results of joint ventures and associates	2	(754)	–	–	(10)	–	(5)	(767)	
Gain on acquisition	–	11,173	–	(11,173)	–	–	–	–	
Fair value unwind	–	–	–	–	–	–	6,100	6,100	
Profit (loss) before tax	(4,378)	5,420	(280)	(6,584)	(478)	–	–	(6,300)	
Assets	572,980	454,275	–	–	–	–	–	1,027,255	

<sup>1</sup>This reflects the inclusion in the results reviewed by the chief operating decision maker of the Bank's fellow subsidiary undertakings and its parent undertaking, Lloyds Banking Group plc.

<sup>2</sup>This reflects the consolidated results of HBOS plc from 1 January 2009 up to its acquisition by Lloyds Banking Group plc on 16 January 2009.

<sup>3</sup>Comprises the Government Asset Protection Scheme fee (£2,500 million), integration costs (£1,096 million), amortisation of purchased intangibles (£753 million), goodwill impairment (£240 million) and the gain on acquisition (£11,173 million).

Geographical areas

The Group's activities are focused in the UK and the analyses of income and assets below are based on the location of the branch or entity recording the income or assets.

	2010			2009		
	UK £m	Non-UK £m	Total £m	UK £m	Non-UK £m	Total £m
<b>Total income</b>	<b>39,678</b>	<b>4,199</b>	<b>43,877</b>	20,815	1,374	22,189
<b>Total assets</b>	<b>890,825</b>	<b>117,907</b>	<b>1,008,732</b>	534,306	38,674	572,980

There was no individual non-UK country contributing more than 5 per cent of total income or total assets.

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**5 Net interest income**

	Weighted average effective interest rate		2010 £m	2009 £m
	2010 %	2009 %		
Interest and similar income:				
Loans and advances to customers, excluding lease and hire purchase receivables	4.16	3.95	25,459	9,086
Loans and advances to banks	1.20	0.89	851	1,335
Debt securities held as loans and receivables	4.43	4.35	1,396	123
Lease and hire purchase receivables	6.74	6.69	626	598
Interest receivable on loans and receivables	3.92	2.85	28,332	11,142
Available-for-sale financial assets	2.84	1.59	1,295	433
Held-to-maturity investments	2.51	–	55	–
<b>Total interest and similar income</b>	<b>3.85</b>	<b>2.77</b>	<b>29,682</b>	<b>11,575</b>
Interest and similar expense:				
Deposits from banks, excluding liabilities under sale and repurchase agreements	2.30	0.85	(943)	(723)
Customer deposits, excluding liabilities under sale and repurchase agreements	1.42	1.23	(5,359)	(1,944)
Debt securities in issue	2.49	1.59	(5,835)	(1,642)
Subordinated liabilities	10.54	7.94	(3,217)	(1,242)
Liabilities under sale and repurchase agreements	1.18	1.83	(744)	(509)
Interest payable on liabilities held at amortised cost	2.16	1.56	(16,098)	(6,060)
Other	6.97	3.91	(898)	(216)
<b>Total interest and similar expense</b>	<b>2.24</b>	<b>1.59</b>	<b>(16,996)</b>	<b>(6,276)</b>
<b>Net interest income</b>			<b>12,686</b>	<b>5,299</b>

Included within interest and similar income is £1,288 million (2009: £584 million) in respect of impaired financial assets. Net interest income also includes a charge of £932 million (2009: credit of £17 million) transferred from the cash flow hedging reserve (see note 48).

**6 Net fee and commission income**

	2010 £m	2009 £m
Fee and commission income:		
Current accounts	1,086	761
Credit and debit card fees	812	564
Other	2,517	1,496
<b>Total fee and commission income</b>	<b>4,415</b>	<b>2,821</b>
Fee and commission expense	(1,682)	(680)
<b>Net fee and commission income</b>	<b>2,733</b>	<b>2,141</b>

As discussed in note 2(d), fees and commissions which are an integral part of the effective interest rate form part of net interest income shown in note 5. Fees and commissions relating to instruments that are held at fair value through profit or loss are included within net trading income shown in note 7.

**7 Net trading income**

	2010 £m	2009 £m
Foreign exchange translation gains	29	74
Gains on foreign exchange trading transactions	359	382
Total foreign exchange	388	456
Investment property gains (losses) (note 26)	434	(145)
Securities and other gains (see below)	15,345	6,903
<b>Net trading income</b>	<b>16,167</b>	<b>7,214</b>

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**7 Net trading income** (continued)

Securities and other gains comprise net gains arising on assets and liabilities held at fair value through profit or loss and for trading as follows:

	2010 £m	2009 £m
Net income arising on assets held at fair value through profit or loss:		
Debt securities, loans and advances	2,286	548
Equity shares	10,333	4,929
Total net income arising on assets held at fair value through profit or loss	12,619	5,477
Net expense arising on liabilities held at fair value through profit or loss – debt securities in issue	(216)	(119)
Total net gains arising on assets and liabilities held at fair value through profit or loss	12,403	5,358
Net gains on financial instruments held for trading	2,942	1,545
<b>Securities and other gains</b>	<b>15,345</b>	<b>6,903</b>

**8 Insurance premium income**

	2010 £m	2009 £m
<i>Life insurance</i>		
Gross premiums	7,026	3,753
Ceded reinsurance premiums	(253)	(183)
Net earned premiums	6,773	3,570
<i>Non-life insurance</i>		
Gross premiums written	1,332	596
Ceded reinsurance premiums	(104)	(34)
Net written premiums	1,228	562
Change in provision for unearned premiums (note 37(2))	156	85
Change in provision for ceded unearned premiums (note 37(2))	(9)	11
Net earned premiums	1,375	658
<b>Total net earned premiums</b>	<b>8,148</b>	<b>4,228</b>

Life insurance gross premiums can be further analysed as follows:

	2010 £m	2009 £m
Life and pensions	6,428	3,278
Annuities	583	462
Other	15	13
<b>Gross premiums</b>	<b>7,026</b>	<b>3,753</b>

Non-life insurance gross written premiums can be further analysed as follows:

	2010 £m	2009 £m
Credit protection	363	115
Home	964	476
Health	5	5
<b>Gross written premiums</b>	<b>1,332</b>	<b>596</b>

**9 Other operating income**

	2010 £m	2009 £m
Operating lease rental income	1,410	409
Rental income from investment properties (note 26)	337	180
Other rents receivable	41	32
Gains less losses on disposal of available-for-sale financial assets (note 48)	399	1
Movement in value of in-force business (note 28)	789	510
Gains on capital transactions	352	1,773
Other income	815	402
<b>Total other operating income</b>	<b>4,143</b>	<b>3,307</b>

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**9 Other operating income** (continued)

**Gains on capital transactions**

During 2010 and 2009, as part of the Lloyds Banking Group's management of capital, the Group exchanged certain existing subordinated debt securities for new securities. These exchanges resulted in a gain on extinguishment of the existing liabilities of £352 million (2009: £1,773 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.

**10 Insurance claims**

Insurance claims comprise:

	2010 £m	2009 £m
<b>Life insurance and participating investment contracts</b>		
Claims and surrenders:		
Gross	(9,397)	(4,062)
Reinsurers' share	159	76
	(9,238)	(3,986)
Change in insurance and participating investment contract liabilities (note 37(1)):		
Change in gross liabilities	(4,622)	(3,178)
Change in reinsurers' share of liabilities	256	25
	(4,366)	(3,153)
Change in non-participating investment contract liabilities:		
Change in gross liabilities	(4,872)	(2,179)
Change in reinsurers' share of liabilities	65	–
	(4,807)	(2,179)
Change in unallocated surplus (note 40)	439	(40)
<b>Total life insurance and participating investment contracts</b>	<b>(17,972)</b>	<b>(9,358)</b>
<b>Non-life insurance</b>		
Claims and claims paid:		
Gross	(470)	(233)
Reinsurers' share	11	3
	(459)	(230)
Change in liabilities (note 37(2)):		
Gross	(82)	(40)
Reinsurers' share	2	(2)
	(80)	(42)
Total non-life insurance	(539)	(272)
<b>Total insurance claims expense</b>	<b>(18,511)</b>	<b>(9,630)</b>
Life insurance and participating investment contracts gross claims can also be analysed as follows:		
Deaths	(662)	(270)
Maturities	(1,763)	(1,596)
Surrenders	(5,904)	(1,589)
Annuities	(741)	(540)
Other	(327)	(67)
<b>Total life insurance gross claims</b>	<b>(9,397)</b>	<b>(4,062)</b>

A non-life insurance claims development table is included in note 37.

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**11 Operating expenses**

	2010 £m	2009 £m
Staff costs:		
Salaries	4,220	2,364
Social security costs	396	194
Pensions and other post-retirement benefit schemes (note 42):		
Curtailment gain <sup>1</sup>	(910)	–
Other	628	362
	(282)	362
Other staff costs	1,135	788
	5,469	3,708
Premises and equipment:		
Rent and rates	601	348
Hire of equipment	18	10
Repairs and maintenance	199	175
Other	407	202
	1,225	735
Other expenses:		
Communications and data processing	891	561
Advertising and promotion	362	188
Professional fees	742	342
Customer goodwill payments provision (note 44)	500	–
Other	1,413	516
	3,908	1,607
Depreciation and amortisation:		
Depreciation of tangible fixed assets (note 30)	1,635	681
Amortisation of acquired value of in-force non-participating investment contracts (note 28)	76	–
Amortisation of other intangible assets (note 29)	721	52
	2,432	733
Impairment of tangible fixed assets (note 30)	202	–
Goodwill impairment (note 27)	–	240
Total operating expenses, excluding subvention payment and Government Asset Protection Scheme fee	13,236	7,023
Subvention payment <sup>2</sup>	–	3,000
Government Asset Protection Scheme fee <sup>3</sup>	–	2,500
<b>Total operating expenses</b>	<b>13,236</b>	<b>12,523</b>

<sup>1</sup>Following changes by the Group to the terms of its 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 the year there was a change in commutation factors in certain defined benefit schemes. The combined effect of these changes is a reduction in the Group's defined benefit obligation of £1,081 million and a reduction in the Group's actuarial losses of £171 million, resulting in a net curtailment gain of £910 million recognised in the income statement and a reduction in the balance sheet liability.

<sup>2</sup>During the year ended 31 December 2009, the Bank made a payment of £3,000 million to its then fellow subsidiary, Bank of Scotland plc, to support its financial and reputational position and to facilitate the on-going integration of the group's banking operations.

<sup>3</sup>During the year ended 31 December 2009, in relation to the Lloyds Banking Group's agreement not to enter into the Government Asset Protection Scheme, the Bank paid a fee of £2,500 million to the UK Government.

The average number of persons on a headcount basis employed by the Group during the year was as follows:

	2010	2009
UK	118,149	63,891
Overseas	4,830	2,124
<b>Total</b>	<b>122,979</b>	<b>66,015</b>



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**11 Operating expenses** (continued)

**Fees payable to the Bank's auditors**

During the year the auditors earned the following fees:

	<b>2010</b>	2009
	<b>£m</b>	£m
Fees payable for the audit of the Bank's current year annual report	<b>6.3</b>	4.5
Fees payable for other services:		
Audit of the Bank's subsidiaries pursuant to legislation	<b>11.6</b>	3.6
Other services supplied pursuant to legislation	<b>1.3</b>	2.5
Other services – audit-related fees	<b>0.5</b>	–
Other services relating to taxation	<b>1.0</b>	0.4
Services relating to corporate finance transactions	<b>0.3</b>	0.2
All other services	<b>0.8</b>	1.0
<b>Total fees payable to the Bank's auditors</b>	<b>21.8</b>	12.2

During the year the auditors also earned fees payable by entities outside the consolidated Lloyds TSB Bank Group in respect of the following:

	<b>2010</b>	2009
	<b>£m</b>	£m
Audits of the Group pension schemes	<b>0.3</b>	0.2
Audits of unconsolidated Open Ended Investment Companies managed by the Group	<b>0.8</b>	0.6
Reviews of the financial position of corporate and other borrowers	<b>17.2</b>	7.3
Acquisition due diligence and other work performed in respect of potential venture capital investments	<b>1.2</b>	1.4

**12 Impairment**

	<b>2010</b>	2009
	<b>£m</b>	£m
Impairment losses on loans and receivables (note 23):		
Loans and advances to banks	<b>(13)</b>	(3)
Loans and advances to customers	<b>10,727</b>	4,248
Debt securities classified as loans and receivables	<b>57</b>	108
Total impairment losses on loans and receivables	<b>10,771</b>	4,353
Impairment of available-for-sale financial assets	<b>106</b>	25
Other credit risk provisions (note 44)	<b>75</b>	38
<b>Total impairment charged to the income statement</b>	<b>10,952</b>	4,416

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### 13 Investments in joint ventures and associates

The Group's share of results of and investments in joint ventures and associates comprises:

	Joint ventures		Associates		Total	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Share of income statement amounts:						
Income	318	–	135	2	453	2
Expenses	(209)	–	(91)	–	(300)	–
Impairment	(126)	–	(92)	–	(218)	–
Profit (loss) before tax	(17)	–	(48)	2	(65)	2
Tax	(22)	–	(1)	–	(23)	–
<b>Share of post-tax results</b>	<b>(39)</b>	<b>–</b>	<b>(49)</b>	<b>2</b>	<b>(88)</b>	<b>2</b>
Share of balance sheet amounts:						
Current assets	3,370	54	378	2	3,748	56
Non-current assets	2,868	–	1,183	–	4,051	–
Current liabilities	(588)	–	(433)	–	(1,021)	–
Non-current liabilities	(5,324)	–	(1,025)	–	(6,349)	–
<b>Share of net assets at 31 December</b>	<b>326</b>	<b>54</b>	<b>103</b>	<b>2</b>	<b>429</b>	<b>56</b>
Movement in investments over the year:						
At 1 January	54	55	2	–	56	55
Adjustment on transfer of HBOS (note 31)	316	–	107	–	423	–
Additional investments	71	–	6	–	77	–
Disposals	(68)	–	(2)	–	(70)	–
Share of post-tax results	(39)	–	(49)	2	(88)	2
Dividends paid	–	–	(1)	–	(1)	–
Exchange and other adjustments	(8)	(1)	40	–	32	(1)
<b>Share of net assets at 31 December</b>	<b>326</b>	<b>54</b>	<b>103</b>	<b>2</b>	<b>429</b>	<b>56</b>

The Group's unrecognised share of losses of associates for the year is £8 million (2009: £nil) and of joint ventures is £180 million (2009: £nil). For entities making losses, subsequent profits earned are not recognised until previously unrecognised losses are extinguished. The Group's unrecognised share of losses net of unrecognised profits on a cumulative basis of associates is £104 million (2009: £nil) and of joint ventures is £339 million (2009: £nil).

The Group's principal joint venture investment at 31 December 2010 was in Sainsbury's Bank plc; the Group owns 50 per cent of the ordinary share capital of Sainsbury's Bank plc, whose business is banking and principal area of operation is the UK. Sainsbury's Bank plc is incorporated in the UK and the Group's interest is held by a subsidiary.

Where entities have statutory accounts drawn up to a date other than 31 December management accounts are used when accounting for them by the Group.

### 14 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. These companies, which had gross assets of £860 million, were sold to Seadrill Limited; a loss of £365 million arose on disposal.

The Group extended vendor financing, on normal commercial terms and negotiated on an arms length basis, to Seadrill 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.

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**15 Taxation**

**a Analysis of tax (charge) credit for the year**

	2010 £m	2009 £m
UK corporation tax:		
Current tax on profit (loss) for the year	(243)	(309)
Adjustments in respect of prior years	315	(128)
	72	(437)
Double taxation relief	1	–
	73	(437)
Foreign tax:		
Current tax on profit (loss) for the year	(82)	(111)
Adjustments in respect of prior years	49	7
	(33)	(104)
Current tax credit (charge)	40	(541)
Deferred tax (note 43):		
Origination and reversal of temporary differences	(555)	2,051
Reduction in UK corporation tax rate	(142)	–
Adjustments in respect of prior years	(161)	95
	(858)	2,146
<b>Tax (charge) credit</b>	<b>(818)</b>	<b>1,605</b>

The (charge) credit for tax on the profit for 2010 and 2009 is based on a UK corporation tax rate of 28.0 per cent.

The above income tax (charge) credit is made up as follows:

	2010 £m	2009 £m
Tax charge attributable to policyholders	(315)	(44)
Shareholder tax (charge) credit	(503)	1,649
Tax (charge) credit	(818)	1,605

**b Factors affecting the tax (charge) credit for the year**

A reconciliation of the (charge) credit that would result from applying the standard UK corporation tax rate to profit before tax to the tax (charge) credit for the year is given below:

	2010 £m	2009 £m
Profit (loss) before tax	725	(4,378)
Tax (charge) credit thereon at UK corporation tax rate of 28.0 per cent (2009: 28.0 per cent)	(203)	1,226
Factors affecting (charge) credit:		
UK corporation tax rate change	(142)	–
Goodwill impairment	–	(67)
Disallowed and non-taxable items	(25)	463
Overseas tax rate differences	134	(13)
Gains exempted or covered by capital losses	65	14
Policyholder interests	(227)	(32)
Losses surrendered for no payment	(123)	–
Tax losses where no deferred tax provided	(478)	–
Adjustments in respect of previous years	203	12
Effect of profit (loss) in joint ventures and associates	(25)	1
Other items	3	1
<b>Tax (charge) credit on profit (loss) on ordinary activities</b>	<b>(818)</b>	<b>1,605</b>

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16 Trading and other financial assets at fair value through profit or loss

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Trading assets	23,743	510	3,526	510
Other financial assets at fair value through profit or loss	132,533	48,384	1,061	2,123
<b>Total</b>	<b>156,276</b>	<b>48,894</b>	<b>4,587</b>	<b>2,633</b>

These assets are comprised as follows:

	2010		2009		2010		2009	
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Trading assets £m	Other financial assets at fair value through profit or loss £m
Loans and advances to customers	9,486	325	273	166	-	325	273	166
Loans and advances to banks	2,734	-	-	-	-	-	-	-
Debt securities:								
Government securities	1,623	22,217	72	7,866	220	13	72	-
Other public sector securities	-	919	6	34	-	-	6	-
Bank and building society certificates of deposit	3,692	606	-	-	-	-	-	-
Asset-backed securities:								
Mortgage-backed securities	-	422	-	393	-	-	-	-
Other asset-backed securities	1,020	1,592	-	1,656	47	47	-	247
Corporate and other debt securities	4,955	16,190	159	10,412	3,259	647	159	1,706
	11,290	41,946	237	20,361	3,526	707	237	1,953
Equity shares:								
Listed	-	50,276	-	18,964	-	-	-	-
Unlisted	6	39,986	-	8,893	-	29	-	4
	6	90,262	-	27,857	-	29	-	4
Treasury bills and other bills	227	-	-	-	-	-	-	-
<b>Total</b>	<b>23,743</b>	<b>132,533</b>	<b>510</b>	<b>48,384</b>	<b>3,526</b>	<b>1,061</b>	<b>510</b>	<b>2,123</b>

At 31 December 2010 £129,792 million (2009: £48,307 million) of trading and other financial assets at fair value through profit or loss of the Group and £2,426 million (2009: £2,478 million) of the Bank had a contractual residual maturity of greater than one year.

Other financial assets at fair value through profit or loss represent the following assets designated into that category:

- financial assets backing insurance contracts and investment contracts which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise;
- certain loans and advances to customers which are economically hedged by interest rate derivatives which are not in hedge accounting relationships and where significant measurement inconsistencies would otherwise arise if the related derivatives were treated as trading liabilities and the loans and advances were carried at amortised cost; and
- certain private equity investments that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

The maximum exposure to credit risk at 31 December 2010 of the loans and advances to customers designated at fair value through profit or loss by the Bank and the Group was £325 million (2009: £166 million); the Bank and the Group do not hold any credit derivatives or other instruments in mitigation of this risk. There was no significant movement in the fair value of these loans attributable to changes in credit risk; this is determined by reference to the publicly available credit ratings of the instruments involved.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £824 million (2009: £nil) for the Group; the value of the related liability is £828 million (2009: £nil). In all cases the transferee has the right to sell or repledge the assets concerned.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £12,211 million for the Group (2009: £nil). Collateral is held with a fair value of £14,299 million for the Group (2009: £nil), all of which the Group is able to repledge. At 31 December 2010, £3,161 million had been repledged by the Group (2009: £nil).

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**17 Derivative financial instruments**

The Group holds derivatives as part of the following strategies:

- Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;
- To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value, cash flow and net investment hedge approaches as described in note 55;
- Derivatives held in policyholders funds as permitted by the investment strategies of those funds.

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS39. Derivatives are held at fair value on the Group's balance sheet. A description of the methodology used to determine the fair value of derivative financial instruments and the effect of using reasonably possible alternative assumptions for those derivatives valued using unobservable inputs is set out in note 54.

The principal derivatives used by the Group are as follows:

- Interest rate related contracts include interest rate swaps, forward rate agreements and options. An interest rate swap is an agreement between two parties to exchange fixed and floating interest payments, based upon interest rates defined in the contract, without the exchange of the underlying principal amounts. Forward rate agreements are contracts for the payment of the difference between a specified rate of interest and a reference rate, applied to a notional principal amount at a specific date in the future. An interest rate option gives the buyer, on payment of a premium, the right, but not the obligation, to fix the rate of interest on a future loan or deposit, for a specified period and commencing on a specified future date.
- Exchange rate related contracts include forward foreign exchange contracts, currency swaps and options. A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; the exchange of principal can be notional or actual. A currency option gives the buyer, on payment of a premium, the right, but not the obligation, to sell specified amounts of currency at agreed rates of exchange on or before a specified future date.
- Credit derivatives, principally credit default swaps, are used by the Group as part of its trading activity and to manage its own exposure to credit risk. A credit default swap is a swap in which one counterparty receives a premium at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place. The Group also uses credit default swaps to securitise, in combination with external funding, £4,149 million (2009: £6,455 million) of corporate and commercial banking loans.
- Equity derivatives are also used by the Group as part of its equity based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

The fair values and notional amounts of derivative instruments are set out in the following table:

	2010			2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>The Group</b>						
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	212,832	2,513	2,242	139,295	1,571	1,594
Currency swaps	108,681	5,696	1,958	45,684	2,594	1,485
Options purchased	18,096	602	–	11,286	684	–
Options written	19,387	–	536	11,133	–	437
	<b>358,996</b>	<b>8,811</b>	<b>4,736</b>	207,398	4,849	3,516
Interest rate contracts:						
Interest rate swaps	1,399,197	28,448	29,504	507,684	9,727	10,588
Forward rate agreements	718,227	309	297	108,567	70	49
Options purchased	59,578	2,371	–	50,339	1,076	–
Options written	60,828	–	2,170	33,991	–	1,089
Futures	23,361	3	1	635	1	1
	<b>2,261,191</b>	<b>31,131</b>	<b>31,972</b>	701,216	10,874	11,727
Credit derivatives	7,108	256	207	15,869	1,558	433
Equity and other contracts	22,596	1,996	1,332	14,592	521	355
<b>Total derivative assets/liabilities held for trading</b>	<b>2,649,891</b>	<b>42,194</b>	<b>38,247</b>	939,075	17,802	16,031
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Cross currency swaps	9,418	606	35	–	–	–
Interest rate swaps (including swap options)	75,831	4,366	1,200	24,219	950	492
Options written	–	–	–	628	–	144
Derivatives designated as cash flow hedges:						
Cross currency swaps	17,745	232	121	–	–	–
Interest rate swaps	112,507	2,199	3,042	659	1	47
Futures	1,299	1	–	–	–	–
Derivatives designated as net investment hedges:						
Cross currency swaps	86	2	–	2,507	44	19
<b>Total derivative assets/liabilities held for hedging</b>	<b>216,886</b>	<b>7,406</b>	<b>4,398</b>	28,013	995	702
<b>Total recognised derivative assets/liabilities</b>	<b>2,866,777</b>	<b>49,600</b>	<b>42,645</b>	967,088	18,797	16,733

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17 Derivative financial instruments (continued)

**Hedged cash flows**

For designated cash flow hedges the following table shows when the Group's hedged cash flows are expected to occur and when they will affect income.

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
<b>2010</b>									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	76	246	427	478	373	329	131	143	2,203
Forecast payable cash flows	(85)	(34)	(137)	(82)	(58)	(175)	(286)	(57)	(914)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	76	287	387	478	373	345	136	121	2,203
Forecast payable cash flows	(85)	(79)	(92)	(82)	(58)	(244)	(248)	(26)	(914)
<b>2009</b>									
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	39	44	–	49	80	468	374	142	1,196
Forecast payable cash flows	(300)	(569)	(247)	(184)	(82)	(257)	(606)	(84)	(2,329)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	39	44	22	37	123	453	340	138	1,196
Forecast payable cash flows	(300)	(569)	(331)	(130)	(74)	(287)	(563)	(75)	(2,329)

At 31 December 2010 £42,303 million of total recognised derivative assets of the Group and £36,059 million of total recognised derivative liabilities of the Group (2009: £3,776 million of assets and £3,134 million of liabilities) had a contractual residual maturity of greater than one year.

	2010			2009		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
<b>The Bank</b>						
<b>Trading</b>						
Exchange rate contracts:						
Spot, forwards and futures	218,976	2,459	2,286	167,889	1,572	1,640
Currency swaps	60,551	1,903	1,343	47,703	1,804	1,504
Options purchased	18,228	601	–	11,272	685	–
Options written	19,435	–	539	11,152	–	439
	317,190	4,963	4,168	238,016	4,061	3,583
Interest rate contracts:						
Interest rate swaps	788,077	12,593	12,887	509,259	9,739	10,401
Forward rate agreements	12,872	83	84	108,567	70	48
Options purchased	46,624	1,933	–	48,083	1,068	–
Options written	40,665	–	1,626	34,368	–	1,101
Futures	1,883	–	–	4	–	1
	890,121	14,609	14,597	700,281	10,877	11,551
Credit derivatives	5,749	205	228	15,532	1,558	439
Equity and other contracts	9,970	589	589	10,368	489	484
<b>Total derivative assets/liabilities held for trading</b>	<b>1,223,030</b>	<b>20,366</b>	<b>19,582</b>	<b>964,197</b>	<b>16,985</b>	<b>16,057</b>
<b>Hedging</b>						
Derivatives designated as fair value hedges:						
Interest rate swaps (including swap options)	30,777	927	589	23,219	951	581
Options written	–	–	–	628	–	144
Derivatives designated as cash flow hedges:						
Interest rate swaps	1,597	29	89	659	1	47
<b>Total derivative assets/liabilities held for hedging</b>	<b>32,374</b>	<b>956</b>	<b>678</b>	<b>24,506</b>	<b>952</b>	<b>772</b>
<b>Total recognised derivative assets/liabilities</b>	<b>1,255,404</b>	<b>21,322</b>	<b>20,260</b>	<b>988,703</b>	<b>17,937</b>	<b>16,829</b>

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**17 Derivative financial instruments** (continued)

**Hedged cash flows**

For designated cash flow hedges the following table shows when the Bank's hedged cash flows are expected to occur and when they will affect income.

	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
<b>2010</b>									
Hedged forecast cash flows expected to occur:									
Forecast payable cash flows	(5)	(6)	(11)	(16)	(22)	(139)	–	–	(199)
Hedged forecast cash flows affect profit or loss:									
Forecast payable cash flows	(5)	(6)	(11)	(16)	(22)	(139)	–	–	(199)
	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
<b>2009</b>									
Hedged forecast cash flows expected to occur:									
Forecast payable cash flows	(2)	(9)	(13)	(13)	(7)	(7)	–	–	(51)
Hedged forecast cash flows affect profit or loss:									
Forecast payable cash flows	(2)	(9)	(13)	(13)	(7)	(7)	–	–	(51)

At 31 December 2010 £17,047 million of total recognised derivative assets of the Bank and £8,123 million of total recognised derivative liabilities of the Bank (2009: £2,478 million of assets and £4,225 million of liabilities) had a contractual residual maturity of greater than one year.

The principal amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group and Bank should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 55.

**18 Loans and advances to banks**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Lending to banks	1,042	153,826	146,585	169,882
Money market placements with banks	29,250	21,877	6,031	6,823
<b>Total loans and advances to banks before allowance for impairment losses</b>	<b>30,292</b>	<b>175,703</b>	<b>152,616</b>	<b>176,705</b>
Allowance for impairment losses (note 23)	(20)	(149)	(20)	(149)
<b>Total loans and advances to banks</b>	<b>30,272</b>	<b>175,554</b>	<b>152,596</b>	<b>176,556</b>

At 31 December 2010 £2,449 million (2009: £3,174 million) of loans and advances to banks of the Group and £22,258 million (2009: £3,789 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £4,185 million for the Group and £61,099 million for the Bank (2009: £4,188 million for the Group and Bank). Collateral is held with a fair value of £3,909 million for the Group and £61,926 million for the Bank (2009: £4,171 million for the Group and Bank), all of which the Group and Bank are able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £4 million for the Group and £nil for the Bank (2009: £nil for the Group and Bank).

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**19 Loans and advances to customers**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Agriculture, forestry and fishing	5,558	4,457	2,513	2,198
Energy and water supply	3,576	2,085	2,418	2,056
Manufacturing	11,495	8,807	7,217	7,880
Construction	7,904	2,842	3,017	2,427
Transport, distribution and hotels	34,176	12,280	10,982	10,357
Postal and telecommunications	1,908	833	893	790
Property companies	78,263	23,110	22,987	21,439
Financial, business and other services	59,363	32,889	24,036	27,200
Personal:				
Mortgages	356,261	115,349	98,938	101,922
Other	36,967	23,658	16,304	18,734
Lease financing	8,291	4,317	457	483
Hire purchase	7,208	5,224	523	528
Due from fellow Group undertakings	18,492	14,188	64,039	60,692
<b>Total loans and advances to customers before allowance for impairment losses</b>	<b>629,462</b>	<b>250,039</b>	<b>254,324</b>	<b>256,706</b>
Allowance for impairment losses (note 23)	(18,373)	(4,813)	(3,151)	(3,595)
<b>Total loans and advances to customers</b>	<b>611,089</b>	<b>245,226</b>	<b>251,173</b>	<b>253,111</b>

At 31 December 2010 £511,650 million (2009: £190,831 million) of loans and advances to customers of the Group and £170,780 million (2009: £163,944 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are reverse repurchase agreements treated as collateralised loans with a carrying value of £3,096 million for the Group and £517 million for the Bank (2009: £1,108 million for the Group and Bank). Collateral is held with a fair value of £2,987 million for the Group and £510 million for the Bank (2009: £1,110 million for the Group and Bank), all of which the Group and Bank are able to repledge.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of reverse repurchase agreements amounting to £42 million for the Group and £nil for the Bank (2009: £nil for the Group and Bank).

Loans and advances to customers include finance lease receivables, which may be analysed as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Gross investment in finance leases, receivable:				
Not later than 1 year	1,358	648	49	48
Later than 1 year and not later than 5 years	2,522	1,473	124	148
Later than 5 years	7,218	4,922	616	638
	11,098	7,043	789	834
Unearned future finance income on finance leases	(2,603)	(2,599)	(334)	(353)
Rentals received in advance	(183)	(119)	2	2
Commitments for expenditure in respect of equipment to be leased	(21)	(8)	-	-
<b>Net investment in finance leases</b>	<b>8,291</b>	<b>4,317</b>	<b>457</b>	<b>483</b>

The net investment in finance leases represents amounts recoverable as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Not later than 1 year	986	364	24	21
Later than 1 year and not later than 5 years	1,965	892	60	84
Later than 5 years	5,340	3,061	373	378
<b>Net investment in finance leases</b>	<b>8,291</b>	<b>4,317</b>	<b>457</b>	<b>483</b>

Equipment leased to customers under finance leases primarily relates to structured financing transactions to fund the purchase of aircraft, ships and other large individual value items. During 2010 and 2009 no contingent rentals in respect of finance leases were recognised in the income statement. The allowance for uncollectable finance lease receivables included in the allowance for impairment losses is £287 million for the Group (2009: £19 million).



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**19 Loans and advances to customers** (continued)

The unguaranteed residual values included in finance lease receivables were as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Not later than 1 year	11	4	1	–
Later than 1 year and not later than 5 years	44	46	17	17
Later than 5 years	6	5	–	–
<b>Total unguaranteed residual values</b>	<b>61</b>	<b>55</b>	<b>18</b>	<b>17</b>

**20 Securitisations and covered bonds**

**Securitisation programmes**

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by Group companies to bankruptcy remote special purpose entities (SPEs). As the SPEs are funded by the issue of debt on terms whereby the majority of risks and rewards of the portfolio are retained by the Group company, the SPEs are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue. In addition to the SPEs described below, the Group sponsors four conduit programmes, Argento, Cancara, Grampian and Landale.

**Covered bond programmes**

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans and the partnerships are consolidated fully with the loans retained on the Group's balance sheet, and the related covered bonds in issue included within debt securities in issue.

The Group's principal securitisation and covered bonds programmes, together with the balances of the loans subject to securitisation and the carrying value of the notes in issue at 31 December, are listed below. The notes in issue are reported in note 36.

	2010		2009	
	Gross assets securitised £m	Notes in issue £m	Gross assets securitised £m	Notes in issue £m
<b>Securitisation programmes<sup>1</sup></b>				
UK residential mortgages	146,200	114,428	49,390	36,470
Commercial loans	11,860	8,936	12,173	7,479
Irish residential mortgages	6,007	6,191	–	–
Credit card receivables	7,327	3,856	–	–
Dutch residential mortgages	4,526	4,316	–	–
Personal loans	3,012	2,011	–	–
PPP/PFI and project finance loans	776	110	877	45
Corporate loans and revolving credit facilities	–	–	595	7
Motor vehicle loans	926	975	–	–
	<b>180,634</b>	<b>140,823</b>	<b>63,035</b>	<b>44,001</b>
Less held by the Group		<b>(100,081)</b>		<b>(37,438)</b>
<b>Total securitisation programmes (note 36)</b>		<b>40,742</b>		<b>6,563</b>
<b>Covered bond programmes</b>				
Residential mortgage-backed	93,651	73,458	38,753	29,000
Social housing loan-backed	3,317	2,181	–	–
	<b>96,968</b>	<b>75,639</b>	<b>38,753</b>	<b>29,000</b>
Less held by the Group		<b>(43,489)</b>		<b>(29,000)</b>
<b>Total covered bond programmes (note 36)</b>		<b>32,150</b>		<b>–</b>
<b>Total securitisation and covered bond programmes</b>		<b>72,892</b>		<b>6,563</b>

<sup>1</sup>Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £36,579 million (2009: £7,209 million) held by the Group are restricted in use to repayment of the debt securities issued by the special purpose entities and other legal obligations.

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## 21 Special purpose entities

In addition to the special purpose entities discussed in note 20, which are used for securitisation and covered bond programmes, the Group sponsors four asset-backed conduits, Argento, Cancara, Grampian and Landale, which invest in debt securities and client receivables. All of the external assets in these conduits are consolidated in the Group's financial statements. The total consolidated exposures in these conduits are set out in the table below:

	Argento £m	Cancara £m	Grampian £m	Landale £m	Total £m
<b>At 31 December 2010</b>					
Loans and advances	–	3,957	–	–	3,957
Debt securities:					
Classified as loans and receivables:					
Asset-backed securities	1,448	–	6,957	–	8,405
Corporate and other debt securities	202	–	–	–	202
	<b>1,650</b>	<b>–</b>	<b>6,957</b>	<b>–</b>	<b>8,607</b>
Classified as available-for-sale financial assets (note 24):					
Asset-backed securities	1,436	2,587	–	–	4,023
Corporate and other debt securities	463	–	–	–	463
	<b>1,899</b>	<b>2,587</b>	<b>–</b>	<b>–</b>	<b>4,486</b>
<b>Total debt securities</b>	<b>3,549</b>	<b>2,587</b>	<b>6,957</b>	<b>–</b>	<b>13,093</b>
<b>Total assets</b>	<b>3,549</b>	<b>6,544</b>	<b>6,957</b>	<b>–</b>	<b>17,050</b>
<b>At 31 December 2009</b>					
Loans and advances	–	3,681	–	–	3,681
Debt securities:					
Classified as loans and receivables	–	15	–	–	15
Classified as available-for-sale financial assets – asset-backed securities (note 24)	–	5,382	–	–	5,382
<b>Total debt securities</b>	<b>–</b>	<b>5,397</b>	<b>–</b>	<b>–</b>	<b>5,397</b>
<b>Total assets</b>	<b>–</b>	<b>9,078</b>	<b>–</b>	<b>–</b>	<b>9,078</b>

### Other special purpose entities

During 2009, the Group established Lloyds TSB Pension ABCS (No 1) LLP and Lloyds TSB Pension ABCS (No 2) LLP and transferred approximately £5 billion of assets, primarily comprising notes in certain of the Group's securitisation programmes, in aggregate to these entities. Further details are provided in note 42.

## 22 Debt securities classified as loans and receivables

Debt securities accounted for as loans and receivables comprise:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Asset-backed securities:				
Mortgage-backed securities	11,650	600	653	590
Other asset-backed securities	12,827	313	99	518
Corporate and other debt securities	1,816	1,968	917	1,967
<b>Total debt securities classified as loans and receivables before allowance for impairment losses</b>	<b>26,293</b>	<b>2,881</b>	<b>1,669</b>	<b>3,075</b>
Allowance for impairment losses (see note 23)	(558)	(245)	(190)	(245)
<b>Total debt securities classified as loans and receivables</b>	<b>25,735</b>	<b>2,636</b>	<b>1,479</b>	<b>2,830</b>

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £1,386 million for the Group (2009: £nil); the value of the related liability is £1,043 million for the Group (2009: £nil). In all cases the transferee has the right to sell or repledge the assets concerned.

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**23 Allowance for impairment losses on loans and receivables**

<b>The Group</b>	<b>Loans and advances to customers £m</b>	<b>Loans and advances to banks £m</b>	<b>Debt securities £m</b>	<b>Total £m</b>
Balance at 1 January 2009	3,459	135	133	3,727
Exchange and other adjustments	(17)	17	4	4
Advances written off	(2,896)	–	–	(2,896)
Recoveries of advances written off in previous years	110	–	–	110
Unwinding of discount	(91)	–	–	(91)
Charge (credit) to the income statement	4,248	(3)	108	4,353
At 31 December 2009	4,813	149	245	5,207
Adjustment on transfer of HBOS	<b>9,988</b>	–	<b>185</b>	<b>10,173</b>
Exchange and other adjustments	<b>118</b>	<b>(5)</b>	<b>(1)</b>	<b>112</b>
Reclassifications	<b>(120)</b>	–	<b>120</b>	–
Advances written off	<b>(6,966)</b>	<b>(111)</b>	<b>(48)</b>	<b>(7,125)</b>
Recoveries of advances written off in previous years	<b>216</b>	–	–	<b>216</b>
Unwinding of discount	<b>(403)</b>	–	–	<b>(403)</b>
Charge (credit) to the income statement	<b>10,727</b>	<b>(13)</b>	<b>57</b>	<b>10,771</b>
<b>At 31 December 2010</b>	<b>18,373</b>	<b>20</b>	<b>558</b>	<b>18,951</b>

Of the Group's total allowance in respect of loans and advances to customers, £15,585 million (2009: £4,259 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the Group's total allowance in respect of loans and advances to customers, £6,076 million (2009: £3,254 million) was assessed on a collective basis.

<b>The Bank</b>	<b>Loans and advances to customers £m</b>	<b>Loans and advances to banks £m</b>	<b>Debt securities £m</b>	<b>Total £m</b>
Balance at 1 January 2009	2,700	135	133	2,968
Exchange and other adjustments	(20)	17	(1)	(4)
Advances written off	(2,619)	–	–	(2,619)
Recoveries of advances written off in previous years	107	–	–	107
Unwinding of discount	(98)	–	–	(98)
Charge (credit) to the income statement	3,525	(3)	113	3,635
At 31 December 2009	3,595	149	245	3,989
Exchange and other adjustments	<b>15</b>	<b>(5)</b>	<b>(5)</b>	<b>5</b>
Reclassifications	<b>(120)</b>	–	<b>120</b>	–
Advances written off	<b>(2,772)</b>	<b>(111)</b>	<b>(187)</b>	<b>(3,070)</b>
Recoveries of advances written off in previous years	<b>159</b>	–	–	<b>159</b>
Unwinding of discount	<b>(93)</b>	–	–	<b>(93)</b>
Charge (credit) to the income statement	<b>2,367</b>	<b>(13)</b>	<b>17</b>	<b>2,371</b>
<b>At 31 December 2010</b>	<b>3,151</b>	<b>20</b>	<b>190</b>	<b>3,361</b>

Of the Bank's total allowance in respect of loans and advances to customers, £2,755 million (2009: £3,081 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the Bank's total allowance in respect of loans and advances to customers, £1,450 million (2009: £2,238 million) was assessed on a collective basis.

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**24 Available-for-sale financial assets**

	2010			2009		
	Conduits £m	Other £m	Total £m	Conduits £m	Other £m	Total £m
<b>The Group</b>						
Debt securities:						
Government securities	–	12,552	12,552	–	8,342	8,342
Other public sector securities	–	29	29	–	31	31
Bank and building society certificates of deposit	–	407	407	–	729	729
Asset-backed securities:						
Mortgage-backed securities	3,203	1,090	4,293	3,481	1,283	4,764
Other asset-backed securities	820	4,399	5,219	1,901	5,660	7,561
Corporate and other debt securities	463	11,669	12,132	–	2,049	2,049
	<b>4,486</b>	<b>30,146</b>	<b>34,632</b>	5,382	18,094	23,476
Equity shares:						
Listed	–	72	72	–	4	4
Unlisted	–	2,183	2,183	–	77	77
	–	2,255	2,255	–	81	81
Treasury bills and similar securities	–	6,068	6,068	–	2,532	2,532
<b>Total available-for-sale financial assets</b>	<b>4,486</b>	<b>38,469</b>	<b>42,955</b>	5,382	20,707	26,089

	2010 £m	2009 £m
<b>The Bank</b>		
Debt securities:		
Government securities	12,405	8,200
Other public sector securities	29	31
Bank and building society certificates of deposit	272	463
Asset-backed securities:		
Mortgage-backed securities	971	1,080
Other asset-backed securities	1,254	2,122
Corporate and other debt securities	6,023	1,471
	<b>20,954</b>	13,367
Equity shares:		
Listed	4	1
Unlisted	69	75
	73	76
Treasury bills and similar securities	3,924	71
<b>Total available-for-sale financial assets</b>	<b>24,951</b>	13,514

Details of the Group's asset-backed conduits shown in the table above are included in note 21.

Further information on asset-backed security exposures is provided in note 54.

At 31 December 2010 £38,967 million (2009: £21,352 million) of available-for-sale financial assets of the Group and £26,518 million (2009: £12,546 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are assets subject to repurchase agreements with a carrying value of £1,467 million for the Group (2009: £nil); the value of the related liability is £1,378 million for the Group (2009: £nil). In all cases the transferee has the right to sell or repledge the assets concerned.

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2h(2). Included in available-for-sale financial assets at 31 December 2010 are debt securities individually determined to be impaired whose gross amount before impairment allowances was £2 million (2009: £32 million) and in respect of which no collateral was held.

At 31 December 2010, the Bank had sold £254 million (2009: £1,277 million) of debt securities to two of its subsidiary undertakings; however the related agreements are such that the Bank has retained substantially all of the risks and rewards of ownership and, as a consequence, the debt securities continue to be recognised on the Bank's balance sheet.

With effect from 1 November 2010, the Bank transferred £3,601 million of government securities from available-for-sale financial assets to held-to-maturity investments (see note 25). Further information on the reclassification of financial assets is provided in note 54.

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**25 Held-to-maturity investments**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Debt securities: government securities	<b>7,905</b>	–	<b>7,905</b>	–

During 2010, the Bank and the Group reclassified £3,601 million of government securities from available-for-sale financial assets to held-to-maturity investments (note 24).

**26 Investment properties of the Group**

	2010 £m	2009 £m
At 1 January	2,340	2,631
Adjustment on transfer of HBOS (note 31)	2,417	–
Exchange and other adjustments	(6)	(15)
Additions:		
Acquisitions of new properties	398	82
Consolidation of new subsidiary undertakings	921	–
Additional expenditure on existing properties	52	67
Total additions	1,371	149
Disposals	(559)	(280)
Changes in fair value (note 7)	434	(145)
<b>At 31 December</b>	<b>5,997</b>	<b>2,340</b>

The investment properties are valued at least annually at open-market value, by independent, professionally qualified valuers, who have recent experience in the location and categories of the investment properties being valued.

In addition the following amounts have been recognised in the income statement:

	2010 £m	2009 £m
Rental income	337	180
Direct operating expenses arising from investment properties that generate rental income	77	37

Capital expenditure in respect of investment properties:

	2010 £m	2009 £m
Capital expenditure contracted for at the balance sheet date but not recognised in the financial statements	86	9

**27 Goodwill of the Group**

	2010 £m	2009 £m
At 1 January	2,016	2,256
Impairment charged to the income statement	–	(240)
<b>At 31 December</b>	<b>2,016</b>	<b>2,016</b>
Cost <sup>1</sup>	2,362	2,362
Accumulated impairment losses	(346)	(346)
<b>At 31 December</b>	<b>2,016</b>	<b>2,016</b>

<sup>1</sup>For acquisitions made prior to 1 January 2004, the date of transition to IFRS, cost is included net of amounts amortised up to 31 December 2003.

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (31 December 2009: £2,016 million), £1,836 million (or 91 per cent of the total) has been allocated to Scottish Widows and £170 million (or 8 per cent of the total) to Asset Finance.

The recoverable amount of Scottish Widows has been based on a value-in-use calculation. The calculation uses projections of future cash flows based upon budgets and plans approved by management covering a five-year period, and a discount rate of 12 per cent (gross of tax). The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. Cash flows beyond the five-year period have been extrapolated using a steady 3 per cent growth rate which does not exceed the long-term average growth rate for the life assurance market. Management believes that any reasonably possible change in the key assumptions would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

## 27 Goodwill of the Group (continued)

In 2009, the markets in which the Consumer Finance unit of Asset Finance operate had deteriorated further with both macroeconomic and market conditions worsening, leading to a fall off in demand and increasing arrears. This, together with continuing uncertainties over the likely short-term macroeconomic environment, had resulted in a reassessment of the carrying value of the consumer finance cash generating unit and the recognition of a goodwill impairment charge of £240 million during 2009, reflecting the write down of the entire balance of goodwill allocated to the Consumer Finance unit of Asset Finance and leaving goodwill of £170 million in the Autolease unit of Asset Finance.

The recoverable amount of Asset Finance has also been based on a value in use calculation using cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 15 per cent (gross of tax). The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Asset Finance participates.

## 28 Value of in-force business of the Group

The gross value of in-force business asset in the consolidated balance sheet is as follows:

	2010 £m	2009 £m
Acquired value of in-force non-participating investment contracts	1,469	–
Value of in-force insurance and participating investment contracts	5,898	2,403
<b>Total value of in-force business</b>	<b>7,367</b>	<b>2,403</b>

The movement in the acquired value of in-force non-participating investment contracts over the year is as follows:

	2010 £m	2009 £m
At 1 January	–	–
Adjustment on transfer of HBOS (note 31)	1,545	–
Amortisation taken to income statement (note 11)	(76)	–
<b>At 31 December</b>	<b>1,469</b>	<b>–</b>

The acquired value of in-force non-participating investment contracts includes £356 million (2009: £nil) in relation to OEIC business.

The movement in the value of in-force insurance and participating investment contracts over the year is as follows:

	2010 £m	2009 £m
At 1 January	2,403	1,893
Adjustment on transfer of HBOS (note 31)	2,737	–
Exchange and other adjustments	(31)	–
Movements in the year:		
New business	497	201
Existing business:		
Expected return	(400)	(111)
Experience variances	85	(28)
Non-economic assumption changes	306	16
Economic variance	301	432
Movement in the value of in-force business taken to income statement (note 9)	789	510
<b>At 31 December</b>	<b>5,898</b>	<b>2,403</b>

This breakdown shows the movement in the value of in-force business only, and does not represent the full contribution that each item in the breakdown contributes to profit before tax, which would also contain changes in the other assets and liabilities of the relevant businesses. Economic variance is the element of earnings which is generated from changes to economic experience in the period and to economic assumptions over time. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

The principal features of the methodology and process used for determining key assumptions used in the calculation of the value of in-force business are set out below:

### *Economic assumptions*

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate.

A market consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. The risk-free rate used for the value of financial options and guarantees is defined as the spot yield derived from the relevant government bond yield curve in line with FSA realistic balance sheet assumptions.

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**28 Value of in-force business of the Group** (continued)

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. 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 these corporate bond holdings. The illiquidity premium is estimated to be 75 basis points as at 31 December 2010 (31 December 2009: 75 basis points).

The risk-free rate assumed in valuing the non-annuity in-force business is the 15 year government bond yield for the appropriate territory. The risk-free rate assumed in valuing the in-force asset for the UK annuity business is presented as a single risk free rate to allow a better comparison to the rate used for other business. That single risk-free rate has been derived to give the equivalent value to the UK annuity book, had that book been valued using the UK gilt yield curve increased to reflect the illiquidity premium described above.

The table below shows the resulting range of yields and other key assumptions at 31 December for UK business:

	2010 %	2009 %
Risk-free rate (value of in-force non-annuity business)	<b>3.99</b>	4.45
Risk-free rate (value of in-force annuity business)	<b>4.66</b>	5.05
Risk-free rate (financial options and guarantees)	<b>0.63 to 4.50</b>	0.87 to 4.76
Retail price inflation	<b>3.56</b>	3.64
Expense inflation	<b>4.20</b>	4.42

*Non-market risk*

An allowance for non-market risk is made through the choice of best estimate assumptions based upon experience, which generally will give the mean expected financial outcome for shareholders and hence no further allowance for non-market risk is required. However, in the case of operational risk, reinsurer default and the with-profit fund these can be asymmetric in the range of potential outcomes for which an explicit allowance is made.

*Non-economic assumptions*

Future mortality, morbidity, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of future experience. These assumptions are intended to represent a best estimate of future experience.

Further information about the effect of changes in key assumptions is given in note 38.

**29 Other intangible assets**

	The Group					The Bank	
	Brands £m	Core deposit intangibles £m	Purchased credit card relation- ships £m	Customer related intangibles £m	Capitalised software enhance- ments £m	Total £m	Capitalised software enhance- ments £m
Cost:							
At 1 January 2009	–	–	–	63	320	383	221
Additions	–	–	–	–	60	60	38
Disposals	–	–	–	–	(69)	(69)	(69)
At 31 December 2009	–	–	–	63	311	374	190
Adjustment on transfer of HBOS (note 31)	<b>596</b>	<b>2,770</b>	<b>300</b>	<b>814</b>	<b>175</b>	<b>4,655</b>	–
Additions	–	–	–	–	154	154	42
Disposals	–	–	–	–	(30)	(30)	–
<b>At 31 December 2010</b>	<b>596</b>	<b>2,770</b>	<b>300</b>	<b>877</b>	<b>610</b>	<b>5,153</b>	<b>232</b>
Accumulated amortisation:							
At 1 January 2009	–	–	–	12	174	186	121
Charge for the year	–	–	–	6	46	52	27
Disposals	–	–	–	–	(69)	(69)	(69)
At 31 December 2009	–	–	–	18	151	169	79
Adjustment on transfer of HBOS (note 31)	<b>21</b>	<b>393</b>	<b>58</b>	<b>219</b>	<b>84</b>	<b>775</b>	–
Charge for the year	<b>25</b>	<b>400</b>	<b>60</b>	<b>161</b>	<b>75</b>	<b>721</b>	<b>35</b>
Disposals	–	–	–	–	(8)	(8)	–
<b>At 31 December 2010</b>	<b>46</b>	<b>793</b>	<b>118</b>	<b>398</b>	<b>302</b>	<b>1,657</b>	<b>114</b>
<b>Balance sheet amount at 31 December 2010</b>	<b>550</b>	<b>1,977</b>	<b>182</b>	<b>479</b>	<b>308</b>	<b>3,496</b>	<b>118</b>
Balance sheet amount at 31 December 2009	–	–	–	45	160	205	111

Included within brands above are assets of £380 million (31 December 2009: £nil) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not continue indefinitely.

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

Capitalised software enhancements of the Bank and the Group principally comprise identifiable and directly associated internal staff and other costs.

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30 Tangible fixed assets

	The Group				The Bank		
	Premises £m	Equipment £m	Operating lease assets £m	Total tangible fixed assets £m	Premises £m	Equipment £m	Total tangible fixed assets £m
Cost:							
At 1 January 2009	1,516	3,148	1,564	6,228	1,160	2,720	3,880
Exchange and other adjustments	–	(28)	358	330	(2)	(8)	(10)
Additions	53	1,200	584	1,837	49	354	403
Disposals	(25)	(93)	(422)	(540)	(23)	(83)	(106)
At 31 December 2009	1,544	4,227	2,084	7,855	1,184	2,983	4,167
Adjustment on transfer of HBOS (note 31)	<b>917</b>	<b>1,108</b>	<b>4,299</b>	<b>6,324</b>	–	–	–
Exchange and other adjustments	<b>26</b>	<b>34</b>	<b>(76)</b>	<b>(16)</b>	–	<b>(5)</b>	<b>(5)</b>
Additions	<b>175</b>	<b>754</b>	<b>1,672</b>	<b>2,601</b>	<b>102</b>	<b>431</b>	<b>533</b>
Disposals	<b>(222)</b>	<b>(338)</b>	<b>(1,693)</b>	<b>(2,253)</b>	<b>(13)</b>	<b>(58)</b>	<b>(71)</b>
Disposal of businesses	–	<b>(1,005)</b>	–	<b>(1,005)</b>	–	–	–
<b>At 31 December 2010</b>	<b>2,440</b>	<b>4,780</b>	<b>6,286</b>	<b>13,506</b>	<b>1,273</b>	<b>3,351</b>	<b>4,624</b>
Accumulated depreciation and impairment:							
At 1 January 2009	789	2,208	266	3,263	700	1,847	2,547
Exchange and other adjustments	–	(4)	108	104	(3)	(4)	(7)
Depreciation charge for the year	83	265	333	681	72	240	312
Disposals	(18)	(49)	(251)	(318)	(18)	(41)	(59)
At 31 December 2009	854	2,420	456	3,730	751	2,042	2,793
Adjustment on transfer of HBOS (note 31)	<b>30</b>	<b>378</b>	<b>805</b>	<b>1,213</b>	–	–	–
Exchange and other adjustments	<b>2</b>	<b>(3)</b>	<b>30</b>	<b>29</b>	<b>(2)</b>	<b>(3)</b>	<b>(5)</b>
Impairment charged to the income statement (note 11)	–	<b>202</b>	–	<b>202</b>	–	–	–
Depreciation charge for the year	<b>146</b>	<b>535</b>	<b>954</b>	<b>1,635</b>	<b>78</b>	<b>260</b>	<b>338</b>
Disposals	<b>(31)</b>	<b>(341)</b>	<b>(976)</b>	<b>(1,348)</b>	<b>(8)</b>	<b>(25)</b>	<b>(33)</b>
Disposal of businesses	–	<b>(145)</b>	–	<b>(145)</b>	–	–	–
<b>At 31 December 2010</b>	<b>1,001</b>	<b>3,046</b>	<b>1,269</b>	<b>5,316</b>	<b>819</b>	<b>2,274</b>	<b>3,093</b>
<b>Balance sheet amount at 31 December 2010</b>	<b>1,439</b>	<b>1,734</b>	<b>5,017</b>	<b>8,190</b>	<b>454</b>	<b>1,077</b>	<b>1,531</b>
Balance sheet amount at 31 December 2009	690	1,807	1,628	4,125	433	941	1,374

At 31 December the future minimum rentals receivable by the Group under non-cancellable operating leases were as follows:

	2010 £m	2009 £m
Receivable within 1 year	<b>1,168</b>	418
1 to 5 years	<b>1,791</b>	562
Over 5 years	<b>638</b>	37
<b>Total future minimum rentals receivable</b>	<b>3,597</b>	1,017

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2009 and 2010 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £55 million for the Group and £44 million for the Bank at 31 December 2010 (£72 million for the Group and £64 million for the Bank at 31 December 2009) is expected to be received under non-cancellable sub-leases of premises.

The impairment charge of £202 million comprises £150 million relating to oil drilling rigs under construction acquired from a previous lending relationship in Wholesale (see note 14) and £52 million relating to integration activities.



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**31 Investment in subsidiary undertakings of the Bank**

	<b>2010</b>	2009
	<b>£m</b>	£m
At 1 January	<b>15,960</b>	15,992
Transfer of HBOS (see below)	<b>21,394</b>	–
Additional capital injections and transfers	<b>2,819</b>	1
Disposals	<b>(18)</b>	(33)
<b>At 31 December</b>	<b>40,155</b>	15,960

The principal group undertakings, all of which have prepared accounts to 31 December and whose results are included in the consolidated accounts of Lloyds TSB Bank plc, are:

	Country of registration/ incorporation	Percentage of equity share capital and voting rights held	Nature of business
Lloyds TSB Scotland plc	Scotland	100%	Banking and financial services
Scottish Widows plc	Scotland	100% <sup>1</sup>	Life assurance
HBOS plc	Scotland	100%	Holding company
Bank of Scotland plc	Scotland	100% <sup>1</sup>	Banking and financial services
HBOS Insurance & Investment Group Limited	England	100% <sup>1</sup>	Holding company
St. Andrew's Insurance plc	England	100% <sup>1</sup>	General insurance
Clerical Medical Investment Group Limited	England	100% <sup>1</sup>	Life assurance
Clerical Medical Managed Funds Limited	England	100% <sup>1</sup>	Life assurance

<sup>1</sup>Indirect interest.

The principal area of operation for each of the above group undertakings is the United Kingdom.

In November 2009, as part of the restructuring plan that was a requirement for European Union approval of state aid received, Lloyds Banking Group agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. The Group has agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, subsidiaries may be prevented from making dividend payments on ordinary shares during this period. In addition, certain subsidiary companies currently have insufficient distributable reserves to make dividend payments.

Subject to the foregoing, there were no further significant restrictions on any of the Bank's subsidiaries in paying dividends or repaying loans and advances. All regulated banking and insurance subsidiaries are required to maintain capital at levels agreed with the regulators; this may impact those subsidiaries' ability to make distributions.

**Transfer of HBOS**

On 1 January 2010, as part of a restructuring of the Lloyds Banking Group, Lloyds Banking Group plc's investment in 100 per cent of the ordinary share capital of HBOS plc was transferred to Lloyds TSB Bank plc for a consideration of £21,394 million. The consideration was satisfied by the issue of 21.4 million ordinary shares in Lloyds TSB Bank plc to Lloyds Banking Group plc.

In accordance with the accounting treatment available under IFRS 3 (Revised) for business combinations involving entities under common control, Lloyds TSB Bank plc was not required to fair value the acquired business at the date of transfer. Instead, the assets and liabilities were incorporated at the amounts at which they were recorded within Lloyds Banking Group at that date. The difference between the consolidated net asset value of HBOS plc at the date of transfer and the consideration paid, which was equal to Lloyds Banking Group plc's original cost of investment, has been credited to a merger reserve.

The post-transfer impact of HBOS plc on the Group's consolidated income statement for the year ended 31 December 2010 was as follows:

Net interest income	<b>7,757</b>
Other income	<b>16,431</b>
Total income	<b>24,188</b>
Insurance claims	<b>(9,125)</b>
Total income, net of insurance claims	<b>15,063</b>
Operating expenses	<b>(6,260)</b>
Trading surplus	<b>8,803</b>
Impairment	<b>(8,108)</b>
Share of results of joint ventures and associates	<b>(94)</b>
Profit before tax	<b>601</b>

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**31 Investment in subsidiary undertakings of the Bank** (continued)

The consolidated balance sheet of HBOS plc at the date of transfer, with assets and liabilities incorporated at the amounts at which they were recorded within Lloyds Banking Group, was as follows:

	£m
<b>Assets</b>	
Cash and balances at central banks	2,905
Items in course of collection from banks	534
Trading and other financial assets at fair value through profit or loss	101,119
Derivative financial instruments	30,919
Loans and receivables:	
Loans and advances to banks	9,928
Loans and advances to customers	395,931
Debt securities	30,016
	435,875
Available-for-sale financial assets	21,459
Investment properties	2,417
Investments in joint ventures and associates	423
Value of in-force business	4,282
Other intangible assets	3,880
Tangible fixed assets	5,111
Current tax recoverable	495
Deferred tax assets	2,811
Retirement benefit assets	67
Amounts due from fellow Lloyds Banking Group undertakings	92,679
Other assets	7,235
<b>Total assets</b>	712,211
<b>Equity and liabilities</b>	
Deposits from other banks	29,600
Customer deposits	232,091
Items in course of transmission to banks	495
Trading and other financial liabilities at fair value through profit or loss	21,909
Derivative financial instruments	25,801
Notes in circulation	981
Debt securities in issue	112,815
Liabilities arising from insurance contracts and participating investment contracts	39,231
Liabilities arising from non-participating investment contracts	30,614
Unallocated surplus within insurance businesses	772
Amounts due to fellow Lloyds Banking Group undertakings	156,098
Other liabilities	17,092
Retirement benefit obligations	373
Current tax liabilities	29
Deferred tax liabilities	208
Other provisions	436
Subordinated liabilities	14,653
<b>Total liabilities</b>	683,198
<b>Equity</b>	
Shareholders' equity	27,742
Non-controlling interests	1,271
<b>Total equity</b>	29,013
<b>Total equity and liabilities</b>	712,211

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**32 Other assets**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets arising from reinsurance contracts held (notes 37 and 39)	2,146	419	–	–
Deferred acquisition and origination costs (see below)	602	188	–	–
Settlement balances	985	152	236	13
Other assets and prepayments	8,699	4,223	1,007	803
<b>Total other assets</b>	<b>12,432</b>	<b>4,982</b>	<b>1,243</b>	<b>816</b>
			<b>2010</b>	2009
			<b>£m</b>	<b>£m</b>
Deferred acquisition and origination costs of the Group:				
At 1 January			188	196
Adjustment on transfer of HBOS (note 31)			345	–
Acquisition and origination costs deferred, net of amounts amortised to the income statement			69	(8)
<b>At 31 December</b>			<b>602</b>	<b>188</b>

**33 Deposits from banks**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Liabilities in respect of securities sold under repurchase agreements	24,017	48,803	19,064	48,803
Other deposits from banks	26,346	90,754	99,273	111,625
<b>Total deposits from banks</b>	<b>50,363</b>	<b>139,557</b>	<b>118,337</b>	<b>160,428</b>

At 31 December 2010 £11,453 million (2009: £911 million) of deposits from banks of the Group and £10,562 million (2009: £2,769 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £22,420 million (2009: £nil) for the Group and £36,886 million for the Bank (2009: £nil) and a fair value of £25,626 million (2009: £nil for the Group and Bank).

**34 Customer deposits**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Non-interest bearing current accounts	22,897	6,793	16,438	6,272
Interest bearing current accounts	77,785	47,738	39,291	45,109
Savings and investment accounts	222,226	75,682	72,376	67,168
Liabilities in respect of securities sold under repurchase agreements	11,145	224	3,033	226
Other customer deposits	82,223	62,608	92,674	82,278
<b>Total customer deposits</b>	<b>416,276</b>	<b>193,045</b>	<b>223,812</b>	<b>201,053</b>

At 31 December 2010 £57,124 million (2009: £19,005 million) of customer deposits of the Group and £36,636 million (2009: £22,928 million) of the Bank had a contractual residual maturity of greater than one year.

Included in the amounts reported above are deposits held as collateral for facilities granted, with a carrying value of £11,112 million (2009: £nil) for the Group and £3,033 million for the Bank (2009: £nil) and a fair value of £11,278 million (2009: £nil) for the Group and £3,023 million (2009: £nil) for the Bank.

Included in the amounts reported above are collateral balances in the form of cash provided in respect of repurchase agreements amounting to £122 million (2009: £nil) for the Group and £nil for the Bank (2009: £nil).

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**35 Trading and other financial liabilities at fair value through profit or loss**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Liabilities held at fair value through profit or loss (debt securities)	<b>6,665</b>	6,160	<b>6,665</b>	6,160
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	<b>14,612</b>	–	–	–
Short positions in securities	<b>1,755</b>	202	<b>894</b>	202
Other	<b>3,730</b>	–	<b>3,709</b>	–
	<b>20,097</b>	202	<b>4,603</b>	202
<b>Trading and other financial liabilities at fair value through profit or loss</b>	<b>26,762</b>	6,362	<b>11,268</b>	6,362

At 31 December 2010, for both the Group and the Bank, £8,627 million (2009: £4,057 million) of trading and other liabilities at fair value through profit or loss had a contractual residual maturity of greater than one year.

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2010 was £6,607 million (2009: £5,866 million), which was £58 million lower than the balance sheet carrying value (2009: £294 million lower). At 31 December 2010 there was a cumulative £11 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of the Bank. Of the £11 million increase, none arose in 2010 and £11 million arose in 2009.

Liabilities designated at fair value through profit or loss represent debt securities in issue which either contain substantive embedded derivatives which would otherwise need to be recognised and measured at fair value separately from the related debt securities, or which are accounted for at fair value to significantly reduce an accounting mismatch.

**36 Debt securities in issue**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Medium-term notes issued	<b>80,426</b>	47,786	<b>56,747</b>	47,791
Covered bonds (note 20)	<b>32,150</b>	–	<b>4,642</b>	–
Certificates of deposit issued	<b>42,276</b>	44,508	<b>39,246</b>	44,494
Securitisation notes (note 20)	<b>40,742</b>	6,563	<b>5,658</b>	3,404
Commercial paper	<b>32,723</b>	21,862	<b>8,829</b>	14,181
<b>Total debt securities in issue</b>	<b>228,317</b>	120,719	<b>115,122</b>	109,870

At 31 December 2010 £118,296 million (2009: £52,690 million) of debt securities in issue of the Group and £48,781 million (2009: £49,554 million) of the Bank had a contractual residual maturity of greater than one year.

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**37 Liabilities of the Group arising from insurance contracts and participating investment contracts**

Insurance contract and participating investment contract liabilities are comprised as follows:

	2010			2009		
	Gross £m	Reinsurance <sup>1</sup> £m	Net £m	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	61,891	(2,044)	59,847	24,077	(405)	23,672
Participating investment contracts	17,642	–	17,642	12,273	–	12,273
	<b>79,533</b>	<b>(2,044)</b>	<b>77,489</b>	36,350	(405)	35,945
Non-life insurance contracts (see (2) below):						
Unearned premiums	632	(22)	610	387	(11)	376
Claims outstanding	584	(15)	569	223	(3)	220
	<b>1,216</b>	<b>(37)</b>	<b>1,179</b>	610	(14)	596
<b>Total</b>	<b>80,749</b>	<b>(2,081)</b>	<b>78,668</b>	36,960	(419)	36,541

<sup>1</sup>Reinsurance balances are reported within other assets (note 32).

At 31 December 2010 £71,719 million (2009: £33,303 million) of liabilities arising from insurance contracts and participating investment contracts had a contractual residual maturity of greater than one year.

**(1) Life insurance**

The movement in life insurance contract and participating investment contract liabilities over the year can be analysed as follows:

	Insurance contracts	Participating investment contracts	Gross £m	Reinsurance £m	Net £m
	At 1 January 2009	21,553	11,619	33,172	(380)
New business	2,182	98	2,280	(27)	2,253
Changes in existing business	342	556	898	2	900
Change in liabilities charged to the income statement (note 10)	2,524	654	3,178	(25)	3,153
At 31 December 2009	24,077	12,273	36,350	(405)	35,945
Adjustment on transfer of HBOS (note 31)	32,735	5,815	38,550	(1,427)	37,123
New business	3,807	325	4,132	(48)	4,084
Changes in existing business	1,348	(858)	490	(208)	282
Change in liabilities charged to the income statement (note 10)	5,155	(533)	4,622	(256)	4,366
Exchange and other adjustments	(76)	87	11	44	55
<b>At 31 December 2010</b>	<b>61,891</b>	<b>17,642</b>	<b>79,533</b>	<b>(2,044)</b>	<b>77,489</b>

Liabilities for life insurance contracts and participating investment contracts can be split into with-profit fund liabilities, accounted for using the FSA's realistic capital regime (realistic liabilities) and non-profit fund liabilities, accounted for using a prospective actuarial discounted cash flow methodology, as follows:

	2010			2009		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	13,617	48,274	61,891	7,641	16,436	24,077
Participating investment contracts	10,648	6,994	17,642	5,720	6,553	12,273
<b>Total</b>	<b>24,265</b>	<b>55,268</b>	<b>79,533</b>	13,361	22,989	36,350

### 37 Liabilities of the Group arising from insurance contracts and participating investment contracts (continued)

#### **With-profit fund realistic liabilities**

##### **(i) Business description**

The Group has with-profit funds within Scottish Widows plc and Clerical Medical Investment Group Limited containing both insurance contracts and participating investment contracts.

The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a long-term smoothed investment vehicle to the policyholders, protecting them against short-term market fluctuations. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at maturity.

##### **(ii) Method of calculation of liabilities**

With-profit liabilities are stated at their realistic value, the main components of which are:

- With-profit benefit reserve, the total asset shares for with-profit policies;
- Cost of options and guarantees;
- Deductions levied against asset shares;
- Planned enhancements to with-profits benefits reserve; and
- Impact of the smoothing policy.

The realistic assessment is carried out using a stochastic simulation model which values liabilities on a market-consistent basis. The calculation of realistic liabilities uses best estimate assumptions for mortality, persistency rates and expenses. These are calculated in a similar manner to those used for the value of in-force business as discussed in note 28.

##### **(iii) Assumptions**

Key assumptions used in the calculation of with-profit liabilities, and the processes for determining these, are:

#### **Investment returns and discount rates**

The realistic capital regime dictates that with-profit fund liabilities are valued on a market-consistent basis. This is achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant government bond yield curve.

#### **Guaranteed annuity option take-up rates**

Certain pension contracts contain guaranteed annuity options that allow the policyholder to take an annuity benefit on retirement at annuity rates that were guaranteed at the outset of the contract. For contracts that contain such options, key assumptions in determining the costs of the options are economic conditions in which the option has value, mortality rates and take-up rates of other options. The financial impact is dependent on the value of corresponding investments, interest rates and longevity at the time of the claim.

#### **Investment volatility**

The calibration of the stochastic simulation model uses implied volatilities of derivatives where possible, or historical volatility where it is not possible to observe meaningful prices.

#### **Mortality**

The mortality assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this is significant, and relevant industry data otherwise.

### 37 Liabilities of the Group arising from insurance contracts and participating investment contracts (continued)

#### Lapse rates (persistence)

Lapse rates refer to the rate of policy termination or the rate at which policyholders stop paying regular premiums due under the contract.

Historical persistence experience is analysed using statistical techniques. As experience can vary considerably between different product types and for contracts that have been in force for different periods, the data is broken down into broadly homogenous groups for the purposes of this analysis.

The most recent experience is considered along with the results of previous analyses and management's views on future experience, taking into consideration potential changes in future experience that may result from guarantees and options becoming more valuable under adverse market conditions, in order to determine a 'best estimate' view of what persistence will be. In determining this best estimate view a number of factors are considered, including the credibility of the results (which will be affected by the volume of data available), any exceptional events that have occurred during the period under consideration, any known or expected trends in underlying data and relevant published market data.

#### Non-profit fund liabilities

##### (i) Business description

The Group principally writes the following types of life insurance contracts within its non-profit funds. Shareholder profits on these types of business arise from management fees and other policy charges.

Unit-linked business – This includes unit-linked pensions and unit-linked bonds, the primary purpose of which is to provide an investment vehicle where the policyholder is also insured against death.

Life insurance – The policyholder is insured against death or permanent disability, usually for predetermined amounts. Such business includes whole-of-life and term assurance and long-term creditor policies.

Annuities – The policyholder is entitled to payments for the duration of their life and is therefore insured against surviving longer than expected.

German insurance business is written through the Group's subsidiary Heidelberger Leben and comprises policies similar to the UK definitions above, except that there is participation by the policyholder in the investment, insurance and expense profits of Heidelberger Leben. A minimum level of policyholder participation is prescribed by German Law. The following types of life insurance contracts are written:

- Traditional or unit linked endowment or pensions business; and
- Life insurance business

##### (ii) Method of calculation of liabilities

The non-profit fund liabilities are determined on the basis of recognised actuarial methods and consistent with the approach required by regulatory rules. The methods used involve estimating future policy cash flows over the duration of the in-force book of policies, and discounting the cash flows back to the valuation date allowing for probabilities of occurrence.

##### (iii) Assumptions

Generally, assumptions used to value non-profit fund liabilities are prudent in nature and therefore contain a margin for adverse deviation. This margin for adverse deviation is based on management's judgement and reflects management's views on the inherent level of uncertainty. The key assumptions used in the measurement of non-profit fund liabilities are:

#### Interest rates

The rates used are derived in accordance with the guidelines set by local regulatory bodies. These limit the rates of interest that can be used by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

Margins for risk are allowed for in the assumed interest rates. These are derived from the limits in the guidelines set by local regulatory bodies, including reductions made to the available yields to allow for default risk based upon the credit rating of the securities allocated to the insurance liability.

#### Mortality and morbidity

The mortality and morbidity assumptions, including allowances for improvements in longevity for annuitants, are set with regard to the Group's actual experience where this provides a reliable basis, and relevant industry data otherwise, and include a margin for adverse deviation. For German business appropriate industry tables have been considered.

**37 Liabilities of the Group arising from insurance contracts and participating investment contracts** (continued)

**Lapse rates (persistence)**

Lapse rates are allowed for on some non-profit fund contracts. The process for setting these rates is as described for with-profit liabilities, however a prudent scenario is assumed by the inclusion of a margin for adverse deviation within the non-profit fund liabilities.

**Maintenance expenses**

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation. For German business appropriate cost assumptions have been set in accordance with the rules of the local regulatory body.

**Key changes in assumptions**

A detailed review of the Group's assumptions in 2010 resulted in the following key impacts on profit before tax:

- Change in persistence assumptions (£38 million decrease)
- Change in the assumption in respect of future mortality rates (£40 million increase)

These amounts include the impacts of movements in liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

**(2) Non-life insurance**

Gross non-life insurance contract liabilities are analysed by line of business as follows:

	2010 £m	2009 £m
Credit protection	380	228
Home	833	379
Health	3	3
<b>Total gross non-life insurance contract liabilities</b>	<b>1,216</b>	<b>610</b>

For non-life insurance contracts, the methodology and assumptions used in relation to determining the bases of the earned premium and claims provisioning levels are derived for each individual underwritten product. Assumptions are intended to be neutral estimates of the most likely or expected outcome. There has been no significant change in the assumptions and methodologies used for setting reserves.

The reserving methodology and associated assumptions are set out below:

The unearned premium reserve is determined on a basis that reflects the length of time for which contracts have been in force and the projected incidence of risk over the term of each contract.

Claims outstanding comprise those claims that have been notified and those that have been incurred but not reported. Claims incurred but not reported are determined based on the historical emergence of claims and their average cost. The notified claims element represents the best estimate of the cost of claims reported using projections and estimates based on historical experience.

The movements in non-life insurance contract liabilities and reinsurance assets over the year have been as follows:

	Gross £m	Reinsurance £m	Net £m
<b>Provisions for unearned premiums</b>			
At 1 January 2009	472	–	472
Increase in the year	596	(34)	562
Release in the year	(681)	23	(658)
Change in provision for unearned premiums charged to income statement (note 10)	(85)	(11)	(96)
At 31 December 2009	387	(11)	376
Adjustment on transfer of HBOS (note 31)	402	(20)	382
Increase in the year	1,230	(104)	1,126
Release in the year	(1,386)	113	(1,273)
Change in provision for unearned premiums charged to income statement (note 10)	(156)	9	(147)
Exchange and other adjustments	(1)	–	(1)
<b>At 31 December 2010</b>	<b>632</b>	<b>(22)</b>	<b>610</b>



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**37 Liabilities of the Group arising from insurance contracts and participating investment contracts** (continued)

These provisions represent the liability for short-term insurance contracts for which the Group's obligations are not expired at the year end.

	Gross £m	Reinsurance £m	Net £m
<b>Claims and loss adjustment expenses</b>			
Notified claims	160	(5)	155
Incurred but not reported	23	–	23
At 1 January 2009	183	(5)	178
Cash paid for claims settled in the year	(234)	2	(232)
Increase (decrease) in liabilities:			
Arising from current year claims	287	–	287
Arising from prior year claims	(13)	–	(13)
Change in liabilities charged to income statement (note 10)	40	2	42
At 31 December 2009	223	(3)	220
Adjustment on transfer of HBOS (note 31)	282	(9)	273
Cash paid for claims settled in the year	(467)	11	(456)
Increase (decrease) in liabilities:			
Arising from current year claims	581	(12)	569
Arising from prior year claims	(32)	(1)	(33)
Change in liabilities charged to income statement (note 10)	82	(2)	80
Exchange and other adjustments	(3)	(1)	(4)
<b>At 31 December 2010</b>	<b>584</b>	<b>(15)</b>	<b>569</b>
Notified claims	420	(4)	416
Incurred but not reported	164	(11)	153
<b>At 31 December 2010</b>	<b>584</b>	<b>(15)</b>	<b>569</b>
Notified claims	165	(3)	162
Incurred but not reported	58	–	58
At 31 December 2009	223	(3)	220

*Non-life insurance claims development table*

The development of insurance liabilities provides a measure of the Group's ability to estimate the ultimate value of claims. The top half of the table below illustrates how the Group's estimate of total claims outstanding for each accident year shown has changed at successive year ends. The bottom half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. The accident year basis is considered the most appropriate for the business written by the Group.

**Non-life insurance all risks – gross**

	Accident year					2010 £m	Total £m
	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m		
<b>Estimate of ultimate claims costs</b>							
At end of accident year	211	208	317	205	262	609	1,812
One year later	207	206	311	199	237		
Two years later	204	204	299	195			
Three years later	202	204	292				
Four years later	201	205					
Five years later	201						
Current estimate in respect of above claims	201	205	292	195	237	609	1,739
Current estimate of claims relating to HBOS general insurance business transferred in 2010 (note 31)	284	326	394	263	302	–	1,569
Current estimate of cumulative claims	485	531	686	458	539	609	3,308
Cumulative payments to date	(472)	(520)	(671)	(430)	(443)	(226)	(2,762)
Liability recognised in the balance sheet	13	11	15	28	96	383	546
Liability in respect of earlier years <sup>1</sup>							22
<b>Total liability included in the balance sheet</b>							<b>568</b>

<sup>1</sup>This balance includes £2 million of claims outstanding relating to the HBOS general insurance business transferred in 2010 (note 31).

The liability of £568 million shown in the above table excludes £16 million of unallocated claims handling expenses.

### 38 Life insurance sensitivity analysis of the Group

The following table demonstrates the effect of changes in key assumptions on profit before tax and equity disclosed in these financial statements assuming that the other assumptions remain unchanged. In practice this is unlikely to occur, and changes in some assumptions may be correlated. These amounts include movements in assets, liabilities and the value of the in-force business in respect of insurance contracts and participating investment contracts. The impact is shown in one direction but can be assumed to be reasonably symmetrical.

	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
<b>31 December 2010</b>			
Non-annuitant mortality <sup>1</sup>	5% reduction	64	46
Annuitant mortality <sup>2</sup>	5% reduction	(131)	(96)
Lapse rates <sup>3</sup>	10% reduction	163	117
Future maintenance and investment expenses <sup>4</sup>	10% reduction	201	145
Risk-free rate <sup>5</sup>	0.25% reduction	61	44
Guaranteed annuity option take-up <sup>6</sup>	5% addition	(4)	(3)
Equity investment volatility <sup>7</sup>	1% addition	(8)	(6)
Widening of credit default spreads on corporate bonds <sup>8</sup>	0.25% addition	(152)	(110)
Increase in illiquidity premia <sup>9</sup>	0.10% addition	78	56
<b>31 December 2009</b>			
Non-annuitant mortality <sup>1</sup>	5% reduction	26	19
Annuitant mortality <sup>2</sup>	5% reduction	(82)	(59)
Lapse rates <sup>3</sup>	10% reduction	39	28
Future maintenance and investment expenses <sup>4</sup>	10% reduction	96	69
Risk-free rate <sup>5</sup>	0.25% reduction	48	35
Guaranteed annuity option take-up <sup>6</sup>	5% addition	(5)	(3)
Equity investment volatility <sup>7</sup>	1% addition	(9)	(6)
Widening of credit default spreads on corporate bonds <sup>8</sup>	0.25% addition	(105)	(76)
Increase in illiquidity premia <sup>9</sup>	0.10% addition	56	41

Assumptions have been flexed on the basis used to calculate the value of in-force business and the realistic and statutory reserving bases.

<sup>1</sup>This sensitivity shows the impact of reducing mortality and morbidity rates on non-annuity business to 95 per cent of the expected rate.

<sup>2</sup>This sensitivity shows the impact on the annuity and deferred annuity business of reducing mortality rates to 95 per cent of the expected rate.

<sup>3</sup>This sensitivity shows the impact of reducing lapse and surrender rates to 90 per cent of the expected rate.

<sup>4</sup>This sensitivity shows the impact of reducing maintenance expenses and investment expenses to 90 per cent of the expected rate.

<sup>5</sup>This sensitivity shows the impact on the value of in-force business, financial options and guarantee costs, statutory reserves and asset values of reducing the risk-free rate by 25 basis points.

<sup>6</sup>This sensitivity shows the impact of a flat 5 per cent addition to the expected rate.

<sup>7</sup>This sensitivity shows the impact of a flat 1 per cent addition to the expected rate.

<sup>8</sup>This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Government bond yields, the non-annuity risk-free rate and illiquidity premia are all assumed to be unchanged.

<sup>9</sup>This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall corporate bond spreads are unchanged and hence market values are unchanged. Government bond yields and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

### 39 Liabilities of the Group arising from non-participating investment contracts

The movement in liabilities arising from non-participating investment contracts may be analysed as follows:

	Gross £m	Reinsurance <sup>1</sup> £m	Net £m
At 1 January 2009	14,243	–	14,243
New business	242	–	242
Changes in existing business	1,249	–	1,249
At 31 December 2009	15,734	–	15,734
Adjustment on transfer of HBOS (note 31)	30,614	–	30,614
New business	3,953	(65)	3,888
Changes in existing business	1,070	–	1,070
Exchange and other adjustments	(8)	–	(8)
<b>At 31 December 2010</b>	<b>51,363</b>	<b>(65)</b>	<b>51,298</b>

<sup>1</sup>Reinsurance balances are reported within other assets (note 32).

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**40 Unallocated surplus within insurance businesses for the Group**

The movement in the unallocated surplus within long-term insurance business over the year can be analysed as follows:

	2010 £m	2009 £m
At 1 January	310	270
Adjustment on transfer of HBOS (note 31)	772	–
Change in unallocated surplus recognised in the income statement (note 10)	(439)	40
<b>At 31 December</b>	<b>643</b>	<b>310</b>

**41 Other liabilities**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Settlement balances	1,269	361	6	101
Unitholders' interest in Open Ended Investment Companies	15,617	5,908	–	–
Other creditors and accruals	13,160	5,994	3,794	3,336
	<b>30,046</b>	<b>12,263</b>	<b>3,800</b>	<b>3,437</b>

At 31 December 2010 £15,383 million (2009: £7,796 million) of other liabilities of the Group and £657 million (2009: £1,032 million) of the Bank had a contractual residual maturity of greater than one year.

**42 Retirement benefit obligations**

	2010 £m	2009 £m
<b>(Credit) charge to the Group income statement:</b>		
Defined benefit pension schemes <sup>1</sup>	(467)	267
Other post-retirement benefit schemes	12	7
Total defined benefit schemes	(455)	274
Defined contribution pension schemes	173	88
<b>Total (credit) charge to the income statement</b>	<b>(282)</b>	<b>362</b>

<sup>1</sup>In 2010, the amount is shown net of a credit of £910 million following the Group's decision to cap all future increases to pensionable salary in its principal UK defined benefit pension schemes, together with a change in commutation factors in certain schemes (see note 11).

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Amounts recognised in the balance sheet:</b>				
Defined benefit pension schemes	479	(360)	356	(17)
Other post-retirement benefit schemes	(166)	(114)	(118)	(114)
<b>Total amounts recognised in the balance sheet</b>	<b>313</b>	<b>(474)</b>	<b>238</b>	<b>(131)</b>

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Amounts recognised in the balance sheet:</b>				
Retirement benefit assets	736	–	530	–
Retirement benefit obligations	(423)	(474)	(292)	(131)
<b>Total amounts recognised in the balance sheet</b>	<b>313</b>	<b>(474)</b>	<b>238</b>	<b>(131)</b>

For accounting purposes, the assets and liabilities of the Group's post-retirement benefit schemes are allocated between the participating employers, including the Bank, in proportion to the cash contributions made to the schemes.

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**42 Retirement benefit obligations** (continued)

**Pension schemes**

*Defined benefit schemes*

The Group has established a number of defined benefit pension schemes in the UK and overseas, the three most significant being the defined benefit sections of the Lloyds TSB Group Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme (HFSPS). These schemes provide retirement benefits calculated as a percentage of final salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2010 was generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The latest full valuations of the two main Lloyds TSB schemes were carried out as at 30 June 2008; the latest full valuation of the HFSPS was carried out as at 31 December 2008. The results have been updated to 31 December 2010 by qualified independent actuaries. The last full valuations of other Group schemes were carried out on a number of different dates; these have been updated to 31 December 2010 by qualified independent actuaries or, in the case of the Scottish Widows Retirement Benefits Scheme, by a qualified actuary employed by Scottish Widows.

The Group's and the Bank's obligations in respect of defined benefit schemes are funded. During 2009, the Group's contributions to its defined benefit schemes of £1,567 million included one-off contributions to the Lloyds TSB Group Pension Scheme No 1 and the Lloyds TSB Group Pension Scheme No 2 of approximately £1 billion in aggregate. These contributions took the form of interests in limited liability partnerships for each of the two schemes which contained assets of approximately £5 billion in aggregate entitling the schemes to annual payments of approximately £215 million in aggregate until 31 December 2014. Thereafter, assuming that all distributions have been made, the value of the partnership interests will equate to a nominal amount. At 31 December 2010, the limited liability partnerships held assets of approximately £4.9 billion; cash payments of £215 million were made to the pension schemes during the year. The limited liability partnerships are fully consolidated in the Group's balance sheet (see note 21).

The Group currently expects to pay contributions of approximately £625 million to its defined benefit schemes in 2011.

**Amounts included in the balance sheet:**

Present value of funded obligations

Fair value of scheme assets

Unrecognised actuarial losses

**Net amount recognised in the balance sheet**

The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m
<b>(26,862)</b>	(18,796)	<b>(14,143)</b>	(14,363)
<b>26,382</b>	16,075	<b>13,784</b>	12,507
<b>(480)</b>	(2,721)	<b>(359)</b>	(1,856)
<b>959</b>	2,361	<b>713</b>	1,839
<b>479</b>	(360)	<b>356</b>	(17)

**Movements in the defined benefit obligation:**

At 1 January

Adjustment on transfer of HBOS (note 31)

Current service cost

Employee contributions

Interest cost

Actuarial gains (losses)

Benefits paid

Past service cost

Curtailments

Settlements

Exchange and other adjustments

**At 31 December**

The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m
<b>(18,796)</b>	(15,617)	<b>(14,363)</b>	(12,015)
<b>(8,277)</b>	–	–	–
<b>(384)</b>	(216)	<b>(144)</b>	(158)
<b>(4)</b>	–	–	–
<b>(1,474)</b>	(956)	<b>(724)</b>	(732)
<b>140</b>	(2,649)	<b>256</b>	(1,938)
<b>950</b>	647	<b>493</b>	494
<b>(46)</b>	(31)	<b>(40)</b>	(26)
<b>1,081</b>	–	<b>449</b>	–
<b>6</b>	–	–	–
<b>(58)</b>	26	<b>(70)</b>	12
<b>(26,862)</b>	(18,796)	<b>(14,143)</b>	(14,363)

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**42 Retirement benefit obligations** (continued)

**Changes in the fair value of scheme assets:**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January	16,075	13,693	12,507	10,488
Adjustment on transfer of HBOS (note 31)	7,443	–	–	–
Expected return	1,507	936	736	720
Employer contributions	648	1,567	182	1,419
Employee contributions	4	–	–	–
Actuarial gains	1,624	542	818	376
Benefits paid	(950)	(647)	(493)	(494)
Settlements	(9)	–	–	–
Exchange and other adjustments	40	(16)	34	(2)
<b>At 31 December</b>	<b>26,382</b>	<b>16,075</b>	<b>13,784</b>	<b>12,507</b>
<b>Actual return on scheme assets</b>	<b>3,131</b>	<b>1,478</b>	<b>1,554</b>	<b>1,096</b>

**Assumptions**

The principal actuarial and financial assumptions used in the valuations of the defined benefit pension schemes were as follows:

	2010 %	2009 %
Discount rate	5.50	5.70
Rate of inflation		
– Retail Prices Index	3.40	3.40
– Consumer Price Index	2.90	–
Rate of salary increases	2.00	3.75
Rate of increase for pensions in payment	3.20	3.20
	Years	Years
Life expectancy for member aged 60, on the valuation date:		
Men	27.2	27.1
Women	28.3	28.2
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	28.2	28.7
Women	29.9	29.8

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 as at 31 December 2010 is assumed to live for, on average, 27.2 years for a male and 28.3 years for a female. In practice there will be much variation between individual members but these assumptions are expected to be appropriate across all members. It is assumed that younger members will live longer in retirement than those retiring now. This reflects the expectation that mortality rates will continue to fall over time as medical science and standards of living improve. To illustrate the degree of improvement assumed the table also shows the life expectancy for members aged 45 now, when they retire in 15 years time at age 60.

**Sensitivity analysis**

The effect of changes in key assumptions on the pension charge in the Group's income statement and on the Group's net defined benefit pension scheme asset or liability is set out below:

	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme asset	
	2010 £m	2009 £m	2010 £m	2009 £m
Inflation <sup>1</sup> :				
Increase of 0.2 per cent	14	60	(791)	(511)
Decrease of 0.2 per cent	(15)	(52)	754	489
Discount rate <sup>2</sup> :				
Increase of 0.2 per cent	(20)	(54)	930	604
Decrease of 0.2 per cent	15	68	(976)	(635)
Expected life expectancy of members:				
Increase of one year	40	64	(620)	(393)
Decrease of one year	(41)	(61)	632	399

<sup>1</sup>At 31 December 2010, the assumed rate of inflation is 3.4 per cent (31 December 2009: 3.4 per cent).

<sup>2</sup>At 31 December 2010, the assumed discount rate is 5.5 per cent (31 December 2009: 5.7 per cent).

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**42 Retirement benefit obligations** (continued)

The expected return on scheme assets has been calculated using the following assumptions:

	2010 %	2009 %
Equities and alternative assets	<b>8.3</b>	8.4
Fixed interest gilts	<b>4.5</b>	3.7
Index linked gilts	<b>4.1</b>	4.0
Non-Government bonds	<b>6.0</b>	6.7
Property	<b>7.5</b>	6.4
Money market instruments and cash	<b>4.3</b>	3.8

The expected return on scheme assets in 2011 will be calculated using the following assumptions:

	2011 %
Equities and alternative assets	<b>8.3</b>
Fixed interest gilts	<b>4.0</b>
Index linked gilts	<b>3.9</b>
Non-Government bonds	<b>4.9</b>
Property	<b>7.3</b>
Money market instruments and cash	<b>3.9</b>

Composition of scheme assets:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Equities	<b>11,856</b>	7,689	<b>6,290</b>	5,932
Fixed interest gilts	<b>2,237</b>	1,327	<b>450</b>	1,071
Index linked gilts	<b>4,159</b>	1,510	<b>2,660</b>	1,007
Non-Government bonds	<b>2,922</b>	1,917	<b>1,916</b>	1,491
Property	<b>1,654</b>	1,391	<b>1,124</b>	1,129
Money market instruments, cash and other assets and liabilities	<b>3,554</b>	2,241	<b>1,346</b>	1,877
<b>At 31 December</b>	<b>26,382</b>	16,075	<b>13,786</b>	12,507

The assets of all the funded plans are held independently of the Group's assets in separate trustee administered funds.

The expected return on plan assets was determined by considering the expected returns available on the assets underlying the current investment policy. Expected yields on fixed interest investments are based on gross redemption yields at the balance sheet date at a term and credit rating broadly appropriate for the bonds held. Expected returns on equity and property investment are long-term rates based on the views of the plans' independent investment consultants. The expected return on equities allows for the different expected returns from the private equity, infrastructure and hedge fund investments held by some of the funded plans. Some of the funded plans also invest in certain money market instruments and the expected return on these investments has been assumed to be the same as cash.

Experience adjustments history:

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
<b>The Group</b>					
Present value of defined benefit obligation	<b>(26,862)</b>	(18,796)	(15,617)	(16,795)	(17,378)
Fair value of scheme assets	<b>26,382</b>	16,075	13,693	16,112	15,279
	<b>(480)</b>	(2,721)	(1,924)	(683)	(2,099)
Experience gains (losses) on scheme liabilities	<b>496</b>	(14)	(39)	(185)	(50)
Experience gains (losses) on scheme assets	<b>1,624</b>	542	(3,520)	139	314
<b>The Bank</b>					
Present value of defined benefit obligation	<b>(14,143)</b>	(14,363)	(12,015)	(12,899)	(13,166)
Fair value of scheme assets	<b>13,784</b>	12,507	10,488	12,410	11,579
	<b>(359)</b>	(1,856)	(1,527)	(489)	(1,587)
Experience gains (losses) on scheme liabilities	<b>366</b>	(4)	(23)	(150)	(42)
Experience gains (losses) on scheme assets	<b>801</b>	377	(2,750)	114	243

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**42 Retirement benefit obligations** (continued)

The expense recognised in the consolidated income statement for the year ended 31 December comprises:

	2010 £m	2009 £m
Current service cost	384	216
Interest cost	1,474	956
Expected return on scheme assets	(1,507)	(936)
Net actuarial losses recognised in the year	43	–
Curtailments (see below)	(910)	–
Settlements	3	–
Past service cost	46	31
<b>Total defined benefit pension expense</b>	<b>(467)</b>	<b>267</b>

Following changes by the Group to the terms of its principal 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 the year there was a change in the commutation factors in certain defined benefit schemes. The combined effect of these changes is 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 and an equivalent reduction in the balance sheet liability.

*Defined contribution schemes*

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally the defined contribution sections of the Lloyds TSB Group Pension Schemes No's 1 and 2.

During the year ended 31 December 2010 the charge to the income statement in respect of defined contribution schemes was £173 million (2009: £88 million), representing the contributions payable by the employer in accordance with each scheme's rules.

**Other post-retirement benefit schemes**

The Group operates a number of schemes which provide post-retirement healthcare benefits and concessionary mortgages to certain employees, retired employees and their dependants. The principal scheme relates to former Lloyds Bank staff and under this scheme the Group has undertaken to meet the cost of post-retirement healthcare for all eligible former employees (and their dependants) who retired prior to 1 January 1996. The Group has entered into an insurance contract to provide these benefits and a provision has been made for the estimated cost of future insurance premiums payable.

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 30 June 2008; this valuation has been updated to 31 December 2010 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 7.54 per cent (2009: 7.33 per cent).

Amount included in the balance sheet:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Present value of unfunded obligations	(175)	(120)	(124)	(120)
Unrecognised actuarial losses	9	6	6	6
<b>Retirement benefit obligation recognised in the balance sheet</b>	<b>(166)</b>	<b>(114)</b>	<b>(118)</b>	<b>(114)</b>

Movements in the other post-retirement benefits obligation:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January	(120)	(118)	(120)	(118)
Adjustment on transfer of HBOS (note 31)	(50)	–	–	–
Exchange and other adjustments	2	1	1	1
Actuarial loss	–	(2)	–	(2)
Insurance premiums paid	5	6	5	6
Charge for the year	(12)	(7)	(10)	(7)
<b>At 31 December</b>	<b>(175)</b>	<b>(120)</b>	<b>(124)</b>	<b>(120)</b>

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### 43 Deferred tax

The movement in the net deferred tax balance is as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Asset at 1 January	2,438	837	2,672	1,161
Adjustment on transfer of HBOS (note 31)	2,603	–	–	–
Exchange and other adjustments	66	1	–	–
Disposals	–	12	–	–
Income statement (charge) credit (note 15):				
Due to change in corporation tax rate	(142)	–	(103)	–
Other	(716)	2,146	484	1,475
	<b>(858)</b>	2,146	<b>381</b>	1,475
Amount (charged) credited to equity:				
Available-for-sale financial assets (note 48)	(330)	(206)	(249)	30
Net investment hedges (note 48)	–	(358)	–	–
Cash flow hedges (note 48)	38	6	(8)	6
	<b>(292)</b>	(558)	<b>(257)</b>	36
<b>Asset at 31 December</b>	<b>3,957</b>	<b>2,438</b>	<b>2,796</b>	<b>2,672</b>

The statutory position reflects the deferred tax assets and liabilities as disclosed in the consolidated balance sheet and takes account of the inability to offset assets and liabilities where there is no legally enforceable right of offset. The tax disclosure of deferred tax assets and liabilities ties to the amounts outlined in the table below which splits the deferred tax assets and liabilities by type.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Statutory position</b>				
Deferred tax assets	4,204	2,438	2,796	2,672
Deferred tax liabilities	(247)	–	–	–
<b>Net deferred tax asset</b>	<b>3,957</b>	<b>2,438</b>	<b>2,796</b>	<b>2,672</b>
<b>Tax disclosure</b>				
Deferred tax assets	8,438	3,420	2,821	2,723
Deferred tax liabilities	(4,481)	(982)	(25)	(51)
<b>Net deferred tax asset</b>	<b>3,957</b>	<b>2,438</b>	<b>2,796</b>	<b>2,672</b>

The deferred tax credit in the consolidated income statement comprises the following temporary differences:

	2010 £m	2009 £m
Accelerated capital allowances	(470)	492
Pensions and other post-retirement benefits	(391)	(191)
Long-term assurance business	(110)	(92)
Trading losses	880	1,810
Tax on fair value of acquired assets	(715)	–
Other temporary differences	(52)	127
<b>Deferred tax credit in the income statement</b>	<b>(858)</b>	<b>2,146</b>



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**43 Deferred tax** (continued)

Deferred tax assets and liabilities are comprised as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Deferred tax assets:				
Pensions and other post-retirement benefits	40	311	67	225
Allowances for impairment losses	577	88	68	85
Other provisions	241	159	68	155
Derivatives	178	91	55	97
Available-for-sale asset revaluation	519	324	–	–
Tax losses carried forward	6,596	2,316	2,365	1,970
Accelerated capital allowances	–	–	163	158
Other temporary differences	287	131	35	33
<b>Total deferred tax assets</b>	<b>8,438</b>	<b>3,420</b>	<b>2,821</b>	<b>2,723</b>
Deferred tax liabilities:				
Accelerated capital allowances	(562)	(56)	–	–
Long-term assurance business	(1,630)	(760)	–	–
Tax on fair value of acquired assets	(2,097)	–	–	–
Other temporary differences	(192)	(166)	(25)	(51)
<b>Total deferred tax liabilities</b>	<b>(4,481)</b>	<b>(982)</b>	<b>(25)</b>	<b>(51)</b>

The Finance (No.2) Act 2010 includes legislation to reduce the main rate of corporation tax from 28 per cent to 27 per cent with effect from 1 April 2011. This resulted in a reduction in the Group's net deferred tax asset at 31 December 2010 of £132 million.

The proposed further reductions in the rate of corporation tax by 1 per cent per annum to 24 per cent by 1 April 2014 are expected to be enacted separately each year starting in 2011. The effect of these further changes upon the Group's deferred tax balances and leasing business cannot be reliably quantified at this stage.

*Deferred tax assets*

Deferred tax assets are recognised for tax losses carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable. Group companies have recognised deferred tax assets of £6,596 million (2009: £2,316 million) in relation to tax losses carried forward. After reviews of medium-term profit forecasts, the Group considers that there will be sufficient profits in the future against which these losses will be offset.

Deferred tax assets of £396 million for the Group and £35 million for the Bank (2009: £91 million for the Group and £55 million for the Bank) have not been recognised in respect of capital losses carried forward as there are no predicted future capital profits. Capital losses can be carried forward indefinitely.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward as at 31 December 2010 of £62 million for the Group and £22 million for the Bank (2009: £13 million for the Group and £13 million for the Bank), as there are no predicted future taxable profits against which the unrelieved foreign tax credits can be utilised. These tax credits can be carried forward indefinitely.

*Deferred tax liabilities*

Future transfers from Scottish Widows plc's long-term business funds to its Shareholder Fund will be subject to a shareholder tax charge. Under IAS 12, no provision is required to be made to the extent that the timing of such transfers is under Scottish Widows plc's control. Accordingly, deferred tax liabilities of £90 million (2009: £90 million) have not been recognised.

Scottish Widows plc has a taxable difference of £152 million (2009: 152 million) in respect of its holding of a life insurance subsidiary. No deferred tax liability is required to be recognised in respect of this taxable temporary difference under IAS 12 as Scottish Widows plc does not intend to dispose of this subsidiary company.

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**44 Other provisions**

	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Restructuring provisions £m	Vacant leasehold property £m	Other £m	Total £m
<b>The Group</b>							
At 1 January 2010	67	186	–	114	38	142	547
Adjustment on transfer of HBOS (note 31)	5	274	–	2	70	85	436
Exchange and other adjustments	16	(26)	–	(1)	4	9	2
Transfers	–	49	–	–	–	–	49
Provisions applied	(9)	(222)	–	(16)	(1)	(5)	(253)
Charge for the year	75	83	500	23	35	35	751
<b>At 31 December 2010</b>	<b>154</b>	<b>344</b>	<b>500</b>	<b>122</b>	<b>146</b>	<b>266</b>	<b>1,532</b>
	Provisions for contingent liabilities and commitments £m	Customer remediation provisions £m	Customer goodwill payments £m	Restructuring provisions £m	Vacant leasehold property £m	Other £m	Total £m
<b>The Bank</b>							
At 1 January 2010	96	184	–	114	38	101	533
Exchange and other adjustments	–	1	–	(1)	(1)	6	5
Provisions applied	(37)	(24)	–	(21)	(1)	(1)	(84)
Charge (release) for the year	64	(12)	–	20	16	27	115
<b>At 31 December 2010</b>	<b>123</b>	<b>149</b>	<b>–</b>	<b>112</b>	<b>52</b>	<b>133</b>	<b>569</b>

*Provisions for contingent liabilities and commitments*

Provisions are held in cases where the Group is irrevocably committed to advance additional funds, but where there is doubt as to the customer's ability to meet its repayment obligations.

*Customer remediation provisions*

The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales, in those cases where the original sales processes have been found to be deficient. During 2010 management has again reviewed the adequacy of the provisions held having regard to current complaint volumes and the level of payments being made and £83 million has been charged to the income statement. At 31 December 2010 the remaining provisions held relate to past sales of a number of products, including mortgage endowment policies, sold through the branch networks.

*Customer goodwill payments*

The Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the 'Halifax' brand. In February 2011, the Lloyds Banking Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group has made a provision of £500 million in relation to this programme.

*Restructuring*

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure.

*Vacant leasehold property*

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biennial basis and will normally run-off over the period of under-recovery of the leases concerned, currently averaging five years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

*Other*

Other provisions include the provisions which the Group carries in respect of its obligations arising from the liquidation of UIC Insurance Company Limited (UIC). The Group has indemnified a third party against losses arising from a reinsurance contract written by UIC which is subject to asbestos and pollution claims in the US. The ultimate cost and timing of payments under the indemnity remain uncertain. The provision held represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

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#### 45 Subordinated liabilities

The movement in subordinated liabilities during the year was as follows:

	The Group £m	The Bank £m
<b>At 1 January 2010</b>	<b>15,999</b>	<b>15,456</b>
Adjustment on transfer of HBOS (note 31)	<b>14,653</b>	–
Issued during the year	<b>3,237</b>	<b>3,237</b>
Repurchases and redemptions during the year	<b>(684)</b>	<b>(353)</b>
Foreign exchange and other movements	<b>(3,596)</b>	<b>(2,766)</b>
<b>At 31 December 2010</b>	<b>29,609</b>	<b>15,574</b>

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Preferred securities	<b>6,932</b>	7,339	<b>5,006</b>	7,339
Undated subordinated liabilities	<b>3,056</b>	2,472	<b>1,520</b>	1,925
Dated subordinated liabilities	<b>19,621</b>	6,188	<b>9,048</b>	6,192
<b>Total subordinated liabilities</b>	<b>29,609</b>	15,999	<b>15,574</b>	15,456

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of the depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of the specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preferred shares and securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of the holders of the dated subordinated liabilities. Neither the Group nor the Bank has had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the year (2009: none). No repayment or purchase by the issuer of the subordinated liabilities may be made prior to their stated maturity without the consent of the Financial Services Authority.

The Group	Note	2010 £m	2009 £m
<b>Preferred securities</b>			
6.90% Perpetual Capital Securities (US\$1,000 million)	e,g	<b>249</b>	645
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a	<b>584</b>	565
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a	<b>628</b>	590
6% Non-cumulative Redeemable Preference Shares	b	–	–
7.375% Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	e,f	<b>16</b>	428
7.875% Fixed/Floating non-cumulative preference shares (€500 million)	f	<b>203</b>	146
7.875% Fixed/Floating non-cumulative preference shares (US\$1,250 million)	f	<b>353</b>	246
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	e	<b>241</b>	456
7.834% Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	e,f	<b>4</b>	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	f	<b>711</b>	705
13.00% Step-up Perpetual Capital Securities callable 2019 (£784 million)	e,f	<b>10</b>	827
13.00% Euro Step-up Perpetual Capital Securities callable 2019 (€532 million)	f	<b>56</b>	510
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US\$2,000 million)		<b>1,288</b>	1,235
13.00% Sterling Step-up Perpetual Capital Securities callable 2029 (£700 million)	e,f	<b>662</b>	738
6.071% Non-cumulative Perpetual Preferred Securities of US\$1,000 each (US\$750 million)		<b>336</b>	–
6.85% Non-cumulative Perpetual Preferred Securities of US\$1,000 each (US\$1,000 million)	g	<b>107</b>	–
6.461% Guaranteed Non-voting Non-cumulative Perpetual Preferred Securities Series A of £1,000 each (£600 million)		<b>421</b>	–
8.117% Non-cumulative Perpetual Preferred Securities Series 1 of £1,000 each (Class A) (£250 million)	g,h	<b>253</b>	–
7.754% Non-cumulative Perpetual Preferred Securities Series 2 of £1,000 each (Class B) (£150 million)		<b>98</b>	–
7.881% Guaranteed Non-voting Non-cumulative Preferred Securities (£245 million)		<b>173</b>	–
7.627% Fixed-to-Floating Rate Guaranteed Non-voting Non-cumulative Preferred Securities (€415 million)	g	<b>308</b>	–
4.939% Non-voting Non-cumulative Perpetual Preferred Securities (€750 million)	f	<b>17</b>	–
Perpetual Regulatory Tier One Securities (£300 million)		<b>214</b>	–
		<b>6,932</b>	7,339

Lloyds TSB Bank plc  
Notes to the accounts

**45 Subordinated liabilities** (continued)

	Note	2010 £m	2009 £m
<b>Undated subordinated liabilities</b>			
Primary Capital Undated Floating Rate Notes:			
Series 1 (US\$750 million)	f,g,i	<b>173</b>	408
Series 2 (US\$500 million)	f,g,i	<b>181</b>	262
Series 3 (US\$600 million)	f,g,i	<b>232</b>	326
11¾% Perpetual Subordinated Bonds (£100 million)		<b>102</b>	102
6⅞% Undated Subordinated Step-up Notes callable 2010 (£410 million)	f,g,j	<b>174</b>	157
5.125% Step-up Perpetual Subordinated Notes callable 2015 (£560 million) (Scottish Widows plc)	d	<b>550</b>	547
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)		<b>194</b>	165
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	f	<b>142</b>	140
6½% Undated Subordinated Step-up Notes callable 2019 (£270 million)	f	<b>97</b>	89
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	f	<b>–</b>	64
6½% Undated Subordinated Step-up Notes callable 2029 (£450 million)	f	<b>111</b>	103
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)		<b>114</b>	109
5.625% Cumulative Callable Fixed to Floating Rate Undated Subordinated Notes (£500 million)	f	<b>3</b>	–
4.875% Undated Subordinated Fixed to Floating Rate Instruments (€750 million)	f	<b>65</b>	–
Floating Rate Undated Subordinated Instruments (€500 million)	f	<b>42</b>	–
5.375% Undated Fixed to Floating Rate Subordinated Notes (US\$1,000 million)	f	<b>12</b>	–
5.125% Undated Subordinated Fixed to Floating Rate Notes (€750 million)	f	<b>47</b>	–
5.75% Undated Subordinated Step-up Notes (£600 million)		<b>3</b>	–
6.05% Fixed to Floating Rate Undated Subordinated Notes (€500 million)	g	<b>57</b>	–
7.5% Undated Subordinated Step-up Notes (£300 million)		<b>3</b>	–
3.50% Undated Subordinated Yen Step-up Notes (¥42,500 million)	i	<b>–</b>	–
8.625% Perpetual Subordinated Notes (£200 million)	f	<b>21</b>	–
7.375% Undated Subordinated Guaranteed Bonds (£200 million)		<b>35</b>	–
Floating Rate Undated Subordinated Step-up Notes (€300 million)	g	<b>63</b>	–
Floating Rate Primary Capital Notes (US\$250 million)	f,g,i	<b>118</b>	–
10.25% Subordinated Undated Instruments (£100 million)	f	<b>1</b>	–
12% Perpetual Subordinated Bonds (£100 million)	f	<b>21</b>	–
8.75% Perpetual Subordinated Bonds (£100 million)	f	<b>4</b>	–
13.625% Perpetual Subordinated Bonds (£75 million)	f	<b>20</b>	–
9.375% Perpetual Subordinated Bonds (£50 million)	f	<b>16</b>	–
5.75% Undated Subordinated Step-up Notes (£500 million)		<b>3</b>	–
4.25% Perpetual Fixed/Floating Rate Reset Subordinated Guaranteed Notes (€750 million)		<b>215</b>	–
7.375% Subordinated Undated Instruments (£150 million)	f	<b>76</b>	–
4.25% Subordinated Undated Instruments (¥17,000 million)		<b>161</b>	–
		<b>3,056</b>	2,472

Lloyds TSB Bank plc  
Notes to the accounts

**45 Subordinated liabilities** (continued)

	Note	2010 £m	2009 £m
<b>Dated subordinated liabilities</b>			
6 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2010 (€400 million)		–	375
12% Guaranteed Subordinated Bonds 2011 (£100 million)	c	109	116
4 <sup>3</sup> / <sub>4</sub> % Subordinated Notes 2011 (€850 million)		764	771
Subordinated Floating Rate Notes 2011 (£150 million)		150	150
Subordinated Floating Rate Notes 2011 (£100 million)		100	100
Subordinated Floating Rate Notes 2012 (£200 million)		200	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		465	465
5 <sup>7</sup> / <sub>8</sub> % Subordinated Notes 2014 (£150 million)		149	154
6 <sup>5</sup> / <sub>8</sub> % Subordinated Notes 2015 (£350 million)		343	335
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	g	296	296
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	g	432	445
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		946	979
6.9625% Subordinated Fixed to Floating Rate Notes due 2020 callable 2015 (£750 million)		715	758
Subordinated Floating Rate Notes 2020 (€100 million)		86	89
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		324	322
9 <sup>5</sup> / <sub>8</sub> % Subordinated Bonds 2023 (£300 million)		332	333
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
6.50% Notes 2011 (US\$150 million)		99	–
5.50% Subordinated Fixed Rate Notes 2012 (€750 million)		657	–
6.25% Instruments 2012 (€12.8 million)		10	–
6.125% Notes 2013 (€325 million)		289	–
4.25% Subordinated Guaranteed Notes 2013 (US\$1,000 million)		619	–
11% Subordinated Bonds 2014 (£250 million)		297	–
4.875% Subordinated Notes 2015 (€1,000 million)		838	–
Callable Floating Rate Subordinated Notes 2016 (€500 million)	g	401	–
Subordinated Notes 2016 (€500 million)	g	417	–
Notes 2016 (US\$750 million)	g	440	–
Subordinated Lower Tier II Notes 2017 (€1,000 million)		758	–
Subordinated Callable Notes 2017 (US\$1,000 million)		548	–
Subordinated Callable Floating Rate Instruments 2017 (Aus\$400 million)		255	–
6.75% Subordinated Callable Fixed/Floating Rate Instruments 2017 (Aus\$200 million)		127	–
5.109% Callable Fixed to Floating Rate Notes 2017 (Can\$500 million)		305	–
6.305% Lower Tier II Subordinated Notes 2017 (£500 million)		486	–
10.5% Subordinated Bonds 2018 (£150 million)		171	–
6.75% Subordinated Fixed Rate Notes 2018 (US\$2,000 million)		1,176	–
6.375% Instruments 2019 (£250 million)		236	–
4.375% Callable Fixed to Floating Rate Subordinated Notes 2019 (€750 million)		600	–
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,353	–
7.375% Dated Subordinated Notes 2020		4	–
7.07% Subordinated Fixed Rate Notes 2020 (US\$2,000 million)		1,202	–
9.375% Subordinated Bonds 2021 (£500 million)		647	–
5.374% Subordinated Fixed Rate Notes 2021 (€160 million)		139	–
6.45% Fixed/Floating Subordinated Guaranteed Bonds 2023 (€400 million)		173	–
6.5% Subordinated Fixed Rate Notes 2023 (€175 million)		162	–
7.625% Dated Subordinated Notes 2025 (£750 million)		763	–
4.50% Fixed Rate Step-up Subordinated Notes due 2030 (€750 million)		463	–
6.00% Subordinated Notes 2033 (US\$750 million)		275	–
		<b>19,621</b>	<b>6,188</b>
<b>Total subordinated liabilities</b>		<b>29,609</b>	<b>15,999</b>

At 31 December 2010 £28,486 million (2009: £15,624 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

Lloyds TSB Bank plc  
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**45 Subordinated liabilities** (continued)

**The Bank**

**Preferred securities**

	Note	2010 £m	2009 £m
6.90% Perpetual Capital Securities (US\$1,000 million)	e,g	249	645
Floating Rate Non-Cumulative Callable Preference Shares callable 2015 (£600 million)	a	584	565
Floating Rate Non-Cumulative Callable Preference Shares callable 2016 (US\$1,000 million)	a	628	590
6% Non-cumulative Redeemable Preference Shares	b	–	–
7.375% Euro Step-up Non-Voting Non-Cumulative Preferred Securities callable 2012 (€430 million)	e,f	17	428
7.875% Fixed/Floating non-cumulative preference shares (€500 million)	f	203	146
7.875% Fixed/Floating non-cumulative preference shares (US\$1,250 million)	f	353	246
6.35% Step-up Perpetual Capital Securities callable 2013 (€500 million)	e	241	456
7.834% Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015 (£250 million)	e,f	4	248
4.385% Step-up Perpetual Capital Securities callable 2017 (€750 million)	f	711	705
13% Step -up Perpetual Capital Securities callable 2019 (£784 million)	e,f	10	827
13% Euro Step-up Perpetual Capital Securities Callable 2019 (€532 million)	f	56	510
13% Sterling Step-up Perpetual Capital Securities Callable 2029 (£700 million)	e,f	662	738
12% Fixed to Floating Rate Perpetual Tier 1 Capital Securities callable 2024 (US\$2,000 million)		<b>1,288</b>	1,235
		<b>5,006</b>	7,339

**Undated subordinated liabilities**

Primary Capital Undated Floating Rate Notes:

Series 1 (US\$750 million)	f,g,i	173	408
Series 2 (US\$500 million)	f,g,i	181	262
Series 3 (US\$600 million)	f,g,i	232	326
11 <sup>3</sup> / <sub>4</sub> % Perpetual Subordinated Bonds (£100 million)		102	102
6 <sup>5</sup> / <sub>8</sub> % Undated Subordinated Step-up Notes callable 2010 (£410 million)	f,g,j	174	157
5.57% Undated Subordinated Step-up Coupon Notes callable 2015 (¥20,000 million)		194	165
5.125% Undated Subordinated Step-up Notes callable 2016 (£500 million)	f	142	140
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2019 (£270 million)	f	97	89
8% Undated Subordinated Step-up Notes callable 2023 (£200 million)	f	–	64
6 <sup>1</sup> / <sub>2</sub> % Undated Subordinated Step-up Notes callable 2029 (£450 million)	f	111	103
6% Undated Subordinated Step-up Guaranteed Bonds callable 2032 (£500 million)	f	114	109
		<b>1,520</b>	1,925

**Dated subordinated liabilities**

6 <sup>1</sup> / <sub>4</sub> % Subordinated Notes 2010 (€400 million)		–	375
12% Guaranteed Subordinated Bonds 2011 (£100 million)	c	112	116
4 <sup>3</sup> / <sub>4</sub> % Subordinated Notes 2011 (€850 million)		764	771
Subordinated Floating Rate Notes 2011 (£150 million)		150	150
Subordinated Floating Rate Notes 2011 (£100 million)		100	100
Subordinated Floating Rate Notes 2012 (£200 million)		200	200
Subordinated Floating Rate Notes 2013 (£150 million)		150	150
Subordinated Floating Rate Notes 2014 (£464 million)		465	465
5 <sup>7</sup> / <sub>8</sub> % Subordinated Notes 2014 (£150 million)		149	154
6 <sup>5</sup> / <sub>8</sub> % Subordinated Notes 2015 (£350 million)		343	335
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (£300 million)	g	300	300
Subordinated Step-up Floating Rate Notes 2016 callable 2011 (€500 million)	g	432	445
5.625% Subordinated Fixed to Floating Rate Notes due 2018 callable 2013 (€1,000 million)		946	979
6.9625% Subordinated Fixed to Floating Rate Notes due 2020 callable 2015 (£750 million)		723	758
Subordinated Floating Rate Notes 2020 (€100 million)		86	89
5.75% Subordinated Step-up Notes 2025 callable 2020 (£350 million)		324	322
9 <sup>5</sup> / <sub>8</sub> % Subordinated Bonds 2023 (£300 million)		332	333
Subordinated Non-Interest Bearing Loan on rolling 6 year notice (£150 million)		150	150
6.5% Dated Subordinated Notes 2020 (€1,500 million)		1,353	–
7.375% Dated Subordinated Notes 2020		4	–
6.5% Subordinated Fixed Rate Notes 2020 (US\$2,000 million)		1,202	–
7.625% Dated Subordinated Notes 2025 (£750 million)		763	–
		<b>9,048</b>	6,192
<b>Total subordinated liabilities</b>		<b>15,574</b>	15,456

At 31 December 2010 £14,448 million (2009: £15,081 million) of subordinated liabilities had a contractual residual maturity of greater than one year.

Lloyds TSB Bank plc  
Notes to the accounts

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**45 Subordinated liabilities** (continued)

- a) In certain circumstances, these preference shares may be mandatorily exchanged for qualifying non-innovative tier 1 securities. The Bank may declare no dividend or a partial dividend on these preference shares. Dividends may be reduced if the distributable profits of the Bank are insufficient to cover the payment in full of the dividends and also the payment in full of all other dividends on shares issued by the Bank.
- b) Since 2004, the Bank has had in issue 100 6 per cent non-cumulative redeemable preference shares of £1 each. The shares, which are redeemable at the option of the Bank at any time, carry the rights to a fixed rate non-cumulative preferential dividend at a rate of 6 per cent per annum; no dividend shall be payable in the event that the directors determine that prudent capital ratios would not be maintained if the dividend were paid. Upon winding up, the shares rank equally with any other preference shares issued by the Bank. The holder of the 100 £1 6 per cent preference shares has waived its rights to payment for the period from 1st March 2010 to 1st March 2012.
- c) Guaranteed by Lloyds Banking Group plc on a subordinated basis.
- d) Scottish Widows plc may elect to defer interest on these securities although in that event Scottish Widows plc cannot declare or pay a dividend on any ordinary share capital until any deferred payments have been made.
- e) As part of the Lloyds Banking Group's recapitalisation and exit from the Government Asset Protection Scheme, following an exchange offer, on 1 December, 10 December and 15 December 2009, certain holders of certain securities elected to exchange some or all of the preference shares they held for equity issued by Lloyds Banking Group plc on 18 February 2010.
- f) In November 2009, as part of the state aid restructuring plan, the Group agreed to suspend the payment of coupons on these instruments for the two year period from 31 January 2010 to 31 January 2012.
- g) These securities are callable at specific dates as per the terms of the securities at the option of the issuer and with approval from the FSA. In November 2009, as part of the state aid restructuring plan, the Group agreed not to exercise any call options on these instruments for the two year period from 31 January 2010 to 31 January 2012.
- h) The fixed rate on this security was reset from 8.117 per cent to 6.059 per cent with effect from 31 May 2010.
- i) Following an exchange offer, on 28 May and 4 June 2010, certain holders elected to exchange some or all of the notes they held for equity issued by Lloyds Banking Group plc.
- j) The fixed rate payable on this security was reset from 6.625 per cent to 4.6482 per cent with effect from 15 July 2010.

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Notes to the accounts

## 46 Share capital

### (1) Authorised share capital

	Group and Bank	
	2010 £m	2009 £m
<i>Sterling</i>		
1,650 million ordinary shares of £1 each	1,650	1,650
1 cumulative floating rate Preference share of £1	–	–
100 6 per cent Non-Cumulative Redeemable Preference shares of £1 each	–	–
175 million Preference shares of 25p each	44	44
	<b>1,694</b>	<b>1,694</b>
<i>US dollars</i>		
160 million Preference shares of 25 cents each	40	40
<i>Euro</i>		
160 million Preference shares of 25 cents each	40	40
<i>Japanese yen</i>		
50 million Preference shares of ¥25 each	1,250	1,250

### (2) Issued and fully paid ordinary shares

	2010 Number of shares	2009 Number of shares	2010 £m	2009 £m
<i>Sterling</i>				
Ordinary shares of £1 each				
At 1 January	1,547,280,932	1,541,680,932	1,547	1,542
Shares issued on the transfer of HBOS <sup>1</sup>	21,394,458	–	21	–
Other share issues in 2010 <sup>2</sup>	5,610,361	–	6	–
Capital injection in 2009 <sup>3</sup>	–	5,600,000	–	5
<b>At 31 December</b>	<b>1,574,285,751</b>	<b>1,547,280,932</b>	<b>1,574</b>	<b>1,547</b>

<sup>1</sup>As explained in note 31, on 1 January 2010, as part of a restructuring of the Lloyds Banking Group, Lloyds Banking Group plc's investment in 100 per cent of the ordinary share capital of HBOS plc was transferred to the Bank for a consideration of £21,394 million. The consideration was satisfied by the issue of 21,394,458 ordinary shares to Lloyds Banking Group plc.

<sup>2</sup>During 2010, the Bank issued a total of 5,610,361 ordinary shares as consideration for the redemption of certain preference shares and other subordinated liabilities issued by the Group (see also note 9).

<sup>3</sup>On 14 December 2009, the Bank issued 5.6 million ordinary shares to its ultimate parent undertaking for a total consideration of £5,600 million; these shares were issued in order to maintain the Bank's capital following payment of the Government Asset Protection Scheme fee and the subvention payment (note 11).

### Issued and fully paid preference shares

The Bank has in issue various classes of preference shares which are all classified as liabilities under IFRS and details of which are shown in note 45.

## 47 Share premium account

	Group and Bank	
	2010 £m	2009 £m
At 1 January	8,555	2,960
Premium arising on shares issued on the transfer of HBOS	21,373	–
Premium arising on other share issues in 2010	5,605	–
Premium arising on capital injection in 2009	–	5,595
<b>At 31 December</b>	<b>35,533</b>	<b>8,555</b>

See note 46 for further details on share issues in 2010 and 2009.



Lloyds TSB Bank plc  
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**48 Other reserves**

Other reserves comprise:

Merger reserve

Revaluation reserve in respect of available-for-sale financial assets

Cash flow hedging reserve

Foreign currency translation reserve

**At 31 December**

Movements in other reserves were as follows:

**Merger reserve**

At 1 January

Reserve arising on transfer of HBOS (notes 1 and 31)

**At 31 December**

**Revaluation reserve in respect of available-for-sale financial assets**

At 1 January:

As previously stated

Prior year adjustment

Restated (note 1)

Change in fair value of available-for-sale financial assets

Change in fair value attributable to non-controlling interests

Deferred tax

Current tax

Income statement transfers:

Disposals (see note 9)

Deferred tax

Impairment

Deferred tax

Other transfers

Deferred tax

**At 31 December**

**Cash flow hedging reserve**

At 1 January

Change in fair value of hedging derivatives

Deferred tax

Current tax

Income statement transfer

Deferred tax

**At 31 December**

The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m
<b>6,348</b>	–	–	–
<b>(943)</b>	(1,441)	<b>259</b>	(399)
<b>(125)</b>	(30)	<b>(10)</b>	(30)
<b>(8)</b>	129	<b>116</b>	99
<b>5,272</b>	(1,342)	<b>365</b>	(330)

The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m
–	–	–	–
<b>6,348</b>	–	–	–
<b>6,348</b>	–	–	–

The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m
	(2,982)		
	131		
<b>(1,441)</b>	(2,851)	<b>(399)</b>	(361)

<b>1,231</b>	1,605	<b>924</b>	(24)
–	(1)	–	–
<b>(460)</b>	(206)	<b>(252)</b>	20
<b>(8)</b>	(2)	–	–
<b>763</b>	1,396	<b>672</b>	(4)

<b>(399)</b>	(1)	<b>6</b>	(1)
<b>106</b>	(2)	<b>(3)</b>	(2)
<b>(293)</b>	(3)	<b>3</b>	(3)

<b>114</b>	44	<b>21</b>	15
<b>(5)</b>	(6)	<b>(6)</b>	(4)
<b>109</b>	38	<b>15</b>	11

<b>(110)</b>	(29)	<b>(44)</b>	(58)
<b>29</b>	8	<b>12</b>	16
<b>(81)</b>	(21)	<b>(32)</b>	(42)

<b>(943)</b>	(1,441)	<b>259</b>	(399)
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The Group		The Bank	
2010	2009	2010	2009
£m	£m	£m	£m

<b>(30)</b>	(15)	<b>(30)</b>	(15)
<b>(1,062)</b>	(4)	<b>(13)</b>	(4)
<b>277</b>	1	<b>(2)</b>	1
<b>(3)</b>	–	–	–
<b>(788)</b>	(3)	<b>(15)</b>	(3)

<b>932</b>	(17)	<b>41</b>	(17)
<b>(239)</b>	5	<b>(6)</b>	5

<b>693</b>	(12)	<b>35</b>	(12)
<b>(125)</b>	(30)	<b>(10)</b>	(30)

Lloyds TSB Bank plc  
Notes to the accounts

**48 Other reserves** (continued)

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Foreign currency translation reserve</b>				
At 1 January	129	173	99	127
Currency translation differences arising in the year	25	(676)	17	(28)
Foreign currency losses on net investment hedges	(162)	814	–	–
Current tax	–	176	–	–
Deferred tax	–	(358)	–	–
	(162)	632	–	–
<b>At 31 December</b>	<b>(8)</b>	<b>129</b>	<b>116</b>	<b>99</b>

**49 Retained profits**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January:				
As previously stated		7,588		
Prior year adjustment		(131)		
Restated (note 1)	4,660	7,457	1,051	2,960
Loss for the year	(155)	(2,797)	(280)	(1,909)
Employee share option schemes – value of employee services	7	–	–	–
<b>At 31 December</b>	<b>4,512</b>	<b>4,660</b>	<b>771</b>	<b>1,051</b>

<sup>1</sup>No income statement has been shown for the Bank, as permitted by Section 408 of the Companies Act 2006.

**50 Ordinary dividends**

No dividends were paid on the Bank's ordinary shares in 2010 or 2009.

In November 2009, as part of the restructuring plan that was a requirement for European Commission approval of state aid received by the Lloyds Banking Group, Lloyds Banking Group plc agreed to suspend the payment of coupons and dividends on certain preference shares and preferred securities for the two year period from 31 January 2010 to 31 January 2012. Lloyds Banking Group plc has also agreed to temporarily suspend and/or waive dividend payments on certain preference shares which have been issued intra-group. Consequently, in accordance with the terms of some of these instruments, the Bank is prevented from making dividend payments on its ordinary shares during this period.

**51 Share-based payments**

**Share-based payment scheme details**

During the year ended 31 December 2010 Lloyds Banking Group plc operated a number of share-based payment schemes for which employees of the Lloyds TSB Bank Group were eligible and all of which are equity settled. Details of all schemes operated by Lloyds Banking Group are set out below.

**Deferred bonus plan**

Bonuses in respect of the performance in 2010 of employees within certain of the Group's bonus plans have been recognised in these financial statements in full.

**Lloyds Banking Group executive share option schemes**

The executive share option schemes were long-term incentive schemes available to certain senior executives of the Group, with grants usually made annually. Options were granted within limits set by the rules of the schemes relating to the number of shares under option and the price payable on the exercise of options. The last grant of executive options was made in August 2005. These options were granted without a performance multiplier and the maximum limit for the grant of options in normal circumstances was three times annual salary. Between April 2001 and August 2004, the aggregate value of the award based upon the market price at the date of grant could not exceed four times the executive's annual remuneration and, normally, the limit for the grant of options to an executive in any one year would be equal to 1.5 times annual salary with a maximum performance multiplier of 3.5. Prior to 18 April 2001, the normal limit was equal to one year's remuneration and no performance multiplier was applied.

**Performance conditions for executive options**

*For options granted up to March 2001*

The performance condition was that growth in earnings per share must be equal to the aggregate percentage change in the Retail Prices Index plus three percentage points for each complete year of the relevant period together with a further condition that Lloyds Banking Group plc's ranking based on total shareholder return (calculated by reference to both dividends and growth in share price) over the relevant period should be in the top fifty companies of the FTSE 100.

The relevant period for the performance conditions began at the end of the financial year preceding the date of grant and continued until the end of the third subsequent year following commencement or, if not met, the end of such later year in which the conditions were met. Once the conditions were satisfied the options remained exercisable without further conditions. If they were not satisfied by the tenth anniversary of the grant the options would lapse.

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**51 Share-based payments** (continued)

*For options granted from August 2001 to August 2004*

The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 17 companies including Lloyds Banking Group plc.

The performance condition was measured over a three year period which commenced at the end of the financial year preceding the grant of the option and continued until the end of the third subsequent year. If the performance condition was not then met, it was measured at the end of the fourth financial year. If the condition was not then met, the options would lapse.

To meet the performance conditions, the Group's ranking against the comparator group was required to be at least ninth. The full grant of options only became exercisable if the Group was ranked first. A performance multiplier (of between nil and 100 per cent) was applied below this level to calculate the number of shares in respect of which options granted to executive directors would become exercisable, and were calculated on a sliding scale. If Lloyds Banking Group plc was ranked below median the options would not be exercisable.

Options granted to senior executives other than executive directors were not so highly leveraged and, as a result, different performance multipliers were applied to their options. For the majority of executives, options were granted with the performance condition but with no performance multiplier.

Options granted in 2004 became exercisable as the performance condition was met on the re-test. The performance condition vested at 14 per cent for executive directors, 24 per cent for managing directors, and 100 per cent for all other executives.

*For options granted in 2005*

The same conditions applied as for grants made up to August 2004, except that:

- The performance condition was linked to the performance of Lloyds Banking Group plc's total shareholder return (calculated by reference to both dividends and growth in share price) against a comparator group of 15 companies including Lloyds Banking Group plc;
- If the performance condition was not met at the end of the third subsequent year, the options would lapse; and
- The full grant of options became exercisable only if the Group was ranked in the top four places of the comparator group. A sliding scale applied between fourth and eighth positions. If Lloyds Banking Group was ranked below the median (ninth or below) the options would lapse.

Options granted in 2005 became exercisable as the performance condition was met when tested. The performance condition vested at 82.5 per cent for all options granted.

Movements in the number of share options outstanding under the executive share option schemes during 2009 and 2010 are set out below:

	2010		2009	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	8,784,978	476.56	11,203,628	490.05
Rebasement adjustment	7,523,547	(26.43)	-	-
Exercised	-	-	-	-
Forfeited	(2,945,224)	296.36	(2,418,650)	536.46
<b>Outstanding at 31 December</b>	<b>13,363,301</b>	<b>233.09</b>	<b>8,784,978</b>	<b>476.56</b>
<b>Exercisable at 31 December</b>	<b>13,363,301</b>	<b>233.09</b>	<b>8,784,978</b>	<b>476.56</b>

No options were exercised during 2010 or 2009. The weighted average remaining contractual life of options outstanding at the end of the year was 3.6 years (2009: 4.3 years).

Options granted under this plan were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard Her Majesty's Revenue & Customs (HMRC) formula, to negate the dilutionary impact of the above corporate actions.

**Save-As-You-Earn schemes**

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £250 per month and, at the expiry of a fixed term of three, five or seven years, have the option to use these savings within six months of the expiry of the fixed term to acquire shares in the Group at a discounted price of no less than 80 per cent of the market price at the start of the invitation.

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**51 Share-based payments** (continued)

Movements in the number of share options outstanding under the SAYE schemes are set out below:

	2010		2009	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	130,133,992	147.69	190,478,449	152.54
Adjustment on acquisition	–	–	53,755,275	415.21
Rebasement adjustment	22,382,641	(416.83)	–	–
Granted	655,712,663	46.78	–	–
Exercised	(195,339)	49.30	–	–
Forfeited	(13,922,185)	57.34	(9,581,800)	400.93
Cancelled	(107,144,275)	66.53	(93,599,380)	206.07
Expired	(18,923,463)	179.35	(10,918,552)	470.16
<b>Outstanding at 31 December</b>	<b>668,044,034</b>	<b>49.59</b>	<b>130,133,992</b>	<b>177.60</b>
<b>Exercisable at 31 December</b>	<b>663,942</b>	<b>172.93</b>	<b>754,554</b>	<b>317.32</b>

The weighted average share price at the time that options were exercised during 2010 was £0.69 (2009: £nil). The weighted average remaining contractual life of options outstanding at the end of the year was 2.7 years (2009: 2.7 years).

The weighted average fair value of SAYE options granted during 2010 was £0.33 (2009: £nil). The values for the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2010 or 2009. The options outstanding at 31 December 2010 had an exercise price of £1.8066 (2009: £3.64) and a weighted average remaining contractual life of 2.9 years (2009: 4.0 years).

Options granted under these plans were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

**Other share option plans**

**Lloyds Banking Group Executive Share Plan 2003**

The plan was adopted in December 2003 and under the plan share options may be granted to senior employees. Options under this plan have been granted specifically to facilitate recruitment and as such were not subject to any performance conditions. The plan's usage has now been extended to not only compensate new recruits for any lost share awards but also to make grants to key individuals for retention purposes with, in some instances, the grant being made subject to individual performance conditions.

	2010		2009	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	26,099,185	Nil	857,611	Nil
Granted	13,429,561	Nil	24,704,070	Nil
Rebasement adjustment	12,501,246	Nil	1,876,005	Nil
Exercised	(2,661,703)	Nil	(157,105)	Nil
Forfeited	(1,673,532)	Nil	(1,181,396)	Nil
<b>Outstanding at 31 December</b>	<b>47,694,757</b>	<b>Nil</b>	<b>26,099,185</b>	<b>Nil</b>
<b>Exercisable at 31 December</b>	<b>–</b>	<b>Nil</b>	<b>33,794</b>	<b>Nil</b>

The weighted average fair value of options granted in the year was £0.63 (2009: £0.68). The weighted average share price at the time that the options were exercised during 2010 was £0.63 (2009: £0.71). The weighted average remaining contractual life of options outstanding at the end of the year was 2.4 years (2009: 3.0 years).

Options granted under this plan were adjusted on 2 July 2009 as a result of the Placing and Compensatory Open Offer and on 13 August 2010 as a result of the Capitalisation Issue and Rights Issue of 2009. The adjustments were made, where applicable, using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

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**51 Share-based payments** (continued)

**HBOS share option plans**

The table below details the outstanding options for the HBOS Share Option Plan, the St James's Place Share Option Plan, and the 1995 and 1996 Bank of Scotland Executive Stock Option schemes. The final award under the HBOS Share Option Plan was made in 2004. Under this plan, options over shares, at market value with a face value equal to 20 per cent of salary, were granted to employees with the exception of certain senior executives. A separate option plan exists for some partners of St James's Place, which grants options in respect of Lloyds Banking Group plc shares. The final award under the St James's Place Share Option Plan was made in 2009. Movements in the number of share options outstanding under these schemes are set out below:

	2010		2009	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January (16 January 2009)	14,301,748	880.27	13,040,430	1,167.26
Rebasement adjustment	12,899,990	(61.23)	–	–
Granted	–	–	4,040,555	104.50
Forfeited	(2,506,244)	611.90	(2,779,237)	1,099.02
<b>Outstanding at 31 December</b>	<b>24,695,494</b>	<b>415.70</b>	<b>14,301,748</b>	<b>880.27</b>
<b>Exercisable at 31 December</b>	<b>15,320,780</b>	<b>593.79</b>	<b>9,198,557</b>	<b>1,169.14</b>

No options were exercised during 2010 or 2009. The options outstanding under the HBOS Share Option Plan and St James's Place Share Option Plan at 31 December 2010 had exercise prices in the range of £0.5183 to £8.7189 (2009: £1.05 to £17.576) and a weighted average remaining contractual life of 3.0 years.

No options were outstanding under the Bank of Scotland Executive Stock Option schemes at 31 December 2010. Options outstanding at 31 December 2009 had exercise prices in the range of £8.834 to £10.009 and a weighted average remaining contractual life of 0.8 years.

Options granted under these plans were adjusted on 13 August 2010 as a result of the Capitalisation Issue, the Placing and Compensatory Open Offer and the Rights Issue of 2009. The adjustment was made using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

**Other share plans**

**Lloyds Banking Group Long-Term Incentive Plan**

The Long-Term Incentive Plan (LTIP) introduced in 2006 is aimed at delivering shareholder value by linking the receipt of shares to an improvement in the performance of the Group over a three year period. Awards are made within limits set by the rules of the plan, with the limits determining the maximum number of shares that can be awarded equating to three times annual salary. In exceptional circumstances this may increase to four times annual salary.

The performance conditions for awards made in March and August 2007 are as follows:

- (i) For 50 per cent of the award (the EPS Award) – the percentage increase in earnings per share of the Group (on a compound annualised basis) over the relevant period needed to be at least an average of 6 percentage points per annum greater than the percentage increase (if any) in the Retail Prices Index over the same period. If it was less than 3 per cent per annum the EPS Award would lapse. If the increase was more than 3 per cent but less than 6 per cent per annum then the proportion of shares released would be on a straight line basis between 17.5 per cent and 100 per cent. The relevant period commenced on 1 January 2007 and ended on 31 December 2009.
- (ii) For the other 50 per cent of the award (the TSR Award) – it was necessary for the Group's total shareholder return (calculated by reference to both dividends and growth in share price) to exceed the median of a comparator group (14 companies) over the relevant period by an average of 7.5 per cent per annum for the TSR Award to vest in full. 17.5 per cent of the TSR Award would vest where the Group's total shareholder return was equal to median and vesting would occur on a straight line basis in between these points. Where the Group's total shareholder return was below the median of the comparator group, the TSR Award would lapse. The relevant period commenced on 8 March 2007 and ended on 7 March 2010.

As a consequence of the acquisition of HBOS and the general market turmoil, in March 2009 the Remuneration Committee decided that the performance test for the 2007 awards should be based on the performance of the Group up to 17 September 2008, the date prior to the announcement of the HBOS acquisition. The performance test was on a fair value basis, on the estimated probability, as at that date, of achieving the performance conditions. As a consequence, for all participants, other than those who were executive directors at the time the award was granted and a small number of other senior executives, the share awards vested at 31 per cent in March 2010.

The performance conditions for awards made in March, April and August 2008 are as follows:

- (i) For 50 per cent of the award (the EPS Award) – the performance condition is as described for the 2007 awards with the relevant performance period commencing on 1 January 2008 and ending on 31 December 2010.
- (ii) For the other 50 per cent of the award (the TSR Award) – the performance condition is as described for the 2007 awards, except that the comparator group comprises of 13 companies, with the relevant performance period commencing on 6 March 2008 (the date of the first award) and ending on 5 March 2011.

The current LTIP rules allow for awards to be made of up to 400 per cent of base salary. Under normal circumstances awards are made of 300 per cent of salary with the additional 100 per cent available for circumstances that the Remuneration Committee deems to be exceptional. In 2008, awards were made of 375 per cent of base salary to the chief executive and two of the executive directors for retention purposes, and in light of data reviewed by the committee which showed total remuneration to be behind median both for the FTSE 20, and the other major UK banks.

As for the 2007 LTIP awards, as a consequence of the acquisition of HBOS and the general market turmoil, in March 2009 the Remuneration Committee decided that the performance test for the 2008 awards should be based on the performance of the Group up to 17 September 2008, the date prior to the announcement of the HBOS acquisition. The performance test was on a fair value basis, on the estimated probability, as at that date, of achieving the performance conditions. As a

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**51 Share-based payments** (continued)

consequence, for all participants, other than those who were executive directors at the time the award was granted and a small number of other senior executives, the share awards will vest at 29 per cent in March 2011.

The performance conditions for awards made in April, May and September 2009 are as follows:

- (i) **EPS:** relevant to 50 per cent of the award. Performance will be measured on the extent to which the growth in EPS achieves cumulative EPS targets over the three-year period.

If the growth in EPS reaches 26 per cent, 25 per cent of this element of the award, being the threshold, will vest. If growth in EPS reaches 36 per cent, 100 per cent of this element will vest.

- (ii) **Economic profit:** relevant to 50 per cent of the award. Performance will be measured based on the extent to which cumulative economic profit targets are achieved over the three-year period.

If the absolute improvement in adjusted economic profit reaches 100 per cent, 25 per cent of this element of the award, being the threshold, will vest. If the absolute improvement in adjusted economic profit reaches 202 per cent, 100 per cent of this element will vest.

The EPS and economic profit performance measures applying to this 2009 LTIP award were set on the basis that the Group would enter into the Government Asset Protection Scheme. As the Group is not participating in the Government Asset Protection Scheme, in June 2010 the Remuneration Committee approved restated performance measures on a basis consistent with the EPS and economic profit measures used for the 2010 LTIP awards.

An additional discretionary award was made in April, May and September 2009. The performance conditions for those awards are as follows:

- (i) **Synergy savings:** The release of 50 per cent of the shares will be dependent on the achievement of target run-rate synergy savings in 2009 and 2010 as well as the achievement of sustainable synergy savings of at least £1.5 billion by the end of 2011. The award will be broken down into three equally weighted annual tranches. Performance will be assessed at the end of each year against annual performance targets based on a trajectory to meet the 2011 target. The extent to which targets have been achieved will determine the proportion of shares to be banked each year. Any release of shares will be subject to the Remuneration Committee judging the overall success of the delivery of the integration programme.

- (ii) **Integration balanced scorecard:** The release of the remaining 50 per cent of the shares will be dependent on the outcome of a Balanced Scorecard of non-financial measures of the success of the integration in each of 2009, 2010 and 2011. The Balanced scorecard element will be broken down into three equally weighted tranches. The tranches will be crystallised and banked for each year of the performance cycle subject to separate annual performance targets across the four measurement categories of Building the Business, Customer, Risk and People and Organisation Development.

Performance against the first two years of the award has been assessed and all targets have been met or exceeded.

The performance conditions for awards made in March and August 2010 are as follows:

- (i) **EPS:** relevant to 50 per cent of the award. Performance will be measured based on absolute improvement in adjusted EPS over the three financial years starting on 1 January 2010 relative to an adjusted fully diluted 2009 EPS base.

If the absolute improvement in adjusted EPS reaches 158 per cent, 25 per cent of this element of the award, being the threshold, will vest. If absolute improvement in adjusted EPS reaches 180 per cent, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

- (ii) **Economic profit:** relevant to 50 per cent of the award. Performance will be measured based on the compound annual growth rate of adjusted economic profit over the three financial years starting on 1 January 2010 relative to an adjusted 2009 economic profit base.

If the compounded annual growth rate of adjusted Economic Profit reaches 57 per cent per annum, 25 per cent of this element of the award, being the threshold, will vest. If the compounded annual growth rate of adjusted economic profit reaches 77 per cent per annum, 100 per cent of this element will vest.

Vesting between threshold and maximum will be on a straight line basis.

For awards made to executive directors, a third performance condition was set, relating to Absolute Share Price, relevant to 28 per cent of the award. Performance will be measured based on the Absolute Share Price on 26 March 2013, being the third anniversary of the award date. If the share price at the end of the performance period is 75 pence or less, none of this element of the award will vest. If the share price is 114 pence or higher, 100 per cent of this element will vest. Vesting between threshold and maximum will be on a straight line basis, provided that shares comprised in the Absolute Share Price element may only be released if both the EPS and economic profit performance measures have been satisfied at the threshold level or above. The EPS and economic profit performance conditions will each relate to 36 per cent of the total award.

	2010 Number of shares	2009 Number of shares
Outstanding at 1 January	223,233,052	22,237,282
Granted	148,810,591	199,293,192
Rebasement adjustment	106,990,259	10,443,102
Forfeited	(31,891,411)	(8,740,524)
<b>Outstanding at 31 December</b>	<b>447,142,491</b>	<b>223,233,052</b>

The fair value of the share awards granted in 2010 was £0.61 (2009: £0.68).

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**51 Share-based payments** (continued)

Conditional awards of shares made under this plan were adjusted on 2 July 2009 as a result of the Placing and Compensatory Open Offer and on 13 August 2010 as a result of the Capitalisation Issue and Rights Issue of 2009. The adjustments were made, where applicable, using a standard HMRC formula, to negate the dilutionary impact of the above corporate actions.

**Performance share plan**

Under the performance share plan, introduced during 2005, participating executives would have been eligible for an award of free shares, known as performance shares, to match the bonus shares awarded as part of their 2004 and 2005 bonus. The maximum match was two performance shares for each bonus share, awarded at the end of a three year period. The actual number of shares which would have been awarded was dependent on the Group's total shareholder return performance measured over a three year period, compared to other companies in the comparator group. The maximum of two performance shares for each bonus share would have been awarded only if the Group's total shareholder return performance placed it first in the comparator group; one performance share for each bonus share would have been granted if the Group was placed fifth; and one performance share for every two bonus shares if the Group was placed eighth (median). Between first and fifth position, and fifth and eighth position, sliding scales would have applied. If the total shareholder return performance was below median, no performance shares would have been awarded. There was no retest. Whilst income tax and national insurance were deducted from the bonus before deferral into the plan, where a match of performance shares was justified, these shares would have been awarded as if income tax and national insurance had not been deducted.

The performance condition attached to the March 2006 award was not met, with Lloyds Banking Group ranked in ninth place. Bonus shares were released on 20 March 2009, at which time the performance shares lapsed.

	<b>2010</b>	2009
	<b>Number of shares</b>	Number of shares
Outstanding at 1 January	–	941,324
Lapsed	–	(941,324)
<b>Outstanding at 31 December</b>	<b>–</b>	<b>–</b>

The ranges of exercise prices, weighted average exercise prices, weighted average remaining contractual life and number of options outstanding for the option schemes were as follows:

	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
<b>31 December 2010</b>									
Exercise price range									
£0 to £1	–	–	–	47.74	2.7	658,912,847	7.41	2.5	55,656,496
£1 to £2	199.91	3.6	262,725	178.74	2.8	7,984,764	–	–	–
£2 to £3	225.83	3.9	12,052,934	210.74	1.4	1,146,423	–	–	–
£3 to £4	324.92	0.2	1,047,642	–	–	–	–	–	–
£5 to £6	–	–	–	–	–	–	567.65	2.9	15,462,949
	Executive schemes			SAYE schemes			Other share option plans		
	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options	Weighted average exercise price (pence)	Weighted average remaining life (years)	Number of options
<b>31 December 2009</b>									
Exercise price range									
£0 to £1	–	–	–	–	–	–	Nil	3.1	26,099,185
£1 to £2	–	–	–	139.00	2.5	107,939,699	104.50	2.3	4,019,026
£2 to £3	–	–	–	220.98	3.9	18,054,765	–	–	–
£3 to £4	–	–	–	349.18	2.0	2,842,644	394.64	5.2	721,886
£4 to £5	464.19	4.9	7,526,441	427.04	1.8	1,296,884	499.91	0.2	273,986
£5 to £6	552.02	0.2	515,527	–	–	–	573.60	0.6	53,328
£6 to £7	653.55	1.2	743,010	–	–	–	640.00	0.0	2,388,026
£7 to £8	–	–	–	–	–	–	707.40	0.2	6,845,496

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**51 Share-based payments** (continued)

The fair value calculations at 31 December 2010 for grants made in the year are based on the following assumptions:

	SAYE	Other option schemes	Other share plans
Risk-free interest rate	1.80%	0.76%	1.33%
Expected life	3.0 years	1-5 years	2-4 years
Expected volatility	85%	83%	70%
Expected dividend yield	1.4%	0.5%	0.9%
Weighted average share price	0.59	0.67	0.67
Weighted average exercise price	0.48	Nil	Nil
Expected forfeitures	4%	4%	4%

Expected volatility is a measure of the amount by which the Group's shares are expected to fluctuate during the life of an option. The expected volatility is estimated based on the historical volatility of the closing daily share price over the most recent period that is commensurate with the expected life of the option. The historical volatility is compared to the implied volatility generated from market traded options in the Group's shares to assess the reasonableness of the historical volatility and adjustments made where appropriate.

**Share incentive plan**

**Free shares**

An award of shares may be made annually to employees based on a percentage of each employee's salary in the preceding year up to a maximum of £3,000. The percentage is normally announced concurrently with the Group's annual results and the price of the shares awarded is announced at the time of award. The shares awarded are held in trust for a mandatory period of three years on the employee's behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves the Group within this three year period for other than a 'good' reason, all of the shares awarded will be forfeited.

No free shares were awarded in 2009 or 2010.

**Matching shares**

The Group undertakes to match shares purchased by employees up to the value of £30 per month; these shares are held in trust for a mandatory period of three years on the employees' behalf, during which period the employee is entitled to any dividends paid on such shares. The award is subject to a non-market based condition: if an employee leaves within this three year period for other than a 'good' reason, 100 per cent of the matching shares are forfeited. Similarly if the employees sell their purchased shares within three years, their matching shares are forfeited.

The number of shares awarded relating to matching shares in 2010 was 17,411,651 (2009: 16,746,310), with an average fair value of £0.63 (2009: £0.69), based on market prices at the date of award.

**52 Related party transactions**

**Key management personnel**

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of an entity; the Group's key management personnel are the members of the Lloyds Banking Group plc group executive committee together with its non-executive directors.

As detailed in note 31, HBOS plc became a subsidiary of the Bank on 1 January 2010 and the compensation below reflects the increase in the amount of key management personnel time devoted to the Bank and its subsidiaries.

The table below details, on an aggregated basis, key management personnel compensation:

	2010 £m	2009 £m
<b>Compensation</b>		
Salaries and other short-term benefits	15	8
Post-employment benefits	2	1
<b>Total compensation</b>	17	9

The aggregate of the emoluments of the directors was £10.6 million (2009: £5.0 million).

The number of directors to whom retirement benefits were accruing under defined contribution and defined benefit pension schemes were three and two respectively (2009: three and two). Aggregate company contributions in respect of directors to defined contribution pension schemes were £435,000 (2009: £214,000).

The total for the highest paid director J E Daniels was £2,572,000 (2009: (G T Tate) £903,000); this did not include any gain on exercise of Lloyds Banking Group plc shares in either year.

	2010 million	2009 million
<b>Share options over Lloyds Banking Group plc shares</b>		
At 1 January	2	2
Granted, including certain adjustments (includes entitlements of appointed directors) <sup>1</sup>	4	–
<b>At 31 December</b>	6	2

<sup>1</sup> Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.



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**52 Related party transactions** (continued)

	2010 million	2009 million
<b>Share plans settled in Lloyds Banking Group plc shares</b>		
At 1 January	19	7
Granted, including certain adjustments (includes entitlements of appointed directors) <sup>1</sup>	39	17
Exercised/lapsed (includes entitlements of former directors)	(2)	(5)
<b>At 31 December</b>	<b>56</b>	<b>19</b>

<sup>1</sup> Adjustments have been made, using a standard HMRC formula, to negate the dilutionary impact of the Lloyds Banking Group's 2009 capital raising activities.

The tables below detail, on an aggregated basis, balances outstanding at the year end and related income and expense, together with information relating to other transactions between the Group and its key management personnel:

	2010 £m	2009 £m
<b>Loans</b>		
At 1 January	2	3
Advanced (includes loans of appointed directors)	2	–
Repayments (includes loans of former directors)	(1)	(1)
<b>At 31 December</b>	<b>3</b>	<b>2</b>

The loans are on both a secured and unsecured basis and are expected to be settled in cash. The loans attracted interest rates of between 0.50 per cent and 17.90 per cent in 2010 (2009: 1.28 per cent and 24.90 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2009: £nil).

	2010 £m	2009 £m
<b>Deposits</b>		
At 1 January	4	6
Placed (includes deposits of appointed directors)	12	12
Withdrawn (includes deposits of former directors)	(12)	(14)
<b>At 31 December</b>	<b>4</b>	<b>4</b>

Deposits placed by key management personnel attracted interest rates of up to 4.25 per cent (2009: 6.50 per cent).

At 31 December 2010, the Group did not provide any guarantees in respect of key management personnel (2009 £nil).

At 31 December 2010, transactions, arrangements and agreements entered into by the Group and its banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £2 million with six directors and four connected persons (2009: £2 million with seven directors and four connected persons).

**Balances and transactions with fellow Lloyds Banking Group undertakings**

*Balances and transactions between members of the Lloyds TSB Bank group*

In accordance with IAS 27, transactions and balances between the Bank and its subsidiary undertakings, and between those subsidiary undertakings, have all been eliminated on consolidation and thus are not reported as related party transactions of the Group.

The Bank, as a result of its position as parent of a banking group, has a large number of transactions with various of its subsidiary undertakings; these are included on the balance sheet of the Bank as follows:

	2010 £m	2009 £m
Assets, included within:		
Derivative financial instruments	2,136	301
Loans and receivables:		
Loans and advances to banks	145,542	29,046
Loans and advances to customers	50,188	47,021
Available-for-sale financial assets	5,046	–
	<b>202,912</b>	<b>76,368</b>
Liabilities, included within:		
Deposits from banks	80,476	21,369
Customer deposits	41,181	27,800
Derivative financial instruments	1,775	302
Debt securities in issue	5,167	3,410
Subordinated liabilities	37	677
	<b>128,636</b>	<b>53,558</b>

Due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Bank earned interest income on the above asset balances of £2,176 million (2009: £1,826 million) and incurred interest expense on the above liability balances of £1,565 million (2009: £1,364 million).

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## 52 Related party transactions (continued)

In addition, the Bank raised recharges of £660 million (2009: £505 million) on its subsidiaries in respect of costs incurred and also received fees of £278 million (2009: £411 million), and paid fees of £387 million (2009: £322 million), for various services provided between the Bank and its subsidiaries.

Details of contingent liabilities and commitments entered into on behalf of fellow Lloyds Banking Group undertakings are given in note 53.

### Balances and transactions with Lloyds Banking Group plc

The Bank and its subsidiaries have balances due to and from the Bank's parent company, Lloyds Banking Group plc and fellow subsidiaries of the Bank. These are included on the balance sheet as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets, included within:				
Derivative financial instruments	–	923	–	923
Loans and receivables:				
Loans and advances to banks	–	150,121	–	150,121
Loans and advances to customers	<b>18,492</b>	14,188	<b>13,851</b>	14,088
Other	<b>36</b>	909	<b>36</b>	435
	<b>18,528</b>	166,141	<b>13,887</b>	165,567
Liabilities, included within:				
Deposits from banks	–	86,512	–	86,512
Customer deposits	<b>22,633</b>	18,387	<b>16,098</b>	17,986
Derivative financial instruments	<b>487</b>	1,195	<b>487</b>	1,195
Subordinated liabilities	<b>4,686</b>	5,896	<b>4,434</b>	5,572
Debt securities in issue	–	671	–	391
	<b>27,806</b>	112,661	<b>21,019</b>	111,656

These balances include Lloyds Banking Group plc's banking arrangements and, due to the size and volume of transactions passing through these accounts, it is neither practical nor meaningful to disclose information on gross inflows and outflows. During 2010 the Group earned £373 million and the Bank earned £321 million interest income on the above asset balances (2009: Group £746 million; Bank £724 million); the Group incurred £1,215 million and the Bank incurred £950 million interest expense on the above liability balances (2009: Group £554 million; Bank £547 million).

### HM Treasury

In January 2009, HM Treasury became a related party of Lloyds Banking Group plc, the Bank's parent company, following its subscription for ordinary shares issued under a placing and open offer. As at 31 December 2010, HM Treasury held a 41 per cent interest (December 2009: 43 per cent) in Lloyds Banking Group plc's ordinary share capital and consequently HM Treasury remained a related party of the Bank and its subsidiaries throughout 2010.

### Capital transactions

During 2010 there were no further subscriptions by HM Treasury for Lloyds Banking Group plc's ordinary or preference share capital, with the decline in the percentage of ordinary shares held by HM Treasury reflecting the issuance by Lloyds Banking Group plc of ordinary shares.

### Lending commitments

On 23 March 2010, Lloyds Banking Group plc entered into a deed poll in favour of HM Treasury, the Department for Business, Innovation and Skills and the Departments for Communities and Local Government confirming its lending commitments for the 12 month period commencing 1 March 2010. Lloyds Banking Group plc agreed, subject to, amongst other things, sufficient customer demand, to provide gross new lending to UK businesses of £44,000 million and to adjust the undertakings (but not the level of lending agreed in 2009) given in connection with lending to homeowners for the 12 month period. This additional lending is expressed to be subject to the Group's prevailing commercial terms and conditions (including pricing and risk assessment) and, in relation to mortgage lending, the Group's standard credit and other acceptance criteria.

### Credit Guarantee Scheme

HM Treasury launched the Credit Guarantee Scheme in October 2008 as part of a range of measures announced by the UK Government intended to ease the turbulence in the UK banking system. It charges a commercial fee for the guarantee of new short and medium-term debt issuance. The fee payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus the median five-year credit default swap spread. At 31 December 2010, the Group had £45,308 million (2009: £40,345 million) of debt issued under the Credit Guarantee Scheme. During 2010, the Group redeemed £4,987 million of bonds. The Group's income statement includes fees of £454 million (2009: £262 million) payable to HM Treasury in respect of guaranteed funding.

There were no other material transactions between the Group and HM Treasury during 2010 that were not made in the ordinary course of business or that were unusual in their nature or conditions.

### Other related party transactions

#### Pensions funds

The Group provides banking and some investment management services to certain of the Group pension funds. At 31 December 2010, customer deposits of £64 million (2009: £53 million) and investment and insurance contract liabilities of £850 million (2009: £nil) related to the Group's pension funds.

#### OEICs

The Group manages 402 (2009: 109) Open Ended Investment Companies (OEICs), and of these 111 (2009: 47) are consolidated. The Group invested £1,460 million (2009: £412 million) and redeemed £982 million (2009: £362 million) in the unconsolidated OEICs during the year and had investments, at fair value, of £7,920 million (2009: £3,365 million) at 31 December. The Group earned fees of £271 million from the unconsolidated OEICs (2009: £188 million). The Bank held no investments in OEICs at any time during 2009 or 2010.

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## 52 Related party transactions (continued)

### Taxation

Group relief was surrendered for no payment as per note 15.

### Joint ventures and associates

The Group provides both administration and processing services to its principal joint venture, Sainsbury's Bank plc. The amounts receivable by the Group during the year were £31 million (2009: £nil), of which £8 million was outstanding at 31 December 2010 (2009: £nil). At 31 December 2010, Sainsbury's Bank plc also had balances with the Group that were included in loans and advances to banks of £1,277 million (2009: £nil) and deposits by banks of £1,358 million (2009: £nil).

At 31 December 2010 there were loans and advances to customers of £5,660 million (2009: £nil) outstanding and balances within customer deposits of £151 million (2009: £nil) relating to other joint ventures and associates.

In addition to the above balances, the Group has a number of other associates held by its venture capital business that it accounts for at fair value through profit or loss. At 31 December 2010, these companies had total assets of approximately £12,216 million (2009: £3,024 million), total liabilities of approximately £15,853 million (2009: £3,194 million) and for the year ended 31 December 2010 had turnover of approximately £3,829 million (2009: £1,804 million) and made a net profit of approximately £182 million (2009: net loss of £80 million). In addition, the Group has provided £3,316 million (2009: £868 million) of financing to these companies on which it received £93 million (2009: £51 million) of interest income in the year.

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## 53 Contingent liabilities and commitments

### Unarranged overdraft charges

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

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

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

### Interchange fees

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

### Payment protection insurance

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

In October 2010, the UK Competition Commission (Competition Commission) confirmed its decision to prohibit the active sale of PPI by a distributor to a customer within seven days of a sale of credit. This followed the completion of its formal investigation into the supply of PPI services (other than store card PPI) to non-business customers in the UK in January 2009 and a referral of the proposed prohibition to the Competition Appeal Tribunal. Following an earlier decision to stop selling single premium PPI products, the Group ceased to offer PPI products to its customers in July 2010.

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

On 8 October 2010, the British Bankers Association (BBA), the principal trade association for the UK banking and financial services sector, filed an application for permission to seek judicial review against the FSA and the FOS. The BBA is seeking an order quashing the FSA policy statement and an order quashing the decision

### 53 Contingent liabilities and commitments (continued)

of the FOS to determine PPI sales in accordance with the guidance published on its website in November 2008. The Judicial hearing was held in late January 2011 and the judgment (which may be subject to appeal) is expected shortly.

This legal challenge has affected the implementation of the Policy Statement, since the challenge has called into question the standards to be applied when assessing PPI complaints. As a result of that challenge, a large number of complaints cannot be decided until the outcome of the legal challenge is clear.

The ultimate impact on the Group of the FSA's complaints handling policy (if implemented in full) and the FOS's most recent approach to PPI complaints could be material to the Group's financial position, although the precise effect can only be assessed once the legal proceedings have been finally determined and the steps the Group may be required to take identified and implemented. In addition, it is not practicable to quantify the potential financial impact of the implementation of the Policy Statement given the material uncertainties around, for example, applicable time periods, the extent of application of root cause analysis, the treatment of evidence and the ultimate emergence period for complaints, driven in large part by the activities of the claims management companies, all of which will significantly affect complaints volumes, uphold rates and redress costs. No provision has been made in these financial statements to reflect implementation of the FSA's complaint handling policy in its current form.

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

#### US sanctions

In January 2009 the Bank announced the settlement it had reached with the US Department of Justice and the New York County District Attorney's Office in relation to their investigations into historic US dollar payment practices involving countries, persons or entities subject to the economic sanctions administered by the US Office of Foreign Assets Control (OFAC). On 22 December 2009 OFAC announced the settlement it had reached with the Bank in relation to its investigation and confirmed that the settlement sum due to OFAC had been fully satisfied by the Bank's payment to the Department of Justice and the New York County District Attorney's Office. No further enforcement actions are expected in relation to the matters set out in the settlement agreements.

On 26 February 2009 a purported shareholder filed a derivative civil action in the Supreme Court of New York, Nassau County against certain current and former directors, and nominally against the Bank and Lloyds Banking Group plc, seeking various forms of relief. The derivative action is at an early stage and settlement is being discussed and the ultimate outcome is not expected to have a material impact on the Group.

#### European Union gender directive

An opt-out clause to the European Union Gender Directive currently permits insurers to take gender into account as a risk factor when pricing contracts. In March 2011, the European Court of Justice is expected to rule on whether this infringes fundamental European rights for equal treatment. If the European Court of Justice rules that the opt-out clause does infringe such rights, it could alter the market and alter prices for insurance products to a significant extent. At the date of these financial statements, no provision has been made for the potential costs of rectifying contracts in existence at 31 December 2010, should this ultimately be required. The ultimate impact on the Group can only be known following the European Court of Justice's ruling. However, the Group does not expect the final outcome of this matter to have a material adverse effect on its financial position.

#### Other legal proceedings and regulatory matters

In the course of its business, the Group is engaged in discussions with the FSA in relation to a range of conduct of business matters, especially in relation to retail products including packaged bank accounts, mortgages, structured products and pensions. The Group is keen to ensure that any regulatory concerns regarding product governance or contract terms are understood and addressed. The ultimate impact on the Group of these discussions can only be known at the conclusion of such discussions.

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 advisors 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 matter to have a material adverse effect on its financial position.

#### Contingent liabilities and commitments arising from the banking business

Acceptances and endorsements arise where the Group or the Bank agrees to guarantee payment on a negotiable instrument drawn up by a customer.

Other items serving as direct credit substitutes include standby letters of credit, or other irrevocable obligations, where the Group or the Bank has an irrevocable obligation to pay a third party beneficiary if the customer fails to repay an outstanding commitment; they also include acceptances drawn under letters of credit or similar facilities where the acceptor does not have specific title to an identifiable underlying shipment of goods.

Performance bonds and other transaction-related contingencies (which include bid or tender bonds, advance payment guarantees, VAT Customs & Excise bonds and standby letters of credit relating to a particular contract or non-financial transaction) are undertakings where the requirement to make payment under the guarantee depends on the outcome of a future event.

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**53 Contingent liabilities and commitments** (continued)

The Group's and the Bank's maximum exposure to loss is represented by the contractual nominal amount detailed in the table below. Consideration has not been taken of any possible recoveries from customers for payments made in respect of such guarantees under recourse provisions or from collateral held.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Contingent liabilities</b>				
Acceptances and endorsements	<b>48</b>	53	<b>50</b>	54
Other:				
Other items serving as direct credit substitutes	<b>1,319</b>	1,395	<b>1,154</b>	1,276
Performance bonds and other transaction-related contingencies	<b>2,812</b>	3,292	<b>2,280</b>	2,772
	<b>4,131</b>	4,687	<b>3,434</b>	4,048
<b>Total contingent liabilities</b>	<b>4,179</b>	4,740	<b>3,484</b>	4,102
			The Bank	
			2010 £m	2009 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings			<b>69</b>	30

The contingent liabilities of the Group and the Bank, as detailed above, arise in the normal course of banking business and it is not practicable to quantify their future financial effect.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Commitments</b>				
Documentary credits and other short-term trade-related transactions	<b>255</b>	219	<b>259</b>	219
Forward asset purchases and forward deposits placed	<b>887</b>	758	<b>1,705</b>	3,373
Undrawn formal standby facilities, credit lines and other commitments to lend:				
Less than 1 year original maturity:				
Mortgage offers made	<b>8,113</b>	1,302	<b>1,043</b>	1,135
Other commitments	<b>60,528</b>	36,206	<b>38,216</b>	33,681
	<b>68,641</b>	37,508	<b>39,259</b>	34,816
1 year or over original maturity	<b>47,515</b>	36,020	<b>41,976</b>	43,545
<b>Total commitments</b>	<b>117,298</b>	74,505	<b>83,199</b>	81,953
			The Bank	
			2010 £m	2009 £m
Incurred on behalf of fellow Lloyds Banking Group undertakings			<b>14,008</b>	12,467

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend £63,630 million (2009: £44,327 million) for the Group and £39,280 million (2009: £39,469 million) for the Bank were irrevocable.

**Operating lease commitments**

Where a Group company is the lessee, the future minimum lease payments under non-cancellable premises operating leases are as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Not later than 1 year	<b>356</b>	204	<b>172</b>	188
Later than 1 year and not later than 5 years	<b>1,120</b>	554	<b>479</b>	506
Later than 5 years	<b>1,706</b>	622	<b>561</b>	552
<b>Total operating lease commitments</b>	<b>3,182</b>	1,380	<b>1,212</b>	1,246

Operating lease payments represent rental payable by the Group for certain of its properties. Some of these operating lease arrangements have renewal options and rent escalation clauses, although the effect of these is not material. No arrangements have been entered into for contingent rental payments.

**Capital commitments**

Excluding commitments of the Group in respect of investment property (note 26), capital expenditure contracted but not provided for at 31 December 2010 amounted to £339 million for the Group and £12 million for the Bank (2009: £96 million for the Group and £5 million for the Bank). Of this amount for the Group, £282 million (2009: £91 million) relates to assets to be leased to customers under operating leases. The Group's management is confident that future net revenues and funding will be sufficient to cover these commitments.

## Notes to the accounts

## 54 Financial instruments

**(1) Measurement basis of financial assets and liabilities**

The accounting policies in note 2 describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

The Group	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
<b>As at 31 December 2010</b>								
<b>Financial assets</b>								
Cash and balances at central banks	-	-	-	-	-	38,115	-	38,115
Items in the course of collection from banks	-	-	-	-	-	1,368	-	1,368
Trading and other financial assets at fair value through profit or loss	-	23,743	132,533	-	-	-	-	156,276
Derivative financial instruments	7,406	42,194	-	-	-	-	-	49,600
Loans and receivables:								
Loans and advances to banks	-	-	-	-	30,272	-	-	30,272
Loans and advances to customers	-	-	-	-	611,089	-	-	611,089
Debt securities	-	-	-	-	25,735	-	-	25,735
	-	-	-	-	667,096	-	-	667,096
Available-for-sale financial assets	-	-	-	42,955	-	-	-	42,955
Held-to-maturity investments	-	-	-	-	-	7,905	-	7,905
<b>Total financial assets</b>	<b>7,406</b>	<b>65,937</b>	<b>132,533</b>	<b>42,955</b>	<b>667,096</b>	<b>47,388</b>	<b>-</b>	<b>963,315</b>
<b>Financial liabilities</b>								
Deposits from banks	-	-	-	-	-	50,363	-	50,363
Customer deposits	-	-	-	-	-	416,276	-	416,276
Items in course of transmission to banks	-	-	-	-	-	802	-	802
Trading and other financial liabilities at fair value through profit or loss	-	20,097	6,665	-	-	-	-	26,762
Derivative financial instruments	4,398	38,247	-	-	-	-	-	42,645
Debt securities in issue	-	-	-	-	-	228,317	-	228,317
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	80,749	80,749
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	51,363	51,363
Unallocated surplus within insurance businesses	-	-	-	-	-	-	643	643
Subordinated liabilities	-	-	-	-	-	29,609	-	29,609
<b>Total financial liabilities</b>	<b>4,398</b>	<b>58,344</b>	<b>6,665</b>	<b>-</b>	<b>-</b>	<b>725,367</b>	<b>132,755</b>	<b>927,529</b>

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**54 Financial instruments** (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
		Held for trading £m	Designated upon initial recognition £m					
<b>The Group</b>								
As at 31 December 2009								
<b>Financial assets</b>								
Cash and balances at central banks	-	-	-	-	-	36,089	-	36,089
Items in the course of collection from banks	-	-	-	-	-	1,045	-	1,045
Trading and other financial assets at fair value through profit or loss	-	542	48,352	-	-	-	-	48,894
Derivative financial instruments	995	17,802	-	-	-	-	-	18,797
Loans and receivables:								
Loans and advances to banks	-	-	-	-	175,554	-	-	175,554
Loans and advances to customers	-	-	-	-	245,226	-	-	245,226
Debt securities	-	-	-	-	2,636	-	-	2,636
	-	-	-	-	423,416	-	-	423,416
Available-for-sale financial assets	-	-	-	26,089	-	-	-	26,089
<b>Total financial assets</b>	<b>995</b>	<b>18,344</b>	<b>48,352</b>	<b>26,089</b>	<b>423,416</b>	<b>37,134</b>	<b>-</b>	<b>554,330</b>
<b>Financial liabilities</b>								
Deposits from banks	-	-	-	-	-	139,557	-	139,557
Customer deposits	-	-	-	-	-	193,045	-	193,045
Items in course of transmission to banks	-	-	-	-	-	542	-	542
Trading and other financial liabilities at fair value through profit or loss	-	202	6,160	-	-	-	-	6,362
Derivative financial instruments	702	16,031	-	-	-	-	-	16,733
Debt securities in issue	-	-	-	-	-	120,719	-	120,719
Liabilities arising from insurance contracts and participating investment contracts	-	-	-	-	-	-	36,960	36,960
Liabilities arising from non-participating investment contracts	-	-	-	-	-	-	15,734	15,734
Unallocated surplus within insurance businesses	-	-	-	-	-	-	310	310
Subordinated liabilities	-	-	-	-	-	15,999	-	15,999
<b>Total financial liabilities</b>	<b>702</b>	<b>16,233</b>	<b>6,160</b>	<b>-</b>	<b>-</b>	<b>469,862</b>	<b>53,004</b>	<b>545,961</b>

## Notes to the accounts

## 54 Financial instruments (continued)

	Derivatives designated as hedging instruments £m	At fair value through profit or loss		Available- for-sale £m	Loans and receivables £m	Held at amortised cost £m	Total £m
		Held for trading £m	Designated upon initial recognition £m				
<b>The Bank</b>							
<b>As at 31 December 2010</b>							
<b>Financial assets</b>							
Cash and balances at central banks	-	-	-	-	-	35,585	35,585
Items in the course of collection from banks	-	-	-	-	-	997	997
Trading and other financial assets at fair value through profit or loss	-	3,526	1,061	-	-	-	4,587
Derivative financial instruments	956	20,366	-	-	-	-	21,322
Loans and receivables:							
Loans and advances to banks	-	-	-	-	152,596	-	152,596
Loans and advances to customers	-	-	-	-	251,173	-	251,173
Debt securities	-	-	-	-	1,479	-	1,479
	-	-	-	-	405,248	-	405,248
Available-for-sale financial assets	-	-	-	24,951	-	-	24,951
Held-to-maturity investments	-	-	-	-	-	7,905	7,905
<b>Total financial assets</b>	<b>956</b>	<b>23,892</b>	<b>1,061</b>	<b>24,951</b>	<b>405,248</b>	<b>44,487</b>	<b>500,595</b>
<b>Financial liabilities</b>							
Deposits from banks	-	-	-	-	-	118,337	118,337
Customer deposits	-	-	-	-	-	223,812	223,812
Items in course of transmission to banks	-	-	-	-	-	506	506
Trading and other financial liabilities at fair value through profit or loss	-	4,603	6,665	-	-	-	11,268
Derivative financial instruments	678	19,582	-	-	-	-	20,260
Debt securities in issue	-	-	-	-	-	115,122	115,122
Subordinated liabilities	-	-	-	-	-	15,574	15,574
<b>Total financial liabilities</b>	<b>678</b>	<b>24,185</b>	<b>6,665</b>	<b>-</b>	<b>-</b>	<b>473,351</b>	<b>504,879</b>
<b>As at 31 December 2009</b>							
<b>Financial assets</b>							
Cash and balances at central banks	-	-	-	-	-	35,964	35,964
Items in the course of collection from banks	-	-	-	-	-	1,004	1,004
Trading and other financial assets at fair value through profit or loss	-	510	2,123	-	-	-	2,633
Derivative financial instruments	952	16,985	-	-	-	-	17,937
Loans and receivables:							
Loans and advances to banks	-	-	-	-	176,556	-	176,556
Loans and advances to customers	-	-	-	-	253,111	-	253,111
Debt securities	-	-	-	-	2,830	-	2,830
	-	-	-	-	432,497	-	432,497
Available-for-sale financial assets	-	-	-	13,514	-	-	13,514
<b>Total financial assets</b>	<b>952</b>	<b>17,495</b>	<b>2,123</b>	<b>13,514</b>	<b>432,497</b>	<b>36,968</b>	<b>503,549</b>
<b>Financial liabilities</b>							
Deposits from banks	-	-	-	-	-	160,428	160,428
Customer deposits	-	-	-	-	-	201,053	201,053
Items in course of transmission to banks	-	-	-	-	-	492	492
Trading and other financial liabilities at fair value through profit or loss	-	202	6,160	-	-	-	6,362
Derivative financial instruments	772	16,057	-	-	-	-	16,829
Debt securities in issue	-	-	-	-	-	109,870	109,870
Subordinated liabilities	-	-	-	-	-	15,456	15,456
<b>Total financial liabilities</b>	<b>772</b>	<b>16,259</b>	<b>6,160</b>	<b>-</b>	<b>-</b>	<b>487,299</b>	<b>510,490</b>



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**54 Financial instruments** (continued)

**(2) Reclassification of financial assets**

In 2010 the Group reviewed its approach to managing a portfolio of government securities held as a separately identifiable component of the Group's liquidity portfolio. Given the long-term nature of this portfolio, the Group concluded that certain of these securities will be able to be held until they reach maturity. Consequently, on 31 October 2010, government securities with a fair value of £3,601 million, which are held by the Bank, were reclassified from available-for-sale financial assets to held-to-maturity investments reflecting the Group's positive intent and ability to hold them until maturity.

In 2009, no financial assets were reclassified.

In 2008, in accordance with the amendment to IAS39 that became applicable during that year, the Group reviewed the categorisation of its financial assets classified as held for trading and available-for-sale. On the basis that there was no longer an active market for some of those assets, which are therefore more appropriately managed as loans, with effect from 1 July 2008, the Group transferred £2,993 million of assets previously classified as held for trading into loans and receivables. With effect from 1 November 2008, the Group transferred £437 million of assets previously classified as available-for-sale financial assets into loans and receivables. At the time of these transfers, the Group had the intention and ability to hold them for the foreseeable future or until maturity. As at the date of reclassification, the weighted average effective interest rate of the assets transferred was 6.3 per cent with the estimated recoverable cash flows of £3,524 million.

*Carrying value and fair value of reclassified assets*

The table below sets out the carrying value and fair value of reclassified financial assets.

	31 December 2010		31 December 2009		31 December 2008	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
From held for trading to loans and receivables	750	727	1,833	1,822	2,883	2,926
From available-for-sale financial assets to loans and receivables	313	340	394	422	454	402
From available-for-sale financial assets to held-to-maturity investments	3,455	3,539	–	–	–	–
<b>Total carrying value and fair value</b>	<b>4,518</b>	<b>4,606</b>	<b>2,227</b>	<b>2,244</b>	<b>3,337</b>	<b>3,328</b>

During the year ended 31 December 2010, the carrying value of the assets reclassified to loans and receivables decreased by £1,164 million due to sales and maturities of £1,220 million, accretion of discount of £34 million and foreign exchange and other movements of £22 million.

*Additional fair value gains (losses) that would have been recognised had the reclassifications not occurred*

The table below shows the additional gains (losses) that would have been recognised in the Group's income statement if the reclassifications had not occurred.

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables	–	–	(34)	(34)	–	208	208	(347)	(347)

The table below shows the additional gains (losses) that would have been recognised in other comprehensive income if the reclassifications had not occurred.

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From available-for-sale financial assets to loans and receivables	–	–	69	69	–	161	161	(108)	(108)

*Actual amounts recognised in respect of reclassified assets*

After reclassification the reclassified financial assets contributed the following amounts to the Group income statement.

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From held for trading to loans and receivables:									
Net interest income	–	–	24	24	–	55	55	31	31
Impairment losses	–	–	(6)	(6)	–	(49)	(49)	(158)	(158)
<b>Total amounts recognised</b>	<b>–</b>	<b>–</b>	<b>18</b>	<b>18</b>	<b>–</b>	<b>6</b>	<b>6</b>	<b>(127)</b>	<b>(127)</b>

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54 Financial instruments (continued)

	2010				2009			2008	
	Reclassified in 2010 £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2009 £m	Reclassified in 2008 £m	Total £m	Reclassified in 2008 £m	Total £m
From available-for-sale financial assets to loans and receivables:									
Net interest income	-	-	1	1	-	34	34	3	3
Impairment losses	-	-	(2)	(2)	-	(56)	(56)	(23)	(23)
<b>Total amounts recognised</b>	-	-	(1)	(1)	-	(22)	(22)	(20)	(20)

(3) Fair values of financial assets and liabilities

The following table summarises the carrying values of financial assets and liabilities presented on the Group's balance sheet. The fair values presented in the table are at a specific date and may be significantly different from the amount which will actually be paid on the maturity or settlement date.

	The Group				The Bank			
	Carrying value 2010 £m	Carrying value 2009 £m	Fair value 2010 £m	Fair value 2009 £m	Carrying value 2010 £m	Carrying value 2009 £m	Fair value 2010 £m	Fair value 2009 £m
<b>Financial assets</b>								
Trading and other financial assets at fair value through profit or loss	156,276	48,894	156,276	48,894	4,587	2,633	4,587	2,633
Derivative financial instruments	49,600	18,797	49,600	18,797	21,322	17,937	21,322	17,937
Loans and receivables:								
Loans and advances to banks	30,272	175,554	30,236	175,535	152,596	176,556	152,553	176,537
Loans and advances to customers	611,089	245,226	598,835	241,553	251,173	253,111	248,656	239,096
Debt securities	25,735	2,636	27,102	2,699	1,479	2,830	1,380	2,894
	667,096	423,416	656,173	419,787	405,248	432,497	402,589	418,527
Available-for-sale financial assets	42,955	26,089	42,955	26,089	24,951	13,514	24,951	13,514
Held-to-maturity investments	7,905	-	7,716	-	7,905	-	7,716	-
<b>Financial liabilities</b>								
Deposits from banks	50,363	139,557	50,520	139,478	118,337	160,428	118,027	160,349
Customer deposits	416,276	193,045	417,036	192,892	223,812	201,053	223,262	200,887
Trading and other financial liabilities at fair value through profit or loss	26,762	6,362	26,762	6,362	11,268	6,362	11,268	6,362
Derivative financial instruments	42,645	16,733	42,645	16,733	20,260	16,829	20,260	16,829
Debt securities in issue	228,317	120,719	228,826	120,458	115,122	109,870	115,067	109,790
Liabilities arising from non-participating investment contracts	51,363	15,734	51,363	15,734	-	-	-	-
Financial guarantees	54	38	54	38	42	38	42	38
Subordinated liabilities	29,609	15,999	32,909	14,963	15,574	15,456	15,088	14,419

Valuation methodology

Financial instruments include financial assets, financial liabilities and derivatives. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Wherever possible, fair values have been calculated using unadjusted quoted market prices in active markets for identical instruments held by the Group. Where quoted market prices are not available, or are unreliable because of poor liquidity, fair values have been determined using valuation techniques which, to the extent possible, use market observable inputs, but in some cases use non-market observable inputs. Valuation techniques used include discounted cash flow analysis and pricing models and, where appropriate, comparison to instruments with characteristics similar to those of the instruments held by the Group.

Because a variety of estimation techniques are employed and significant estimates made, comparisons of fair values between financial institutions may not be meaningful. Readers of these financial statements are thus advised to use caution when using this data to evaluate the Group's financial position.

Fair value information is not provided for items that do not meet the definition of a financial instrument. These items include intangible assets, such as the value of the Group's branch network, the long-term relationships with depositors and credit card relationships; premises and equipment; and shareholders' equity. These items are material and accordingly the Group believes that the fair value information presented does not represent the underlying value of the Group.

Valuation control framework

The key elements of the control framework for the valuation of financial instruments include model validation, product implementation review and independent price verification. These functions are carried out by appropriately skilled risk and finance teams, independent of the business area responsible for the products.

Model validation covers both qualitative and quantitative elements relating to new models. In respect of new products, a product implementation review is conducted pre- and post-trading. Pre-trade testing ensures that the new model is integrated into the Group's systems and that the profit and loss and risk reporting are consistent

#### 54 Financial instruments (continued)

throughout the trade life cycle. Post-trade testing examines the explanatory power of the implemented model, actively monitoring model parameters and comparing in-house pricing to external sources. Independent price verification procedures cover financial instruments carried at fair value. The frequency of the review is matched to the availability of independent data, monthly being the minimum. Valuation differences in breach of established thresholds are escalated to senior management. The results from independent pricing and valuation reserves are reviewed monthly by senior management.

Formal committees, consisting of senior risk, finance and business management, meet at least quarterly to discuss and approve valuations in more judgemental areas, in particular for unquoted equities, structured credit, over-the-counter options and the Credit Valuation Adjustment (CVA) reserve.

##### **Fair value of financial instruments carried at amortised cost**

###### *Loans and receivables*

The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value. For fixed rate lending, several different techniques are used to estimate fair value, as considered appropriate. For commercial and personal customers, fair value is principally estimated by discounting anticipated cash flows (including interest at contractual rates) at market rates for similar loans offered by the Group and other financial institutions. The fair value for corporate loans is estimated by discounting anticipated cash flows at a rate which reflects the effects of interest rate changes, adjusted for changes in credit risk. Certain loans secured on residential properties are made at a fixed rate for a limited period, typically two to five years, after which the loans revert to the relevant variable rate. The fair value of such loans is estimated by reference to the market rates for similar loans of maturity equal to the remaining fixed interest rate period. The fair values of asset-backed securities and secondary loans, which were previously within assets held for trading and were reclassified to loans and receivables (see page 94), are determined predominantly from lead manager quotes and, where these are not available, by alternative techniques including reference to credit spreads on similar assets with the same obligor, market standard consensus pricing services, broker quotes and other research data.

###### *Deposits from banks and customer deposits*

The fair value of deposits repayable on demand is considered to be equal to their carrying value. The fair value for all other deposits is estimated using discounted cash flows applying either market rates, where applicable, or current rates for deposits of similar remaining maturities.

###### *Debt securities in issue and subordinated liabilities*

The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities and for subordinated liabilities is estimated using quoted market prices.

###### *Held-to-maturity investments*

The fair values of government securities are based on market prices.

##### **Valuation of financial instruments carried at fair value**

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

###### **Level 1 portfolios**

Level 1 fair value measurements are those derived from unadjusted quoted prices in active markets for identical assets or liabilities. Products classified as level 1 predominantly comprise treasury bills and other government securities.

###### **Level 2 portfolios**

Level 2 valuations are those where quoted market prices are not available, for example where the instrument is traded in a market that is not considered to be active or valuation techniques are used to determine fair value and where these techniques use inputs that are based significantly on observable market data. Examples of such financial instruments include most over-the-counter derivatives, financial institution issued securities, certificates of deposit and certain asset-backed securities.

###### **Level 3 portfolios**

Level 3 portfolios are those where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data. Such instruments would include the Group's venture capital and unlisted equity investments which are valued using various valuation techniques that require significant management judgement in determining appropriate assumptions, including earnings multiples and estimated future cash flows. Certain of the Group's asset-backed securities and derivatives, principally where there is no trading activity in such securities, are also classified as level 3.

The table below provides an analysis of the financial assets and liabilities of the Group that are carried at fair value in the Group's consolidated balance sheet, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

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**54 Financial instruments** (continued)

**Valuation hierarchy**

**At 31 December 2010**

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss	113,277	40,163	2,836	156,276
Available-for-sale financial assets	14,481	25,828	2,646	42,955
Derivative financial instruments	985	47,805	810	49,600
<b>Financial assets</b>	<b>128,743</b>	<b>113,796</b>	<b>6,292</b>	<b>248,831</b>
Trading and other financial liabilities at fair value through profit or loss	864	25,898	–	26,762
Derivative financial instruments	42	42,400	203	42,645
Financial guarantees	–	–	54	54
<b>Financial liabilities</b>	<b>906</b>	<b>68,298</b>	<b>257</b>	<b>69,461</b>

There were no significant transfers between level 2 and level 3 during the year.

**At 31 December 2009**

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Trading and other financial assets at fair value through profit or loss	34,956	12,347	1,591	48,894
Available-for-sale financial assets	11,984	13,361	744	26,089
Derivative financial instruments	1,858	16,873	66	18,797
<b>Financial assets</b>	<b>48,798</b>	<b>42,581</b>	<b>2,401</b>	<b>93,780</b>
Trading and other financial liabilities at fair value through profit or loss	–	6,362	–	6,362
Derivative financial instruments	10	16,723	–	16,733
Financial guarantees	–	–	38	38
<b>Financial liabilities</b>	<b>10</b>	<b>23,085</b>	<b>38</b>	<b>23,133</b>

**Movements in level 3 portfolio**

The table below analyses movements in the level 3 financial assets portfolio:

	Trading and other financial assets at fair value through profit or loss £m	Available- for-sale £m	Derivative assets £m	Total financial assets £m
At 1 January 2009	1,672	3,161	136	4,969
Exchange and other adjustments	(4)	(63)	–	(67)
Gains (losses) recognised in the income statement	(50)	6	(69)	(113)
Gains (losses) recognised in other comprehensive income	–	50	–	50
Purchases	340	19	–	359
Sales	(400)	(412)	(1)	(813)
Transfers into the level 3 portfolio	33	36	–	69
Transfers out of the level 3 portfolio	–	(2,053)	–	(2,053)
At 31 December 2009	1,591	744	66	2,401
Adjustment on transfer of HBOS	1,320	1,867	74	3,261
Exchange and other adjustments	31	12	2	45
Gains (losses) recognised in the income statement	199	(56)	(46)	97
Gains (losses) recognised in other comprehensive income	–	271	–	271
Purchases	921	664	–	1,585
Sales	(550)	(560)	–	(1,110)
Transfers into the level 3 portfolio	62	–	780	842
Transfers out of the level 3 portfolio	(738)	(296)	(66)	(1,100)
<b>At 31 December 2010</b>	<b>2,836</b>	<b>2,646</b>	<b>810</b>	<b>6,292</b>
Gains (losses) recognised in the income statement relating to those assets held at 31 December 2010	149	(81)	(47)	21
Gains recognised in other comprehensive income relating to those assets held at 31 December 2010	–	269	–	269

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**54 Financial instruments** (continued)

The table below analyses movements in the level 3 financial liabilities portfolio:

	Derivative liabilities £m	Financial guarantees £m	Total financial liabilities £m
At 1 January 2009	578	35	613
Gains recognised in the income statement	(104)	–	(104)
Additions	–	3	3
Redemptions	(474)	–	(474)
At 31 December 2009	–	38	38
Adjustment for transfer of HBOS	196	–	196
Exchange and other adjustments	14	–	14
Gains recognised in the income statement	–	–	–
Additions	–	16	16
Redemptions	(210)	–	(210)
Transfers into the level 3 portfolio	203	–	203
<b>At 31 December 2010</b>	<b>203</b>	<b>54</b>	<b>257</b>
Gains (losses) recognised in the income statement relating to those liabilities held at 31 December 2010	–	–	–

Transfers out of the level 3 portfolio arise when inputs that could have a significant impact on the instrument's valuation become market observable after previously having been non-market observable. In the case of asset-backed securities this can arise if more than one consistent independent source of data becomes available. Conversely transfers into the portfolio arise when consistent sources of data cease to be available.

Included with the gains (losses) recognised in the income statement are gains of £21 million (2009: £106 million) related to financial instruments that are held in the level 3 portfolio at the year end. These amounts are included in other operating income.

Included within the gains (losses) recognised in other comprehensive income are gains of £269 million (2009: £190 million) related to financial instruments that are held in the level 3 portfolio at the year end.

	Valuation basis/technique	Main assumptions	At 31 December 2010			At 31 December 2009	
			Carrying value £m	Effect of reasonably possible alternative assumptions £m		Carrying value £m	Effect of reasonably possible alternative assumptions £m
<b>Trading and other financial assets at fair value through profit or loss:</b>							
Asset-backed securities	Lead manager or broker quote /consensus pricing from market data provider.	Use of single pricing source	283	8	(8)	79	–
Equity investments	Various valuation techniques	Earnings, net asset value and earnings multiples, forecast cash flows	2,072	135	(111)	1,162	n/a
Unlisted equities and property partnerships in the life funds	Third party valuations	n/a	481	n/a	n/a	350	–
			<b>2,836</b>			<b>1,591</b>	
<b>Available-for-sale financial assets</b>							
Asset-backed securities	Lead manager or broker quote /consensus pricing from market data provider	Use of single pricing source	579	34	(34)	744	10
Equity investments	Various valuation techniques	Earnings, net asset value, underlying asset values, property prices, forecast cash flows	2,067	141	(91)	–	n/a
			<b>2,646</b>			<b>744</b>	
<b>Derivative financial assets</b>	Industry standard model / consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>810</b>	<b>96</b>	<b>(27)</b>	<b>66</b>	<b>–</b>
<b>Financial assets</b>			<b>6,292</b>			<b>2,401</b>	
<b>Derivative financial liabilities</b>	Industry standard model/ consensus pricing from market data provider	Prepayment rates, probability of default, loss given default and yield curves	<b>203</b>	–	–	–	–
<b>Financial guarantees</b>			<b>54</b>			<b>38</b>	
<b>Financial liabilities</b>			<b>257</b>			<b>38</b>	<b>–</b>

#### 54 Financial instruments (continued)

The main products where level 3 valuations have been used are described below:

##### Asset-backed securities

Where there is no trading activity in asset-backed securities, valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes are used to determine an appropriate valuation. Asset-backed securities are then classified as either level 2 or level 3 depending on whether there is more than one consistent independent source of data. If there is a single, uncorroborated market source for a significant valuation input or where there are materially inconsistent levels then the valuation is reported as level 3. Asset classes classified as level 3 mainly comprise certain residential mortgage-backed securities, collateralised loan obligations and collateralised debt obligations.

##### Equity investments (including venture capital)

Unlisted equities and fund investments are accounted for as trading and other financial assets at fair value through profit or loss or as available-for-sale financial assets. These investments are valued using different techniques as a result of the variety of investments across the portfolio in accordance with the Group's valuation policy and are calculated using International Private Equity and Venture Capital Guidelines.

Depending on the business sector and the circumstances of the investment, unlisted equity valuations are based on earnings multiples, net asset values or discounted cash flows.

- A number of earnings multiples are used in valuing the portfolio including price earnings, earnings before interest and tax and earnings before interest, tax, depreciation and amortisation (EBITDA). The particular multiple selected being appropriate for the type of business being valued and is derived by reference to the current market-based multiple. Consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple.
- Discounted cash flow valuations use estimated future cash flows, usually based on management forecasts, with the application of appropriate exit yields or terminal multiples and discounted using rates appropriate to the specific investment, business sector or recent economic rates of return. Recent transactions involving the sale of similar businesses may sometimes be used as a frame of reference in deriving an appropriate multiple.
- For fund investments the most recent capital account value calculated by the fund manager is used as the basis for the valuation and adjusted, if necessary, to align valuation techniques with the Group's valuation policy.

##### Unquoted equities and property partnerships in the life funds

Third party valuations are used to obtain the fair value of unquoted investments. Management take account of any pertinent information, such as recent transactions and information received on particular investments, to adjust the third party valuations where necessary.

##### Derivatives

Where the Group's derivative assets and liabilities are not traded on an exchange, they are valued using valuation techniques, including discounted cash flow and options pricing models, as appropriate. The types of derivatives classified as level 2 and the valuation techniques used include:

- Interest rate swaps which are valued using discounted cash flow models; the most significant inputs into those models are interest rate yield curves which are developed from publicly quoted rates.
- Foreign exchange derivatives that do not contain options which are priced using rates available from publicly quoted sources.
- Credit derivatives, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves; the Group uses standard models with observable inputs.
- Less complex interest rate and foreign exchange option products are valued using volatility surfaces developed from publicly available interest rate cap, interest rate swaption and other option volatilities; option volatility skew information is derived from a market standard consensus pricing service. For more complex option products, the Group calibrates its models using observable at-the-money data; where necessary, the Group adjusts for out-of-the-money positions using a market standard consensus pricing service.
- Complex interest rate and foreign exchange products where there is significant dispersion of consensus pricing or where implied funding costs are material and unobservable are classified as level 3.

Where credit protection, usually in the form of credit default swaps, has been purchased or written on asset-backed securities, the security is referred to as a negative basis asset-backed security and the resulting derivative assets or liabilities have been classified as either level 2 or level 3 according to the classification of the underlying asset-backed security.

Level 3 derivative assets also include £96 million in respect of credit default swaps written on level 3 negative basis asset-backed securities calculated as set out in the table below:

	2010 £m
Fair value before credit valuation adjustment	114
Less: credit valuation adjustment	(18)
<b>Carrying value</b>	<b>96</b>

##### Sensitivity of level 3 valuations

###### Asset-backed securities

Reasonably possible alternative valuations have been calculated for asset-backed securities by using alternative pricing sources and calculating an absolute difference. The pricing difference is defined as the absolute difference between the actual price used and the closest, alternative price available.

###### Derivative financial instruments

In respect of credit default swaps written on level 3 negative basis ABS, reasonably possible alternative valuations have been calculated by flexing the spread between the underlying asset and the credit default swap, or adjusting market yields, by a reasonable amount. The sensitivity is determined by applying a 60 bps increase/decrease in the spread between the asset and the credit default swap.

## 54 Financial instruments (continued)

### *Venture capital and equity investments*

The valuation techniques used for unlisted equities and venture capital investments vary depending on the nature of the investment. Further details of these are given below. Third party valuers have been used to determine the value of unlisted equities and property partnerships included in the Group's life insurance funds. As these factors differ for each investment depending on the nature of the valuation technique used and the inputs there is no single common factor that could be adjusted to provide a reasonable alternative valuation for these investment portfolios.

### **Derivative valuation adjustments**

Derivative financial instruments which are carried in the balance sheet at fair value are adjusted where appropriate to reflect credit risk, market liquidity and other risks.

Valuation adjustments are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These valuation adjustments reflect the different credit and funding exposures that such counterparties represent.

A Credit Valuation Adjustment (CVA) is applied to the Group's over-the-counter uncollateralised derivative exposures to adjust the derivative valuations provided by standard interbank lending rate curves. The Group uses a bilateral simulation model to develop expected future exposures. This calculates a CVA for scenarios where the Group has a positive future exposure (asset) and a Debit Valuation Adjustment (DVA) where the Group has a negative future exposure (liability). At December 2010, the total reserve booked was £570 million (31 December 2009: £78 million).

## 55 Financial risk management

Financial instruments are fundamental to the Group's activities and, as a consequence, the risks associated with financial instruments represent a significant component of the risks faced by the Group.

The Group has adopted the heritage Lloyds TSB approach to risk management.

The primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and currency risk; and liquidity risk. Qualitative and quantitative information about the Group's management of these risks is given below.

### **QUALITATIVE INFORMATION**

#### **(1) Credit risk**

##### *Definition*

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

##### *Risk appetite*

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

##### *Exposures*

The principal sources of credit risk within the Group arise from loans and advances to retail customers, financial institutions and corporate clients. The credit risk exposures of the Group are set out in the quantitative information section of this note.

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

Credit risk can also arise from debt securities, private equity investments, derivatives and foreign exchange activities. Note 17 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 2010. 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 17.

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

##### *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').

The Group's rating systems assess probability of default and if Advanced, exposure at default and loss given default, in order to derive an expected loss. (If not Advanced, 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 (see note 23). 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.

## 55 Financial risk management (continued)

The Group assesses the probability of default of individual counterparties using internal rating models tailored to the various categories of counterparty. In its principal retail portfolios and a number of wholesale lending portfolios, exposure at default and loss given default models are also in use. They have been developed internally and use statistical analysis, combined, where appropriate, with external data and subject matter expert judgement. Each rating model is subject to a 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 Lloyds Banking Group Model Governance Committee.

Each probability of default model segments counterparties into a number of rating grades, each representing a defined range of default probabilities. Exposures migrate between 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.

### *Mitigation*

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

### *Internal control*

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

- Credit principles and policy: risk specialists set out the Group credit principles and policy according to which credit risk is managed, which in turn is the basis for divisional and business unit credit policy. Principles and policies are reviewed at least annually, and any changes are subject to a review and approval process. Divisional and business unit policies include lending guidelines, which define the responsibilities of lending officers and provide a disciplined and focused benchmark for credit decisions.
- Counterparty limits: Limits are set against all types of exposure in a counterparty name, in accordance with an agreed methodology for each exposure type. This includes credit risk exposure on individual derivative transactions, which incorporates potential future exposures from market movements. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.
- Credit scoring: In the principal retail portfolios, statistically-based decisioning techniques (primarily credit scoring models) are used. Divisional risk departments review model effectiveness, while new models and model changes are referred by them to divisional model governance committees for approval. The most material changes are referred to the Lloyds Banking Group Model Governance Committee.
- Individual credit assessment and sanction: Credit risk in wholesale portfolios is subject to individual credit assessments, which consider the strengths and weaknesses of individual transactions and the balance of risk and reward. Exposure to individual counterparties, groups of counterparties or customer risk segments is controlled through a tiered hierarchy of delegated sanctioning authorities. Approval requirements for each decision are based on the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty underwriting are the same as that for assets intended to be held over the period to maturity.
- Controls over rating systems: An independent team 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 by risk functions either in the business units or divisions, with the business unit managing directors having ownership of the systems. Line management takes responsibility for ensuring the validation of the rating systems, supported and challenged by independent specialist functions in their respective division.
- Cross-border and cross-currency exposures: Country limits are authorised by the country limits panel, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support the approved business and strategic plans of the Group.
- Concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite. Credit policy is aligned to risk appetites and restricts exposure to certain high risk countries and more vulnerable sectors and segments. Note 19 to the financial statements provides an analysis of loans and advances to customers by industry (for wholesale customers) and product (for retail customers). Exposures are monitored to prevent an excessive concentration of risk. These concentration risk controls are not necessarily in the form of a maximum limit on lending, but may instead require new business in concentrated sectors to fulfil additional hurdle requirements. Large exposures are reported in accordance with regulatory reporting requirements.
- Stress testing and scenario analysis: The credit portfolio is also subjected to stress testing and scenario analysis, to simulate outcomes and calculate their associated impact. Events are modelled at a group-wide level, at divisional and business unit level and by rating model and portfolio, for example, within a specific industry sector.
- Specialist expertise: Credit quality is maintained by specialist units providing, for example: intensive management and control; security perfection, maintenance and retention; expertise in documentation for lending and associated products; sector specific expertise; and legal services applicable to the particular market place and product range offered by the business.
- Daily settlement limits: Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from market transactions on any single day.
- Risk assurance and oversight: 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. Lloyds Banking Group credit risk assurance, a group level function comprising experienced credit professionals, is also in place. In conjunction with divisional and group 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 and retail businesses and activities, facilitating a wide range of audit, assurance and review work. These include cyclical ('standard') credit reviews, non-standard reviews, project reviews, credit risk rating model reviews and bespoke assignments, including impairment reviews as required. The work of group credit risk assurance continues to provide executive and senior management with assurance and guidance on credit quality, effectiveness of credit risk controls and accuracy of impairments.

### *Collateral*

The principal collateral types for loans and advances are:

- Mortgages over residential and commercial real estate;



## 55 Financial risk management (continued)

- 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.

Guidelines on the acceptability of specific classes of collateral are maintained.

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

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

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

### Master netting agreements

Where it is efficient and likely to be effective (generally with counterparties with which it undertakes a significant volume of transactions), master netting agreements are put in place. 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

Asset sales, securitisations and credit derivative based transactions are also undertaken 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 Lloyds Banking Group risk, businesses and divisions identify and define portfolios of credit and related risk exposures and the key benchmarks, behaviours and characteristics by which those portfolios are managed in terms of credit risk exposure. This entails the production and analysis of regular portfolio monitoring reports for review by senior management. Lloyds Banking Group Risk in turn produces an aggregated review of credit risk throughout Lloyds Banking Group, including reports on significant credit exposures, which are presented to the Lloyds Banking Group Credit Risk Committee, Lloyds Banking Group Business Risk Committee and Lloyds Banking Group 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 monthly monitoring identifies material exceptions or deviations from expected outcomes, these will be escalated.

## (2) Market Risk

### Definition

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

### Risk appetite

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

### Exposures

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

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

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

Risk also arises from the margin of interbank rates over central bank rates. A further banking risk arises from competitive pressures on product terms in existing loans and deposits, which sometimes restricts the Group in its ability to change interest rates applying to customers in response to changes in interbank and central bank rates.

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

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

## 55 Financial risk management (continued)

- With Profit Funds are managed with the aim of generating rates of return consistent with policyholders' expectations and this involves the mismatch of assets and liabilities.
- Unit-linked liabilities are matched with the same assets that are used to define the liability but future fee income is dependent upon the performance of those assets. (This forms part of the Value of in Force see note 3.)
- For other insurance liabilities the aim is to invest in assets such that the cash flows on investments will match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.
- Surplus assets are held primarily in four portfolios: (a) in the long term funds of Scottish Widows plc, Clerical Medical Investment Group Limited and their subsidiaries; (b) in the shareholder funds of life assurance companies; (c) investment portfolios within the general insurance business and (d) within the main fund of Heidelberger Lebensversicherung AG.

The Group's defined benefit staff pension schemes are exposed to significant risks from the constituent parts of their assets and from the present value of their liabilities, primarily equity and real interest rate risk. For further information on pension scheme assets and liabilities please refer to note 42.

### *Measurement*

The following market risk measures are used for risk reporting and setting risk appetite limits and triggers:

- Value at Risk (VaR): for short term liquid positions a 1-day 95 per cent VaR is used; for structural positions a 1-year 95 per cent VaR is used.
- Standard Stresses: Interest Rates 25bp; Equities 10 per cent; Credit Spreads relative 30 per cent widening
- Bespoke Extreme Stress Scenarios: e.g. stock market crash

Both VaR and standard stress measures are also used in setting divisional market risk appetite limits and triggers.

Although an important measure of risk, VaR has limitations as a result of its use of historical data, assumed distribution, holding periods and frequency of calculation. In addition, the use of confidence levels does not convey any information about potential loss when the confidence level is exceeded. Where VaR models are less well suited to the nature of positions, the Group recognises these limitations and supplements its use with a variety of other techniques. These reflect the nature of the business activity, and include interest rate repricing gaps, open exchange positions and sensitivity analysis. Stress testing and scenario analysis are also used in certain portfolios and at group level, to simulate extreme conditions to supplement these core measures. Trading book VaR (1-day 99 per cent) is back-tested daily against profit and loss.

### Banking – trading assets and other treasury positions

It is the policy of Lloyds Banking Group to monitor and report its trading and other treasury positions on a consolidated basis to facilitate management and control and capture diversification benefits. It is therefore not appropriate to report this data separately for Lloyds TSB Bank plc.

### Banking – non-trading

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

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

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

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

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

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

### Pension schemes

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

The schemes' main exposures are to equity risk, real rate risk and credit spread risk. Accounting for the pension schemes under International Accounting Standard (IAS) 19 spreads any adverse impacts of these risks over time.

Lloyds TSB Bank plc  
Notes to the accounts

**55 Financial risk management** (continued)

Insurance portfolios

The Group's market risk exposure in respect of insurance activities described above is measured using EEV as a proxy for economic value. The pre-tax sensitivity of EEV to standardised stresses is shown below for the years ended 31 December 2010 and 2009. Foreign exchange risk arises predominantly from overseas holdings of equities. Impacts have only been shown in one direction but can be assumed to be reasonably symmetrical. Opening and closing numbers only have been provided as this data is not volatile and consequently is not tracked on a daily basis.

<b>As at 31 December</b>	<b>2010</b> <b>£m</b>	2009 £m
Equity risk (impact of 10% fall pre-tax)	<b>(367)</b>	(196)
Interest rate risk (impact of 25 basis point reduction pre-tax)	<b>82</b>	65
Credit spread risk (impact of relative 30% widening)	<b>(163)</b>	(142)

*Mitigation*

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

Banking – non-trading activities

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

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

Insurance activities

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

*Monitoring*

The Lloyds Banking Group Senior Asset and Liability Committee and the Lloyds Banking Group Market Risk Forum regularly review high level market risk exposure including, but not limited to, the data described above. They also make recommendations to the Lloyds Banking Group Chief Executive concerning overall market risk appetite and market risk policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits are monitored locally by independent risk functions and at a high level by Lloyds Banking Group Risk. Where appropriate, escalation procedures are in place.

Banking activities

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

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

Insurance activities

Market risk exposures from the insurance businesses are controlled via approved investment policies and triggers set with reference to risk appetites and regularly reviewed by the Lloyds Banking Group Senior Asset and Liability Committee and the Lloyds Banking Group Market Risk Forums:

- The With Profit Funds are managed in accordance with the relevant fund's principles and practices of financial management and legal requirements.
- The investment strategy for other insurance liabilities is determined by the term and nature of the underlying liabilities and asset/liability matching positions are actively monitored. Actuarial tools are used to project and match the cash flows.
- Investment strategy for surplus assets held in excess of liabilities takes account of the legal, regulatory and internal business requirements for capital to be held to support the business now and in the future.

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

**(3) Insurance risk**

*Definition*

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

*Risk appetite*

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

*Exposures*

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

## 55 Financial risk management (continued)

### *Measurement*

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

Current and potential future insurance risk exposures are assessed and aggregated using risk measures based on 1-in-20 year stresses and other supporting measures where appropriate.

### *Mitigation*

A key element of the control framework is the consideration of insurance risk by a suitable combination of high level Committees/Boards. For the life assurance businesses the key control bodies are the board of Scottish Widows Group Limited and the board of HBOS Financial Services Limited with the more significant risks also being subject to review by the Group Executive Committee and/or Lloyds Banking Group Board. For the general insurance businesses the key control bodies are the boards of the legal entities including Lloyds TSB General Insurance Limited, St. Andrew's Insurance plc and the Irish subsidiaries, with the more significant risks again being subject to Group Executive Committee and/or Lloyds Banking Group Board review. All Group staff pension schemes issues are covered by the Group Asset and Liability Committee and the Group Business Risk Committee.

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

Insurance risk is primarily controlled via the following processes:

- Underwriting (the process to ensure that new insurance proposals are properly assessed)
- Pricing-to-risk (new insurance proposals are priced to cover the underlying risks inherent within the products)
- Claims management
- Product design
- Policy wording
- Product management
- The use of reinsurance or other risk mitigation techniques.

In addition, limits are used as a control mechanism for insurance risk at policy level.

At all times, close attention is paid to the adequacy of reserves, solvency management and regulatory requirements.

The most significant insurance risks in the life assurance companies are longevity risk and persistency risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed. By their nature persistency risks are difficult to hedge.

General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements which are broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements. Appropriate reinsurance arrangements also apply within the life and pensions businesses with significant mortality risk and morbidity risk being transferred to our chosen reinsurers.

Options and guarantees are incorporated in new insurance products only after careful consideration of the risk management issues that they present. In respect of insurance risks in the staff pension schemes, the Group ensures that effective communication mechanisms are in place for consultation with the trustees to assist with the management of risk in line with the Group's risk appetite.

### *Monitoring*

Ongoing monitoring is in place to track the progression of insurance risks. This normally involves monitoring relevant experiences against expectations (for example claims experience, option take up rates, persistency experience, expenses, non-disclosure at the point of sale), as well as evaluating the effectiveness of controls put in place to manage insurance risk. Reasons for any significant divergence from experience are investigated and remedial action is taken.

Insurance risk exposures are reported and monitored regularly by the Group Executive Committee.

## **(4) Liquidity and funding risk**

### *Definition*

Liquidity risk is defined as the risk that the Group does not have sufficient financial resources to meet its commitments when they fall due, or can secure them only at excessive cost.

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

### *Risk appetite*

Liquidity and funding risk appetite for the banking businesses is defined and reported through various metrics that enable the Group to manage liquidity and funding constraints.

### *Exposure*

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

### *Measurement*

A series of measures are used to monitor both short and long term liquidity including: ratios, cash outflow triggers, wholesale funding maturity profile, early warning indicators and stress test survival period triggers. Strict criteria and limits are in place to ensure highly liquid marketable securities are available as part of the portfolio of liquid assets.

## 55 Financial risk management (continued)

### Mitigation

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through both short-term liquidity management and long-term funding strategy. Short-term liquidity management is considered from two perspectives; business as usual and liquidity under stressed conditions, both of which relate to funding in the less than one year time horizon. Longer term funding is used to manage the Group's strategic liquidity profile which is determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

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

### Monitoring

Liquidity is actively monitored at business unit and Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular the Group Asset and Liability Committee and the Senior Asset and Liability Committee which meet monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent oversight.

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

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

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

## QUANTITATIVE INFORMATION

### (1) Credit risk

The Group's credit risk exposure arises predominantly in the United Kingdom, the European Union, Australia and the United States.

The maximum credit risk exposure of the Group and the Bank in the event of other parties failing to perform their obligations is detailed below. No account is taken of any collateral held and the maximum exposure to loss is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Loans and receivables:				
Loans and advances to banks	30,292	175,703	152,616	176,705
Loans and advances to customers	629,462	250,039	254,324	256,706
Debt securities	26,293	2,881	1,669	3,075
Deposit amounts available for offset <sup>1</sup>	(8,105)	(4,116)	(4,183)	(4,112)
Impairment allowances	(18,951)	(5,207)	(3,361)	(3,989)
	658,991	419,300	401,065	428,385
Available-for-sale financial assets (excluding equity shares)	40,700	26,008	24,878	13,438
Held-to-maturity investments	7,905	–	7,905	–
Trading and other financial assets at fair value through profit or loss (excluding equity shares)	66,008	21,037	4,558	2,629
Derivative assets, before netting	49,600	18,797	21,322	17,937
Amounts available for offset under master netting arrangements <sup>1</sup>	(31,740)	(1,755)	(12,901)	(1,755)
	17,860	17,042	8,421	16,182
Assets arising from reinsurance contracts held	2,146	419	–	–
Financial guarantees	22,975	9,996	11,143	9,869
Irrevocable loan commitments and other credit-related contingencies <sup>2</sup>	67,809	49,067	42,764	43,571
<b>Maximum credit risk exposure</b>	<b>884,394</b>	<b>542,869</b>	<b>500,734</b>	<b>514,074</b>
<b>Maximum credit risk exposure before offset items</b>	<b>924,239</b>	<b>548,740</b>	<b>517,818</b>	<b>519,941</b>

<sup>1</sup>Deposit amounts available for offset and amounts available for offset under master netting arrangements do not meet the criteria under IAS 32 to enable loans and advances and derivative assets respectively to be presented net of these balances in the financial statements.

<sup>2</sup>See note 53 – Contingent liabilities and commitments for further information.

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**55 Financial risk management** (continued)

A general description of collateral held in respect of financial instruments is disclosed on page 102.

**Loans and advances to banks** – the Group may require collateral before entering into a credit commitment with another bank, depending on the type of the financial product and the counterparty involved, and netting agreements are obtained whenever possible and to the extent that such agreements are legally enforceable.

**Available-for-sale debt securities, treasury and other bills, held-to-maturity investments, and trading and other financial assets at fair value through profit or loss** – the credit quality of the Group's available-for-sale debt securities, treasury and other bills, held-to-maturity investments, and the majority of the Group's trading and other financial assets at fair value through profit or loss held is set out below. An analysis of trading and other financial assets at fair value through profit or loss is included in note 16 and a similar analysis for available-for-sale financial assets is included in note 24. The Group's held-to-maturity investments are all government debt securities. The Group's non-participating investment contracts are all unit-linked. Trading and other financial assets at fair value through profit or loss which back those investment contracts were £129,792 million (2009: £48,307 million). Movements in the fair value of such assets, including movements arising from credit risk, are borne by the contract holders.

**Derivative assets** – the Group reduces exposure to credit risk by using master netting agreements and by obtaining collateral in the form of cash or highly liquid securities. An analysis of derivative assets is given in note 17. Of the net derivative assets of £17,860 million for the Group and £8,421 million for the Bank (2009: £17,042 million for the Group and £16,182 million for the Bank), cash collateral of £1,429 million was held for the Group and £75 million for the Bank (2009: £2,029 million for the Group and the Bank) and a further £8,385 million for the Group and £5,083 million for the Bank was due from OECD banks (2009: £11,889 million for the Group and £10,478 million for the Bank).

**Assets arising from reinsurance contracts held** – of the assets arising from reinsurance contracts held at 31 December 2010 of £2,146 million (2009: £419 million), £671 million (2009: £225 million) were due from insurers with a credit rating of AA or above.

**Financial guarantees** – these represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards.

**Reverse repo and repo transactions** – for reverse repo transactions which are accounted for as collateral loans, it is the Group's policy to seek collateral which is at least equal to the amount loaned. As at 31 December 2010, the fair value of collateral accepted under reverse repo transactions that the Group is permitted by contract or custom to sell or repledge was £21,195 million (2009: £nil) and the Bank £62,436 million (2009: £nil). Of this, £3,161 million (2009: £nil) for the Group and £nil (2009: £nil) for the Bank was sold or repledged as at 31 December 2010. The fair value of collateral pledged in respect of repo transactions, accounted for as secured borrowings, where the secured party is permitted by contract or custom to repledge was £53,781million (31 December 2009: £nil) for the Group and £42,744 million (2009: £nil) for the Bank.

**Stock lending** – in addition to financial assets on the balance sheet which are subject to repurchase agreements, there were financial assets on the balance sheet pledged as collateral as part of securities lending transaction which amounted to £82,527 million at 31 December 2010 (2009: £nil) for the Group and £13,133 million for the Bank.

**Stock borrowing** – Securities held as collateral as stock borrowed or under reverse repurchase agreements amounted to £93,419 million at 31 December 2010 (2009: £nil) for the Group and £111,844 million (2009: £nil) for the Bank. Of which £55,554 million at 31 December 2010 (2009: £nil) for the Group and £73,938 million (2009: £nil) for the Bank had been resold or repledged as collateral for its own transaction.

**Loans and advances – The Group**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
Neither past due nor impaired	30,259	339,509	45,058	159,274	543,841	12,545
Past due but not impaired	–	13,215	1,289	3,427	17,931	–
Impaired – no provision required	–	2,189	433	5,313	7,935	–
– provision held	20	5,591	5,149	45,931	56,671	–
Gross	30,279	360,504	51,929	213,945	626,378	12,545
Allowance for impairment losses	(20)	(2,073)	(2,587)	(24,975)	(29,635)	–
Fair value adjustments	13				(4,146)	–
<b>Net</b>	<b>30,272</b>				<b>592,597</b>	<b>12,545</b>
Due from fellow Lloyds Banking Group undertakings	–				18,492	–
	<b>30,272</b>				<b>611,089</b>	<b>12,545</b>

The disclosures in the table above are produced under the combined businesses approach used for the Lloyds Banking Group's segmental reporting. The Group believes that, for reporting periods immediately following a significant business combination such as the transfer of HBOS in 2010, this combined businesses basis, which includes the allowance for loan losses in place at the date of the acquisition of HBOS by the Lloyds Banking Group on a gross basis, more fairly reflects the underlying provisioning status of the loans. The remaining acquisition-related fair value adjustments in respect of this lending are therefore identified separately in this table.

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

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**55 Financial risk management** (continued)

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2009						
Neither past due nor impaired	25,428	110,523	31,651	77,590	219,764	439
Past due but not impaired	–	2,794	1,067	413	4,274	–
Impaired – no provision required	–	519	423	1,588	2,530	–
– provision held	153	1,513	4,465	3,305	9,283	–
Gross	25,581	115,349	37,606	82,896	235,851	439
Allowance for impairment losses	(149)	(362)	(2,629)	(1,822)	(4,813)	–
Net	25,432	114,987	34,977	81,074	231,038	439
Due from fellow Lloyds Banking Group undertakings	150,122				14,188	–
	<u>175,554</u>				<u>245,226</u>	<u>439</u>

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

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

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2h. All impaired loans which exceed certain thresholds, principally within the Group's wholesale and corporate businesses, are individually assessed for impairment by reviewing expected future cash flows including those that could arise from the realisation of security. Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £51,608 million (2009: £4,869 million) which have associated collateral with a fair value of £14,869 million (2009: £661 million).

**Loans and advances which are neither past due nor impaired – The Group**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
Good quality	29,835	332,614	30,076	57,552		12,220
Satisfactory quality	265	5,259	11,084	42,906		163
Lower quality	16	834	1,170	45,750		83
Below standard, but not impaired	143	802	2,728	13,066		79
<b>Total loans and advances which are neither past due nor impaired</b>	<b>30,259</b>	<b>339,509</b>	<b>45,058</b>	<b>159,274</b>	<b>543,841</b>	<b>12,545</b>
31 December 2009						
Good quality	25,261	107,205	20,401	41,210		58
Satisfactory quality	141	3,318	8,441	27,668		268
Lower quality	14	–	848	7,931		90
Below standard, but not impaired	12	–	1,961	781		23
Total loans and advances which are neither past due nor impaired	25,428	110,523	31,651	77,590	219,764	439

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and wholesale are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Wholesale lending has been classified using internal probability of default rating models mapped so that they are comparable to external credit ratings. Good quality lending comprises the lower assessed default probabilities, with other classifications reflecting progressively higher default risk. Classifications of retail lending incorporate expected recovery levels for mortgages, as well as probabilities of default assessed using internal rating models.

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55 Financial risk management (continued)

Loans and advances which are past due but not impaired – The Group

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
0-30 days	–	6,498	1,004	1,331	8,833	–
30-60 days	–	2,674	246	498	3,418	–
60-90 days	–	1,811	29	394	2,234	–
90-180 days	–	2,223	10	337	2,570	–
Over 180 days	–	9	–	867	876	–
<b>Total loans and advances which are past due but not impaired</b>	–	<b>13,215</b>	<b>1,289</b>	<b>3,427</b>	<b>17,931</b>	–
<b>Fair value of collateral held</b>		<b>11,467</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	
<b>31 December 2009</b>						
0-30 days	–	1,325	812	228	2,365	–
30-60 days	–	562	226	37	825	–
60-90 days	–	365	27	86	478	–
90-180 days	–	541	1	21	563	–
Over 180 days	–	1	1	41	43	–
<b>Total loans and advances which are past due but not impaired</b>	–	<b>2,794</b>	<b>1,067</b>	<b>413</b>	<b>4,274</b>	–
<b>Fair value of collateral held</b>		<b>2,396</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	

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

Collateral held against retail mortgage lending is principally comprised of residential properties; their fair value has been estimated based upon the last actual valuation, adjusted to take into account subsequent movements in house prices, after making allowance for indexation error and dilapidations. The resulting valuation has been limited to the principal amount of the outstanding advance in order to provide a clearer representation of the Group's credit exposure.

Lending decisions are based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values for non-mortgage lending are assessed more rigorously at the time of loan origination or when taking enforcement action and may fluctuate, as in the case of floating charges, according to the level of assets held by the customer. Whilst collateral is reviewed on a regular basis in accordance with business unit credit policy, this varies according to the type of lending and collateral involved. It is therefore not practicable to estimate and aggregate current fair values of collateral for non-mortgage lending.

Loans and advances – The Bank

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
Neither past due nor impaired	7,053	94,960	22,257	59,523	176,740	325
Past due but not impaired	–	2,263	562	340	3,165	–
Impaired – no provision required	–	620	343	848	1,811	–
– provision held	20	1,095	2,447	5,027	8,569	–
Gross	7,073	98,938	25,609	65,738	190,285	325
Allowance for impairment losses (note 23)	(20)	(248)	(1,016)	(1,887)	(3,151)	–
<b>Net</b>	<b>7,053</b>	<b>98,690</b>	<b>24,593</b>	<b>63,851</b>	<b>187,134</b>	<b>325</b>
Due from fellow Lloyds Banking Group undertakings	145,543				64,039	–
	<b>152,596</b>				<b>251,173</b>	<b>325</b>



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**55 Financial risk management** (continued)

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
31 December 2009						
Neither past due nor impaired	8,338	97,345	23,666	61,515	182,526	439
Past due but not impaired	–	2,640	732	373	3,745	–
Impaired – no provision required	–	490	280	1,535	2,305	–
– provision held	153	1,447	3,033	2,958	7,438	–
Gross	8,491	101,922	27,711	66,381	196,014	439
Allowance for impairment losses (note 23)	(149)	(338)	(1,642)	(1,615)	(3,595)	–
Net	8,342	101,584	26,069	64,766	192,419	439
Due from fellow Lloyds Banking Group undertakings	168,214				60,692	–
	<u>176,556</u>				<u>253,111</u>	<u>439</u>

No impairment allowances have been raised in respect of amounts due from fellow Lloyds Banking Group undertakings.

Included in loans and receivables are advances individually determined to be impaired with a gross amount before impairment allowances of £5,932 million (2009: £4,440 million) which have associated collateral with a fair value of £1,781 million (2009: £361 million).

**Loans and advances which are neither past due nor impaired – The Bank**

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
Good quality	6,778	93,963	13,947	33,103		–
Satisfactory quality	265	997	6,358	19,748		163
Lower quality	7	–	628	5,606		83
Below standard, but not impaired	3	–	1,324	1,066		79
<b>Total loans and advances which are neither past due nor impaired</b>	<b>7,053</b>	<b>94,960</b>	<b>22,257</b>	<b>59,523</b>	<b>176,740</b>	<b>325</b>
31 December 2009						
Good quality	8,173	94,225	14,779	32,429		58
Satisfactory quality	141	3,120	6,632	23,442		268
Lower quality	12	–	789	5,076		90
Below standard, but not impaired	12	–	1,466	568		23
Total loans and advances which are neither past due nor impaired	8,338	97,345	23,666	61,515	182,526	439

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55 Financial risk management (continued)

Loans and advances which are past due but not impaired – The Bank

	Loans and advances to banks £m	Loans and advances to customers			Total £m	Loans and advances designated at fair value through profit or loss £m
		Retail – mortgages £m	Retail – other £m	Wholesale £m		
<b>31 December 2010</b>						
0-30 days	–	1,136	420	152	1,708	–
30-60 days	–	442	132	18	592	–
60-90 days	–	292	4	41	337	–
90-180 days	–	387	6	22	415	–
Over 180 days	–	6	–	107	113	–
<b>Total loans and advances which are past due but not impaired</b>	–	<b>2,263</b>	<b>562</b>	<b>340</b>	<b>3,165</b>	–
Fair value of collateral held		<b>2,056</b>	n/a	n/a	n/a	
<b>31 December 2009</b>						
0-30 days	–	1,267	489	196	1,952	–
30-60 days	–	520	218	30	768	–
60-90 days	–	345	24	85	454	–
90-180 days	–	508	1	21	530	–
Over 180 days	–	–	–	41	41	–
<b>Total loans and advances which are past due but not impaired</b>	–	<b>2,640</b>	<b>732</b>	<b>373</b>	<b>3,745</b>	–
Fair value of collateral held		<b>2,262</b>	n/a	n/a	n/a	

Renegotiated loans and advances

Loans and advances that were renegotiated during the year and that would otherwise have been past due or impaired at 31 December 2010 totalled £5,475 million (2009: £217 million) for the Group and £633 million (2009: £209 million) for the Bank.

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Repossessed collateral</b>				
Residential property	1,046	210	211	193
Other	32	684	–	–
<b>Total repossessed collateral</b>	<b>1,078</b>	<b>894</b>	<b>211</b>	<b>193</b>

In respect of retail portfolios, the Group does not normally take physical possession of properties or other assets held as collateral and uses external agents to realise the value as soon as practicable, generally at auction, to settle indebtedness. Any surplus funds are returned to the borrower or are otherwise dealt with in accordance with appropriate insolvency regulations.

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

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Loan-to-value ratio of mortgage lending</b>				
Analysis by loan-to-value ratio of residential mortgage lending which is neither past due nor impaired:				
Less than 70 per cent	140,267	53,100	47,956	47,454
70 per cent to 80 per cent	57,979	16,865	16,156	15,035
80 per cent to 90 per cent	53,732	15,061	13,070	13,370
Greater than 90 per cent	87,531	25,497	17,778	21,486
<b>Total residential mortgage lending which is neither past due nor impaired</b>	<b>339,509</b>	<b>110,523</b>	<b>94,960</b>	<b>97,345</b>

55 Financial risk management (continued)

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating:

The Group	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2010</b>							
<b>Debt securities, treasury and other bills held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	651	888	–	84	–	–	1,623
Bank and building society certificates of deposit	–	3,086	506	100	–	–	3,692
Other asset-backed securities	191	633	196	–	–	–	1,020
Corporate and other debt securities	1,205	1,209	1,839	183	13	470	4,919
Total debt securities held as trading assets	2,047	5,816	2,541	367	13	470	11,254
Treasury bills and other bills	219	8	–	–	–	–	227
Total held as trading assets	2,266	5,824	2,541	367	13	470	11,481
<i>Other assets held at fair value through profit or loss</i>							
Government securities	20,509	1,113	408	33	6	148	22,217
Other public sector securities	778	62	68	2	–	9	919
Bank and building society certificates of deposit	52	107	447	–	–	–	606
<i>Asset-backed securities:</i>							
Mortgage-backed securities	259	68	48	23	–	24	422
Other asset-backed securities	298	372	458	384	70	10	1,592
	557	440	506	407	70	34	2,014
Corporate and other debt securities	3,870	1,619	4,397	3,269	1,275	1,760	16,190
Total other assets held at fair value through profit or loss	25,766	3,341	5,826	3,711	1,351	1,951	41,946
	28,032	9,165	8,367	4,078	1,364	2,421	53,427
Due from fellow Group undertakings:							
Corporate and other debt securities – trading							36
<b>Total held at fair value through profit or loss</b>							<b>53,463</b>
<b>Derivative financial instruments</b>							
Trading	157	18,161	13,486	1,006	86	9,298	42,194
Hedging	57	1,992	4,368	46	–	943	7,406
<b>Total derivative financial instruments</b>	214	20,153	17,854	1,052	86	10,241	49,600
<b>Debt securities classified as loans and receivables</b>							
<i>Asset-backed securities:</i>							
Mortgage-backed securities	6,524	2,856	1,057	840	222	151	11,650
Other asset-backed securities	7,535	2,514	1,377	475	823	103	12,827
	14,059	5,370	2,434	1,315	1,045	254	24,477
Corporate and other debt securities	163	164	459	106	166	758	1,816
<b>Total debt securities classified as loans and receivables</b>	14,222	5,534	2,893	1,421	1,211	1,012	26,293
<b>Available-for-sale financial assets</b>							
<i>Debt securities</i>							
Government securities	12,462	78	–	–	–	12	12,552
Other public sector securities	–	–	–	–	–	29	29
Bank and building society certificates of deposit	–	225	162	20	–	–	407
<i>Asset-backed securities:</i>							
Mortgage-backed securities	2,809	673	601	202	8	–	4,293
Other asset-backed securities	3,625	781	395	115	79	224	5,219
	6,434	1,454	996	317	87	224	9,512
Corporate and other debt securities	1,135	4,824	5,150	913	42	68	12,132
Total debt securities	20,031	6,581	6,308	1,250	129	333	34,632
Treasury bills and other bills	4,439	–	1,629	–	–	–	6,068
<b>Total held as available-for-sale financial assets</b>	24,470	6,581	7,937	1,250	129	333	40,700
<b>Held-to-maturity investments</b>							
Government securities	7,905	–	–	–	–	–	7,905

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55 Financial risk management (continued)

**Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating**

The Group	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	42	–	–	–	–	30	72
Other public sector securities	–	–	6	–	–	–	6
Corporate and other debt securities	25	12	1	65	44	12	159
Total held as trading assets	<u>67</u>	<u>12</u>	<u>7</u>	<u>65</u>	<u>44</u>	<u>42</u>	<u>237</u>
<i>Other assets held at fair value through profit or loss</i>							
Government securities	7,497	139	182	2	–	46	7,866
Other public sector securities	25	–	–	–	–	9	34
Asset-backed securities:							
Mortgage-backed securities	199	127	43	23	–	1	393
Other asset-backed securities	254	294	536	302	250	20	1,656
	453	421	579	325	250	21	2,049
Corporate and other debt securities	2,549	582	2,933	2,416	604	1,328	10,412
Total other assets held at fair value through profit or loss	<u>10,524</u>	<u>1,142</u>	<u>3,694</u>	<u>2,743</u>	<u>854</u>	<u>1,404</u>	<u>20,361</u>
Total held at fair value through profit or loss	<u>10,591</u>	<u>1,154</u>	<u>3,701</u>	<u>2,808</u>	<u>898</u>	<u>1,446</u>	<u>20,598</u>
<b>Derivative financial instruments</b>							
Trading	84	9,881	2,802	363	51	3,698	16,879
Hedging	–	–	–	–	–	995	995
	<u>84</u>	<u>9,881</u>	<u>2,802</u>	<u>363</u>	<u>51</u>	<u>4,693</u>	<u>17,874</u>
Due from fellow Group undertakings							923
Total derivative financial instruments							<u>18,797</u>
<b>Debt securities classified as loans and receivables</b>							
Asset-backed securities:							
Mortgage-backed securities	231	52	39	39	83	156	600
Other asset-backed securities	26	71	6	1	209	–	313
	257	123	45	40	292	156	913
Corporate and other debt securities	–	439	823	69	306	331	1,968
Total debt securities classified as loans and receivables	<u>257</u>	<u>562</u>	<u>868</u>	<u>109</u>	<u>598</u>	<u>487</u>	<u>2,881</u>
<b>Available-for-sale financial assets</b>							
<i>Debt securities</i>							
Government securities	8,192	–	1	–	–	149	8,342
Other public sector securities	–	–	–	–	–	31	31
Bank and building society certificates of deposit	–	357	353	–	19	–	729
Asset-backed securities:							
Mortgage-backed securities	3,803	555	215	156	35	–	4,764
Other asset-backed securities	6,011	721	448	179	186	16	7,561
	9,814	1,276	663	335	221	16	12,325
Corporate and other debt securities	9	637	292	–	–	165	1,103
Total debt securities	<u>18,015</u>	<u>2,270</u>	<u>1,309</u>	<u>335</u>	<u>240</u>	<u>361</u>	<u>22,530</u>
Treasury bills and other bills	269	2,263	–	–	–	–	2,532
	<u>18,284</u>	<u>4,533</u>	<u>1,309</u>	<u>335</u>	<u>240</u>	<u>361</u>	<u>25,062</u>
Due from fellow Group undertakings:							
Corporate and other debt securities							946
Total held as available-for-sale financial assets							<u>26,008</u>

55 Financial risk management (continued)

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating

The Bank	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
<b>As at 31 December 2010</b>							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	133	3	–	84	–	–	220
Asset-backed securities – other	–	–	47	–	–	–	47
Corporate and other debt securities	79	1,009	1,428	165	13	473	3,167
Total held as trading assets	212	1,012	1,475	249	13	473	3,434
<i>Other assets held at fair value through profit or loss</i>							
Government securities	13	–	–	–	–	–	13
Asset-backed securities – other	–	–	–	47	–	–	47
Corporate and other debt securities	–	–	41	185	349	72	647
Total other assets held at fair value through profit or loss	13	–	41	232	349	72	707
	225	1,012	1,516	481	362	545	4,141
Due from fellow Group undertakings – corporate and other							92
<b>Total held at fair value through profit or loss</b>							<b>4,233</b>
<b>Derivative financial instruments</b>							
Trading	129	12,035	1,475	550	86	4,443	18,718
Hedging	–	7	30	–	–	919	956
	129	12,042	1,505	550	86	5,362	19,674
Due from fellow Group undertakings							1,648
<b>Total derivative financial instruments</b>							<b>21,322</b>
<b>Debt securities classified as loans and receivables</b>							
Asset-backed securities:							
Mortgage-backed securities	165	54	41	41	134	218	653
Other asset-backed securities	1	35	10	7	46	–	99
	166	89	51	48	180	218	752
Corporate and other debt securities	163	164	264	91	112	123	917
<b>Total debt securities classified as loans and receivables</b>	<b>329</b>	<b>253</b>	<b>315</b>	<b>139</b>	<b>292</b>	<b>341</b>	<b>1,669</b>
<b>Available-for-sale financial assets</b>							
Debt securities							
Government securities	12,398	–	–	–	–	7	12,405
Other public sector securities	–	–	–	–	–	29	29
Bank and building society certificates of deposit	–	225	32	14	–	1	272
Asset-backed securities:							
Mortgage-backed securities	571	208	173	12	7	–	971
Other asset-backed securities	815	177	159	36	58	9	1,254
	1,386	385	332	48	65	9	2,225
Corporate and other debt securities	–	526	369	59	–	23	977
Total debt securities	13,784	1,136	733	121	65	69	15,908
Treasury bills and other bills	3,235	–	689	–	–	–	3,924
	17,019	1,136	1,422	121	65	69	19,832
Due from fellow Group undertakings:							
Corporate and other debt securities							5,046
<b>Total held as available-for-sale financial assets</b>							<b>24,878</b>
<b>Held-to-maturity investments</b>							
Government securities	7,905	–	–	–	–	–	7,905

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55 Financial risk management (continued)

Debt securities, treasury and other bills and derivative financial instruments – analysis by credit rating

The Bank	AAA £m	AA £m	A £m	BBB £m	Rated BB or lower £m	Not rated £m	Total £m
As at 31 December 2009							
<b>Debt securities held at fair value through profit or loss</b>							
<i>Trading assets</i>							
Government securities	42	–	–	–	–	30	72
Other public sector securities	–	–	6	–	–	–	6
Corporate and other debt securities	25	12	1	65	44	12	159
Total held as trading assets	67	12	7	65	44	42	237
<i>Other assets held at fair value through profit or loss</i>							
Other asset-backed securities	44	–	–	–	203	–	247
Corporate and other debt securities	–	–	141	788	481	296	1,706
Total other assets held at fair value through profit or loss	44	–	141	788	684	296	1,953
Total held at fair value through profit or loss	111	12	148	853	728	338	2,190
<b>Derivative financial instruments</b>							
Trading	84	9,374	2,185	363	51	3,704	15,761
Hedging	–	–	–	–	–	952	952
	84	9,374	2,185	363	51	4,656	16,713
Due from fellow Group undertakings							1,224
Total derivative financial instruments							17,937
<b>Debt securities classified as loans and receivables</b>							
<i>Asset-backed securities:</i>							
Mortgage-backed securities	231	52	39	39	73	156	590
Other asset-backed securities	26	110	92	81	209	–	518
	257	162	131	120	282	156	1,108
Corporate and other debt securities	–	439	823	69	306	330	1,967
Total debt securities classified as loans and receivables	257	601	954	189	588	486	3,075
<b>Available-for-sale financial assets</b>							
<i>Debt securities</i>							
Government securities	8,192	–	1	–	–	7	8,200
Other public sector securities	–	–	–	–	–	31	31
Bank and building society certificates of deposit	–	356	93	–	14	–	463
<i>Asset-backed securities:</i>							
Mortgage-backed securities	790	205	59	25	1	–	1,080
Other asset-backed securities	1,686	178	60	65	117	16	2,122
	2,476	383	119	90	118	16	3,202
Corporate and other debt securities	9	637	292	–	–	23	961
Total debt securities	10,677	1,376	505	90	132	77	12,857
Treasury bills and other bills	71	–	–	–	–	–	71
	10,748	1,376	505	90	132	77	12,928
Due from fellow Group undertakings:							510
Corporate and other debt securities							510
Total held as available-for-sale financial assets							13,438

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**55 Financial risk management** (continued)

**Credit market exposures**

The Group's credit market exposures primarily relate to asset-backed securities held in the non-retail businesses. These exposures are classified as loans and receivables (note 22), available-for-sale financial assets (note 24) or trading and other financial assets at fair value through profit or loss (note 16) depending on the nature of the investment.

	Loans and receivables £m	Available-for- sale £m	Trading and other financial assets at fair value through profit or loss £m	Net exposure as at 31 December 2010 £m	Net exposure as at 31 December 2009 £m
<b>Asset-backed securities – the Group</b>					
<b>Mortgaged-backed securities</b>					
US residential mortgage-backed securities	4,242	–	–	4,242	336
Non-US residential mortgage-backed securities	4,916	2,982	–	7,898	3,559
Commercial mortgage-backed securities	2,397	1,119	–	3,516	1,203
	<u>11,555</u>	<u>4,101</u>	<u>–</u>	<u>15,656</u>	<u>5,098</u>
<b>Collateralised debt obligations</b>					
Corporate	43	–	–	43	–
Commercial real estate	306	–	–	306	–
Other	106	39	–	145	151
Collateralised loan obligations	3,578	1,108	–	4,686	1,890
	<u>4,033</u>	<u>1,147</u>	<u>–</u>	<u>5,180</u>	<u>2,041</u>
<b>Personal sector</b>					
Auto loans	569	339	–	908	724
Credit cards	1,795	338	–	2,133	770
Personal loans	663	263	–	926	230
	<u>3,027</u>	<u>940</u>	<u>–</u>	<u>3,967</u>	<u>1,724</u>
<b>Federal family education loan program</b>					
Student loans	5,078	2,699	–	7,777	3,306
<b>Other asset-backed securities</b>	572	463	–	1,035	776
<b>Total uncovered asset-backed securities</b>	<u>24,265</u>	<u>9,350</u>	<u>–</u>	<u>33,615</u>	<u>12,945</u>
<b>Negative basis<sup>1</sup></b>	–	42	1,067	1,109	283
<b>Total Wholesale asset-backed securities</b>	<u>24,265</u>	<u>9,392</u>	<u>1,067</u>	<u>34,724</u>	<u>13,228</u>
Direct	15,860	5,369	1,067	22,296	7,831
Conduits	8,405	4,023	–	12,428	5,397
<b>Total Wholesale asset-backed securities</b>	<u>24,265</u>	<u>9,392</u>	<u>1,067</u>	<u>34,724</u>	<u>13,228</u>

<sup>1</sup>Negative basis means bonds held with separate matching credit default swap protection.

The table below sets out the Wholesale division's net exposure to Non-US residential mortgage-backed securities (RMBS) by vintage:

	Pre-2005 £m	2005 £m	2006 £m	2007 £m	Net exposure as at 31 December 2010 £m	Net exposure as at 31 December 2009 £m
<b>The Group</b>						
<b>Asset class</b>						
Prime	233	215	66	28	542	15
Alt-A	121	765	1,437	1,377	3,700	321
Sub-prime	–	–	–	–	–	–
<b>Total net exposure to US RMBS</b>	<u>354</u>	<u>980</u>	<u>1,503</u>	<u>1,405</u>	<u>4,242</u>	<u>336</u>

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**55 Financial risk management** (continued)

**Exposures to monolines**

During 2009 all exposure to sub-investment grade monolines on CDS contracts was written down to zero, leaving limited exposure to monoline insurers as set out below.

	Credit default swaps		Wrapped loans and receivables		Wrapped bonds	
	Notional £m	Exposure <sup>1</sup> £m	Notional £m	Exposure <sup>2</sup> £m	Notional £m	Exposure <sup>3</sup> £m
<b>The Group</b>						
Investment grade	1,060	40	330	214	-	-
Sub-investment grade	-	-	-	-	-	-
<b>Total monoline insurers</b>	<b>1,060</b>	<b>40</b>	<b>330</b>	<b>214</b>	<b>-</b>	<b>-</b>

<sup>1</sup>The exposure to monolines arising from credit default swaps is calculated as the mark-to-market of the credit default swap protection purchased from the monoline after credit valuation adjustments.

<sup>2</sup>The exposure to monolines on wrapped loans and receivables and bonds is the internal assessment of amounts that will be recovered from the monoline guarantor on interest and principal shortfalls.

<sup>3</sup>In addition, the Group has £1,985 million (2009: £1,196 million) of monoline wrapped bonds and £425 million (2009: £791 million) of monoline liquidity commitments on which the Group currently places no reliance on the guarantor.

**Credit ratings**

An analysis of the Wholesale division's asset-backed securities portfolio by credit rating is provided below.

	Net exposure £m	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Below B £m
<b>The Group</b>								
<b>Asset-class</b>								
<b>Mortgage-backed securities</b>								
US residential mortgage-backed securities:								
Prime	542	312	110	82	26	9	3	-
Alt-A	3,700	2,037	801	591	186	66	19	-
Sub Prime	-	-	-	-	-	-	-	-
	<u>4,242</u>	<u>2,349</u>	<u>911</u>	<u>673</u>	<u>212</u>	<u>75</u>	<u>22</u>	<u>-</u>
Non-US residential mortgage-backed securities	7,898	6,170	1,415	237	76	-	-	-
Commercial mortgage-backed securities	3,516	754	1,390	637	585	62	-	88
	<u>15,656</u>	<u>9,273</u>	<u>3,716</u>	<u>1,547</u>	<u>873</u>	<u>137</u>	<u>22</u>	<u>88</u>
<b>Collateralised debt obligations</b>								
Corporate	43	5	27	-	-	-	-	11
Commercial real estate	306	18	-	-	105	128	27	28
Other	145	-	-	-	-	105	-	40
Collateralised loan obligations	4,686	760	2,189	1,210	140	234	98	55
	<u>5,180</u>	<u>783</u>	<u>2,216</u>	<u>1,210</u>	<u>245</u>	<u>467</u>	<u>125</u>	<u>134</u>
<b>Personal sector</b>								
Auto loans	908	764	68	44	-	32	-	-
Credit cards	2,133	1,762	371	-	-	-	-	-
Personal loans	926	230	306	325	65	-	-	-
	<u>3,967</u>	<u>2,756</u>	<u>745</u>	<u>369</u>	<u>65</u>	<u>32</u>	<u>-</u>	<u>-</u>
<b>Federal family education loan program</b>								
Student loans	7,777	7,646	-	48	64	19	-	-
<b>Other asset-backed securities</b>	1,035	114	-	296	517	108	-	-
<b>Negative basis<sup>1</sup></b>								
Monolines	1,067	191	633	243	-	-	-	-
Banks	42	42	-	-	-	-	-	-
	<u>1,109</u>	<u>233</u>	<u>633</u>	<u>243</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>Total as at 31 December 2010</b>	<b>34,724</b>	<b>20,805</b>	<b>7,310</b>	<b>3,713</b>	<b>1,764</b>	<b>763</b>	<b>147</b>	<b>222</b>
Total as at 31 December 2009	13,235	10,030	1,471	825	404	168	39	298

<sup>1</sup>The external credit rating is based on the bond ignoring the benefit of the credit default swap.



## 55 Financial risk management (continued)

### (2) Market Risk

#### Interest rate risk

In the Group's retail banking business interest rate risk arises from the different repricing characteristics of the assets and liabilities. Liabilities are either insensitive to interest rate movements, for example interest free or very low interest customer deposits, or are sensitive to interest rate changes but bear rates which may be varied at the Group's discretion and that for competitive reasons generally reflect changes in the Bank of England's base rate. There are a relatively small volume of deposits whose rate is contractually fixed for their term to maturity.

Many banking assets are sensitive to interest rate movements; there is a large volume of managed rate assets such as variable rate mortgages which may be considered as a natural offset to the interest rate risk arising from the managed rate liabilities. However a significant proportion of the Group's lending assets, for example personal loans and mortgages, bear interest rates which are contractually fixed for periods of up to five years or longer.

The Group establishes two types of hedge accounting relationships for interest rate risk: fair value hedges and cash flow hedges. The Group is exposed to fair value interest rate risk on its fixed rate customer loans, its fixed rate customer deposits and the majority of its subordinated debt, and to cash flow interest rate risk on its variable rate loans and deposits together with its floating rate subordinated debt. The majority of the Group's hedge accounting relationships are fair value hedges where interest rate swaps are used to hedge the interest rate risk inherent in the fixed rate mortgage portfolio.

At 31 December 2010 the aggregate notional principal of interest rate swaps designated as fair value hedges was £75,831 million (2009: £24,219 million) for the Group and £30,777 million (2009: £23,219 million) for the Bank with a net fair value asset of £3,166 million (2009: asset of £458 million) for the Group and £338 million (2009: asset of £370 million) for the Bank (note 17). The gains recognised by the Group on the hedging instruments were £280 million (2009: losses of £4 million). The Group's losses on the hedged items attributable to the hedged risk were £452 million (2009: gains of £26 million).

In addition the Group has a small number of cash flow hedges which are primarily used to hedge the variability in the cost of funding within the wholesale business. These cash flows are expected to occur over the next six years and the hedge accounting adjustments will be reported in the income statement as the cash flows arise. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2010 was £112,507 million (2009: £659 million) for the Group and £1,597 million (2009: £659 million) for the Bank with a net fair value liability of £843 million (2009: £46 million) for the Group and £60 million (2009: £46 million) for the Bank (note 17). In 2010, ineffectiveness recognised in the income statement that arises from cash flow hedges was a £160 million gain (2009: £nil). There were no transactions for which cash flow hedge accounting had to be ceased in 2010 or 2009 as a result of the highly probable cash flows no longer being expected to occur.

#### Currency risk

Foreign exchange exposures comprise those originating in treasury trading activities and structural foreign exchange exposures, which arise from investment in the Group's overseas operations.

The corporate and retail businesses incur foreign exchange risk in the course of providing services to their customers. All non-structural foreign exchange exposures in the non-trading book are transferred to the trading area where they are monitored and controlled. These risks reside in the authorised trading centres who are allocated exposure limits. The limits are monitored daily by the local centres and reported to the central market risk function.

Risk arises from the Group's investments in its overseas operations. The Group's structural foreign currency exposure is represented by the net asset value of the foreign currency equity and subordinated debt investments in its subsidiaries and branches. Gains or losses on structural foreign currency exposures are taken to reserves.

The Group hedges part of the currency translation risk of the new investment in certain foreign operations using currency borrowings and cross currency derivatives. At 31 December 2010 the aggregate notional principal of these currency borrowings was £5,135 million; the aggregate notional principle of the cross currency derivatives was £86 million (2009: cross currency swaps £2,507 million) with a net fair value asset of £2 million (2009: asset of £25 million) and they were designated on an after tax basis as hedges of net investments in foreign operations. In 2010, an ineffectiveness loss of £28 million before tax and £20 million after tax (2009: £nil before tax and £nil after tax) was recognised on the income statement arising from net investment hedges.

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**55 Financial risk management** (continued)

The Group's main overseas operations are in the Americas, Asia, Australasia and Europe. Details of the Group's structural foreign currency exposures are, after net investment hedges, as follows:

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
<b>Functional currency of Group operations</b>				
Euro:				
Gross exposure	2,468	113	(4)	62
Net investment hedge	(3,270)	–	–	–
	<b>(802)</b>	113	<b>(4)</b>	62
US dollar:				
Gross exposure	47	(122)	53	81
Net investment hedge	(145)	–	–	–
	<b>(98)</b>	(122)	<b>53</b>	81
Swiss franc:				
Gross exposure	53	2,552	31	51
Net investment hedge	–	(2,467)	–	–
	<b>53</b>	85	<b>31</b>	51
Australian dollar:				
Gross exposure	1,567	–	(4)	–
Net investment hedge	(1,634)	–	–	–
	<b>(67)</b>	–	<b>(4)</b>	–
Japanese yen:				
Gross exposure	17	3,220	17	12
Net investment hedge	–	(3,207)	–	–
	<b>17</b>	13	<b>17</b>	12
Other non-sterling	<b>155</b>	318	<b>343</b>	281
<b>Total structural foreign currency exposures, after net investment hedges</b>	<b>(742)</b>	407	<b>436</b>	487

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**55 Financial risk management** (continued)

**(3) Liquidity risk**

The tables below analyse financial instrument liabilities of the Group and the Bank, excluding those arising from insurance and participating investment contracts, on an undiscounted future cash flow basis according to contractual maturity, into relevant maturity groupings based on the remaining period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category.

<b>The Group</b>	<b>Up to 1 month £m</b>	<b>1-3 months £m</b>	<b>3-12 months £m</b>	<b>1-5 years £m</b>	<b>Over 5 years £m</b>	<b>Total £m</b>
<b>As at 31 December 2010</b>						
Deposits from banks	24,938	11,804	4,301	10,557	920	52,520
Customer deposits	307,622	15,136	33,132	43,516	24,415	423,821
Trading and other financial liabilities at fair value through profit or loss	11,293	2,218	5,125	5,544	3,633	27,813
Debt securities in issue	31,225	41,143	52,549	91,166	35,202	251,285
Liabilities arising from non-participating investment contracts	12,944	91	265	1,743	36,320	51,363
Subordinated liabilities	178	1,005	4,087	12,746	21,381	39,397
<b>Total non-derivative financial liabilities</b>	<b>388,200</b>	<b>71,397</b>	<b>99,459</b>	<b>165,272</b>	<b>121,871</b>	<b>846,199</b>
Derivative financial liabilities:						
Gross settled derivatives – outflows	41,594	34,665	19,089	103,600	52,449	251,397
Gross settled derivatives – inflows	(17,094)	(34,823)	(19,211)	(103,563)	(51,815)	(226,506)
Gross settled derivatives – net flows	24,500	(158)	(122)	37	634	24,891
Net settled derivative liabilities	3,001	2,204	6,479	13,537	5,524	30,745
<b>Total derivative financial liabilities</b>	<b>27,501</b>	<b>2,046</b>	<b>6,357</b>	<b>13,574</b>	<b>6,158</b>	<b>55,636</b>
<b>As at 31 December 2009</b>						
Deposits from banks	76,070	51,297	11,852	327	455	140,001
Customer deposits	152,423	8,554	9,844	9,438	13,412	193,671
Trading and other financial liabilities at fair value through profit or loss	716	141	1,582	3,222	1,275	6,936
Debt securities in issue	26,315	26,187	16,281	49,460	5,869	124,112
Liabilities arising from non-participating investment contracts	15,734	–	–	–	–	15,734
Subordinated liabilities	151	70	623	4,659	18,012	23,515
<b>Total non-derivative financial liabilities</b>	<b>271,409</b>	<b>86,249</b>	<b>40,182</b>	<b>67,106</b>	<b>39,023</b>	<b>503,969</b>
Derivative financial liabilities:						
Gross settled derivatives – outflows	4,907	943	365	122	986	7,323
Gross settled derivatives – inflows	(901)	(607)	(189)	(157)	(385)	(2,239)
Gross settled derivatives – net flows	4,006	336	176	(35)	601	5,084
Net settled derivative liabilities	14,817	–	–	–	–	14,817
<b>Total derivative financial liabilities</b>	<b>18,823</b>	<b>336</b>	<b>176</b>	<b>(35)</b>	<b>601</b>	<b>19,901</b>

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £146 million (2009: £216 million) per annum for the Group and £43 million (2009: £216 million) for the Bank which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

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55 Financial risk management (continued)

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>The Bank</b>						
<b>As at 31 December 2010</b>						
Deposits from banks	88,314	23,566	16,300	14,115	6,328	148,623
Customer deposits	148,295	13,449	20,939	19,566	18,550	220,799
Trading and other financial liabilities at fair value through profit or loss	428	132	2,773	5,442	3,632	12,407
Debt securities in issue	9,028	25,513	33,242	35,664	19,371	122,818
Subordinated liabilities	157	889	590	6,199	15,622	23,457
<b>Total non-derivative financial liabilities</b>	<b>246,222</b>	<b>63,549</b>	<b>73,844</b>	<b>80,986</b>	<b>63,503</b>	<b>528,104</b>
Gross settled derivatives – outflows	28,795	21,366	10,414	54,276	22,675	137,526
Gross settled derivatives – inflows	(4,520)	(21,336)	(10,502)	(54,117)	(21,787)	(112,262)
Gross settled derivatives – net flows	24,275	30	(88)	159	888	25,264
Net settled derivative liabilities	955	596	595	1,568	2,057	5,771
<b>Total derivative financial liabilities</b>	<b>25,230</b>	<b>626</b>	<b>507</b>	<b>1,727</b>	<b>2,945</b>	<b>31,035</b>
	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2009</b>						
Deposits from banks	87,385	57,981	12,960	3,625	3,837	165,788
Customer deposits	146,010	9,668	18,774	14,463	13,905	202,820
Trading and other financial liabilities at fair value through profit or loss	716	141	1,582	3,222	1,275	6,936
Debt securities in issue	21,533	23,315	16,205	46,354	5,641	113,048
Subordinated liabilities	144	81	595	4,544	17,519	22,883
<b>Total non-derivative financial liabilities</b>	<b>255,788</b>	<b>91,186</b>	<b>50,116</b>	<b>72,208</b>	<b>42,177</b>	<b>511,475</b>
Gross settled derivatives – outflows	4,244	368	227	126	686	5,651
Gross settled derivatives – inflows	–	(1)	(120)	(442)	(364)	(927)
Gross settled derivatives – net flows	4,244	367	107	(316)	322	4,724
Net settled derivative liabilities	15,021	–	–	–	–	15,021
<b>Total derivative financial liabilities</b>	<b>19,265</b>	<b>367</b>	<b>107</b>	<b>(316)</b>	<b>322</b>	<b>19,745</b>

Liabilities of the Group arising from insurance and participating investment contracts are analysed on a behavioural basis, as permitted by IFRS 4, as follows:

	Up to 1 month £m	1-2 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
<b>As at 31 December 2010</b>	<b>2,481</b>	<b>1,459</b>	<b>5,072</b>	<b>18,431</b>	<b>53,306</b>	<b>80,749</b>
As at 31 December 2009	485	1,203	1,895	7,983	25,394	36,960

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**55 Financial risk management** (continued)

The following tables set out the amounts and residual maturities of off balance sheet contingent liabilities and commitments.

<b>The Group</b>	<b>Within 1 year £m</b>	<b>1-3 years £m</b>	<b>3-5 years £m</b>	<b>Over 5 years £m</b>	<b>Total £m</b>
<b>31 December 2010</b>					
Acceptances	48	–	–	–	48
Other contingent liabilities	1,897	1,248	269	717	4,131
Total contingent liabilities	1,945	1,248	269	717	4,179
Lending commitments	76,456	22,537	13,424	3,739	116,156
Other commitments	1,038	61	–	43	1,142
Total commitments	77,494	22,598	13,424	3,782	117,298
<b>Total contingents and commitments</b>	<b>79,439</b>	<b>23,846</b>	<b>13,693</b>	<b>4,499</b>	<b>121,477</b>

31 December 2009					
Acceptances	53	–	–	–	53
Other contingent liabilities	2,181	1,302	379	825	4,687
Total contingent liabilities	2,234	1,302	379	825	4,740
Lending commitments	46,662	17,205	7,253	2,408	73,528
Other commitments	866	105	–	6	977
Total commitments	47,528	17,310	7,253	2,414	74,505
Total contingents and commitments	49,762	18,612	7,632	3,239	79,245

<b>The Bank</b>	<b>Within 1 year £m</b>	<b>1-3 years £m</b>	<b>3-5 years £m</b>	<b>Over 5 years £m</b>	<b>Total £m</b>
<b>31 December 2010</b>					
Acceptances	50	–	–	–	50
Other contingent liabilities	1,425	1,199	171	639	3,434
Total contingent liabilities	1,475	1,199	171	639	3,484
Lending commitments	54,152	18,898	6,490	1,695	81,235
Other commitments	1,910	51	–	3	1,964
Total commitments	56,062	18,949	6,490	1,698	83,199
<b>Total contingents and commitments</b>	<b>57,537</b>	<b>20,148</b>	<b>6,661</b>	<b>2,337</b>	<b>86,683</b>

31 December 2009					
Acceptances	54	–	–	–	54
Other contingent liabilities	1,537	1,292	379	840	4,048
Total contingent liabilities	1,591	1,292	379	840	4,102
Lending commitments	53,007	16,439	6,836	2,079	78,361
Other commitments	3,481	105	–	6	3,592
Total commitments	56,488	16,544	6,836	2,085	81,953
Total contingents and commitments	58,079	17,836	7,215	2,925	86,055

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## 56 Capital

Capital is actively managed at an appropriate level of frequency and regulatory ratios are a key factor in the Group's budgeting and planning processes with updates of expected ratios reviewed regularly during the year by the Lloyds Banking Group Asset and Liability Committee. Capital raised takes account of expected growth and currency of risk assets. Capital policies and procedures are subject to independent oversight.

The Group's regulatory capital is divided into tiers defined by the European Community Banking Consolidation Directive as implemented in the UK by the Financial Services Authority's (FSA) General Prudential Sourcebook. Tier 1 capital comprises mainly shareholders' equity, tier 1 capital instruments and non-controlling interests, after deducting goodwill, other intangible assets and 50 per cent of the net excess of expected losses over accounting provisions and certain securitisation positions. During the year the FSA has defined Core Tier 1 capital. Accounting equity is adjusted in accordance with FSA requirements, particularly in respect of pensions and available-for-sale assets. Tier 2 capital mainly comprises qualifying subordinated debt after deducting 50 per cent of the excess of expected losses over accounting provisions, and certain securitisation positions. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital. Total capital is reduced by deducting investments in subsidiaries and associates that are not consolidated for regulatory purposes. In the case of the Lloyds TSB Bank Group, this means that the net assets of its life assurance and general insurance businesses are excluded from its total regulatory capital.

	2010 £m	2009 <sup>1</sup> £m
Tier 1 capital	49,375	18,153
Tier 2 capital	21,073	7,700
	<b>70,448</b>	25,853
Supervisory deductions	<b>(13,112)</b>	(5,182)
<b>Total capital</b>	<b>57,336</b>	20,671

<sup>1</sup>Restated to reflect a prior year adjustment to available-for-sale revaluation reserves (note 1).

A number of limits are imposed by the FSA on the proportion of the regulatory capital base that can be made up of subordinated debt and preferred securities. The unpredictable nature of movements in the value of the investments supporting the long-term assurance funds could cause the amount of qualifying tier 2 capital to be restricted because of falling tier 1 resources. The Group seeks to ensure that even in the event of such restrictions the total capital ratio will remain adequate.

The FSA sets Individual Capital Guidance (ICG) for each UK bank calibrated by reference to its Capital Resources Requirement (CRR), broadly equivalent to 8 per cent of risk-weighted assets and thus representing the capital required under Pillar 1 of the Basel II framework. Also a key input into the FSA's ICG setting process, which addresses the requirements of Pillar 2 of the Basel II framework, is each bank's Internal Capital Adequacy Assessment Process. The FSA's approach is to monitor the available capital resources in relation to the ICG requirement. Lloyds Banking Group has been given ICG by the FSA and the board has also agreed a formal buffer to be maintained in addition to this requirement. Any breaches of the formal buffer must be notified to the FSA, together with proposed remedial action. The FSA has made it clear that each ICG remains a confidential matter between each bank and the FSA.

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

## 57 Cash flow statements

### a Change in operating assets

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in loans and receivables	40,624	(149,606)	26,753	(155,255)
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	(8,092)	6,473	(5,342)	9,767
Change in other operating assets	(660)	228	(408)	1,578
<b>Change in operating assets</b>	<b>31,872</b>	<b>(142,905)</b>	<b>21,003</b>	<b>(143,910)</b>

### b Change in operating liabilities

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in deposits from banks	(32,355)	73,678	(42,164)	80,534
Change in customer deposits	(12,620)	21,046	22,617	17,377
Change in debt securities in issue	(6,155)	47,238	4,233	53,469
Change in derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	183	(11,835)	8,334	(13,282)
Change in investment contract liabilities	8,160	2,982	-	-
Change in other operating liabilities	(2,774)	(674)	376	(1,440)
<b>Change in operating liabilities</b>	<b>(45,561)</b>	<b>132,435</b>	<b>(6,604)</b>	<b>136,658</b>

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57 Cash flow statements (continued)

c Non-cash and other items

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Depreciation and amortisation	2,432	733	373	339
Impairment of fixed assets	202	–	–	–
Revaluation of investment properties	(434)	145	–	–
Allowance for loan losses	10,771	4,353	2,371	3,635
Write-off of allowance for loan losses	(6,909)	(2,786)	(2,911)	(2,512)
Impairment of available-for-sale securities	106	21	21	16
Impairment of goodwill	–	240	–	–
Change in insurance contract liabilities	4,029	3,173	–	–
Customer goodwill payments provision	500	–	–	–
Other provision movements	49	159	36	163
Net (credit) charge in respect of defined benefit schemes	(455)	275	(205)	213
Contributions to defined benefit schemes	(653)	(1,574)	(187)	(1,438)
Other non-cash items	(3,214)	(1,033)	417	(1,843)
Total non-cash items	6,424	3,706	(85)	(1,427)
Interest expense on subordinated liabilities	3,217	984	936	956
Other	857	(7)	78	24
Total other items	4,074	977	1,014	980
<b>Non-cash and other items</b>	<b>10,498</b>	<b>4,683</b>	<b>929</b>	<b>(447)</b>

d Analysis of cash and cash equivalents as shown in the balance sheet

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Cash and balances with central banks	38,115	36,089	35,585	35,964
Less: mandatory reserve deposits <sup>1</sup>	(1,089)	(392)	(732)	(372)
	37,026	35,697	34,853	35,592
Loans and advances to banks	30,272	175,554	152,596	176,556
Less: amounts with a maturity of three months or more and balances due from fellow Lloyds Banking Group undertakings	(4,998)	(154,645)	(147,060)	(169,941)
	25,274	20,909	5,536	6,615
<b>Total cash and cash equivalents</b>	<b>62,300</b>	<b>56,606</b>	<b>40,389</b>	<b>42,207</b>

<sup>1</sup>Mandatory reserve deposits are held with local central banks in accordance with statutory requirements; these deposits are not available to finance the Group's day-to-day operations.

Included within cash and cash equivalents of the Group at 31 December 2010 is £14,694 million (2009: £10,358 million) held within the Group's life funds, which is not immediately available for use in the business.

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57 Cash flow statements (continued)

e Analysis of changes in financing during the year

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Share capital (including share premium account and merger reserve):				
At 1 January	10,102	4,502	10,102	4,502
Adjustment on transfer of HBOS	27,742	–	21,394	–
Issue of ordinary shares	5,611	5,600	5,611	5,600
<b>At 31 December</b>	<b>43,455</b>	<b>10,102</b>	<b>37,107</b>	<b>10,102</b>
	The Group			
	2009 £m	2008 £m		
Non-controlling interests:				
At 1 January	293	306		
Exchange and other adjustments	(5)	(19)		
Adjustment on transfer of HBOS	1,271	–		
Extinguishment of non-controlling interests	(735)	–		
Change in non-controlling interests	2	–		
Minority share of profit after tax	62	24		
Dividends paid to non-controlling interests	(47)	(18)		
<b>At 31 December</b>	<b>841</b>	<b>293</b>		
	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Subordinated liabilities				
At 1 January	15,999	17,389	15,456	16,853
Exchange and other adjustments	(6,034)	(2,735)	(2,766)	(2,742)
Adjustment on transfer of HBOS	17,091	–	–	–
Proceeds from issue of subordinated liabilities	3,237	3,187	3,237	3,187
Repayments of subordinated liabilities	(684)	(1,842)	(353)	(1,842)
<b>At 31 December</b>	<b>29,609</b>	<b>15,999</b>	<b>15,574</b>	<b>15,456</b>



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**57 Cash flow statements** (continued)

**f Acquisition of group undertakings and businesses**

	The Group		The Bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Net assets transferred in respect of HBOS:				
Cash and balances at central banks	<b>2,905</b>	–	–	–
Derivatives, trading and other financial assets at fair value through profit or loss	<b>132,038</b>	–	–	–
Loans and receivables	<b>435,875</b>	–	–	–
Available-for-sale financial assets	<b>21,459</b>	–	–	–
Deposits from banks	<b>(29,600)</b>	–	–	–
Customer deposits	<b>(232,091)</b>	–	–	–
Derivatives, trading and other financial liabilities at fair value through profit or loss	<b>(47,710)</b>	–	–	–
Debt securities in issue	<b>(112,815)</b>	–	–	–
Insurance contract liabilities	<b>(70,617)</b>	–	–	–
Subordinated liabilities	<b>(14,653)</b>	–	–	–
Amounts with other Lloyds Banking Group undertakings (net)	<b>(63,419)</b>	–	–	–
Non-controlling interests	<b>(1,271)</b>	–	–	–
Other assets (net)	<b>7,641</b>	–	–	–
Total net assets transferred	<b>27,742</b>	–	–	–
Satisfied by:				
Issue of shares	<b>(21,394)</b>	–	–	–
Merger reserve arising on transfer	<b>(6,348)</b>	–	–	–
Cash and cash equivalents acquired	<b>9,084</b>	–	–	–
Net cash inflow arising from transfer of HBOS	<b>9,084</b>	–	–	–
Additional capital injections to subsidiaries	–	–	<b>(219)</b>	(1)
Acquisition of and additional investment in associates and joint ventures	<b>(65)</b>	–	–	–
Net cash inflow (outflow) arising from acquisitions in the year	<b>9,019</b>	–	<b>(219)</b>	(1)
Payments to former members of Scottish Widows Fund and Life Assurance Society acquired during 2000	<b>(8)</b>	(35)	–	–
Net cash inflow	<b>9,011</b>	(35)	<b>(219)</b>	(1)

For more details on the assets and liabilities relating to the transfer of HBOS see note 31.

**g Disposal of group undertakings and businesses**

The Group generated cash inflows of £428 million (2009: £nil) and the Bank generated cash inflows of £18 million (2009: £33 million) from the disposal and liquidation of subsidiary undertakings.

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## 58 Future accounting developments

The following pronouncements will be relevant to the Group but were not effective at 31 December 2010 and have not been applied in preparing these financial statements. The full impact of these accounting changes is being assessed by the Group.

Pronouncement	Nature of change	Effective date
Amendment to IAS 32 <i>Financial Instruments: Presentation – ‘Classification of Rights Issues’</i>	Requires rights issues denominated in a currency other than the functional currency of the issuer to be classified as equity regardless of the currency in which the exercise price is denominated.	Annual periods beginning on or after 1 February 2010.
<i>Improvements to IFRSs</i> (issued May 2010)	Sets out minor amendments to IFRS standards as part of the annual improvements process.	Dealt with on a standard by standard basis but not earlier than annual periods beginning on or after 1 July 2010.
IFRIC 19 <i>Extinguishing Financial Liabilities with Equity Instruments</i>	Clarifies that when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor, a gain or loss is recognised in the income statement representing the difference between the carrying value of the financial liability and the fair value of the equity instruments issued; the fair value of the financial liability is used to measure the gain or loss where the fair value of the equity instruments cannot be reliably measured. This interpretation is consistent with the Group’s existing accounting policy.	Annual periods beginning on or after 1 July 2010.
Amendment to IFRIC 14 <i>Prepayments of a Minimum Funding Requirement</i>	Applies when an entity is subject to minimum funding requirements in respect of its defined benefit plans and makes an early payment of contributions to cover those requirements and permits such an entity to treat the benefit of such an early payment as an asset.	Annual periods beginning on or after 1 January 2011.
Amendments to IAS 24 <i>Related Party Disclosures</i>	Simplifies the definition of a related party and provides a partial exemption from the disclosure requirements for related party transactions with government related entities.	Annual periods beginning on or after 1 January 2011.
Amendments to IFRS 7 <i>Financial Instruments Disclosures – ‘Disclosures-Transfers of Financial Assets’</i>	Requires additional disclosures in respect of risk exposures arising from transferred financial assets.	Annual periods beginning on or after 1 July 2011.
Amendments to IAS 12 <i>Income Taxes – ‘Deferred Tax: Recovery of Underlying Assets’</i>	Introduces a rebuttable presumption that investment property measured at fair value is recovered entirely through sale and that deferred tax in respect of such investment property is recognised on that basis.	Annual periods beginning on or after 1 January 2012.
IFRS 9 <i>Financial Instruments</i> <sup>1</sup>	Replaces those parts of IAS 39 ‘Financial Instruments: Recognition and Measurement’ relating to the classification, measurement and derecognition of financial assets and liabilities. Requires financial assets to be classified into two measurement categories, fair value and amortised cost, on the basis of the objectives of the entity’s business model for managing its financial assets and the contractual cash flow characteristics of the instrument. The available-for-sale financial asset and held-to-maturity investment categories in the existing IAS 39 will be eliminated. The requirements for financial liabilities and derecognition are broadly unchanged from IAS 39.	Annual periods beginning on or after 1 January 2013.

<sup>1</sup>IFRS 9 is the initial stage of the project to replace IAS 39. Future stages are expected to result in amendments to IFRS 9 to deal with changes to the impairment of financial assets measured at amortised cost and hedge accounting. Until all stages of the replacement project are complete, it is not possible to determine the overall impact on the financial statements of the replacement of IAS 39. The effective date of the standard is annual periods beginning on or after 1 January 2013.

At the date of this report, IFRS 9, the Amendments to IFRS 7 and the Amendments to IAS 12 are awaiting EU endorsement.

## 59 Post balance sheet events

The Lloyds Banking Group has been in discussion with the FSA regarding the application of an interest variation clause in certain Bank of Scotland plc variable rate mortgage contracts where the wording in the offer documents received by certain customers had the potential to cause confusion. The relevant mortgages were written between 2004 and 2007 by Bank of Scotland plc under the ‘Halifax’ brand. In February 2011, the Group reached agreement with the FSA in relation to initiating a customer review and contact programme and making goodwill payments to affected customers. In order to make these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission to carry out the customer review and contact programme to bring it within section 404F(7) of FSMA 2000. The Group has made a provision of £500 million in relation to this programme.

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**60 Approval of the financial statements and other information**

The financial statements were approved by the directors of Lloyds TSB Bank plc on 24 February 2011.

Lloyds TSB Bank plc and its subsidiaries form a leading UK-based financial services group, whose businesses provide a wide range of banking and financial services in the UK and in certain locations overseas.

Lloyds TSB Bank plc's ultimate parent undertaking and controlling party is Lloyds Banking Group plc which is incorporated in Scotland. Copies of the consolidated annual report and accounts of Lloyds Banking Group plc may be obtained from Lloyds Banking Group's head office at 25 Gresham Street, London EC2V 7HN or downloaded via [www.lloydsbankinggroup.com](http://www.lloydsbankinggroup.com).

