HELPING BRITAIN PROSPER

Lloyds Banking Group
Annual Report and Accounts

2016

How we're helping Britain prosper

Helping Britain Prosper is our purpose. It means responding to the social and economic issues we believe we are best placed to address.

We already support people, businesses and communities all over Britain through our iconic brands and extensive range of clear and simple products and services, but we want to do even more to play our part in making Britain a more inclusive and prosperous country. To achieve this we must continue to build a culture where our colleagues put customers first.

We want to take a leading role in helping the UK economy whether through supporting housing, trade, growth, infrastructure or tackling disadvantage. Our Helping Britain Prosper Plan, launched in 2014, helps us achieve this, taking us beyond business as usual by setting measurable targets in the areas where we believe we can make the biggest difference. The Plan is an investment in our long-term sustainable success which underpins our aim to become the best bank for customers whilst delivering superior and sustainable returns for shareholders.

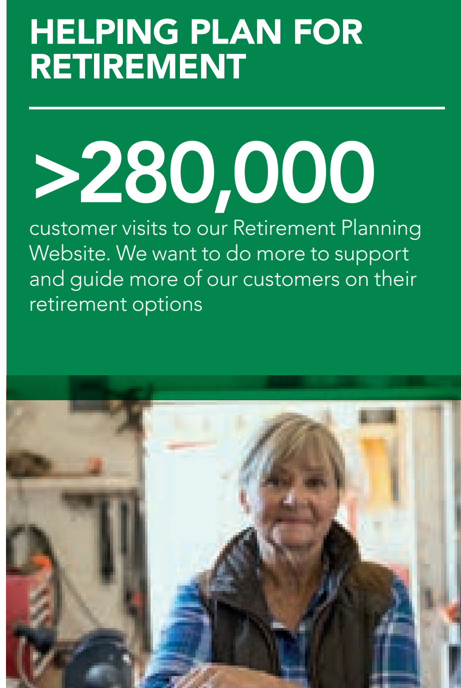
We're helping individuals, families, businesses and communities all across Britain to prosper

Key brands

HELPING PLAN FOR RETIREMENT

>280,000

customer visits to our Retirement Planning Website. We want to do more to support and guide more of our customers on their retirement options



HELPING HOMEBUYERS

£39bn

of gross new mortgage lending in 2016 with 60 per cent going to help homebuyers get on and move up the housing ladder

HELPING UK MANUFACTURING

£1.2bn

of new funding support for UK manufacturing companies. We are supporting future talent to make British manufacturing more productive and competitive, today and tomorrow

HELPING START-UPS

121,000

start-ups helped to get going and grow through funding. We also provide advice and mentoring – including vital support for many charities and social enterprises

HELPING COMMUNITIES

£600m

given to support charities through our independent charitable Foundations over the last 30 years. We believe no other bank has the reach or resources to help tackle social disadvantage

HELPING THE ECONOMY

£1.8bn

tax paid in 2015. We are a major contributor to UK tax revenues and were ranked as the highest payer of UK tax in the most recent PwC Total Tax Contribution Survey for the 100 Group. This payment increased to £2.3 billion in 2016

HELPING TO BUILD DIGITAL BRITAIN

12.5m

customers banking online, making us the UK's largest digital bank. We are also helping Britain's charities and small businesses to build their digital skills and capability

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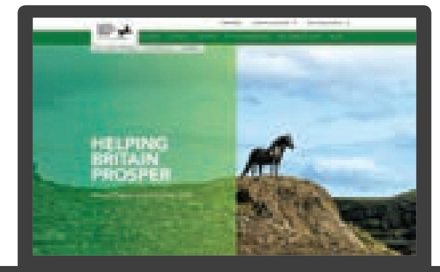
Reporting

Just as we operate in an integrated way, we aim to report in an integrated way. We have taken further steps towards this goal this year. As well as reporting our financial results, we also report on our approach to operating responsibly and take into account relevant economic, political, social, regulatory and environmental factors.



View our Annual Report and Accounts and other information about Lloyds Banking Group at www.lloydsbankinggroup.com

The 2016 Annual Report and Accounts incorporates the strategic report and the consolidated financial statements, both of which have been approved by the Board of Directors.

On behalf of the Board
Lord Blackwell
Chairman
Lloyds Banking Group
21 February 2017

This Annual Report and Accounts contains forward looking statements with respect to certain of the Group's plans and its current goals and expectations relating to its future financial condition, performance, results, strategic initiatives and objectives. For further details, reference should be made to the forward looking statements on page 288.

Please turn over

ABOUT US

We are the leading provider of financial services to individual and business customers in the UK.

Our main business activities are retail and commercial banking, general insurance, and long-term savings, protection and investment. We provide our services under a number of well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows and through a range of distribution channels including the largest branch network and digital bank in the UK.

We are creating a simpler, more responsive, customer focused business.

Doing the right thing for our customers by meeting their financial needs, helping them succeed, improving our service proposition and creating value for them, is key to the long-term sustainable success of our business.

Right: Sophie Unwin's 'Remade in Edinburgh' which was awarded a grant from the Lloyds Bank Social Entrepreneurs Scale Up Programme, teaches local people, including those who are homeless, unemployed, or refugees, to repair household goods to save money.

OUR PURPOSE

Helping Britain prosper

Read more on page 18

OUR AIM

To become the best bank for customers whilst delivering superior and sustainable returns for shareholders

OUR BUSINESS MODEL

Simple, low risk, UK focused, retail and commercial bank

Read more on page 12

OUR STRATEGIC PRIORITIES

- Creating the best customer experience
- Becoming simpler and more efficient
- Delivering sustainable growth

Supported by our colleagues

- Building the best team

Read more on page 14

Our competitive strengths

Our strengths and capabilities provide significant advantage and differentiation, driving value creation

UK focus

Operating primarily in the UK means we are focused on a single developed market that we truly understand while avoiding the complexities and costs of multi-jurisdictional operations.

Financial strength

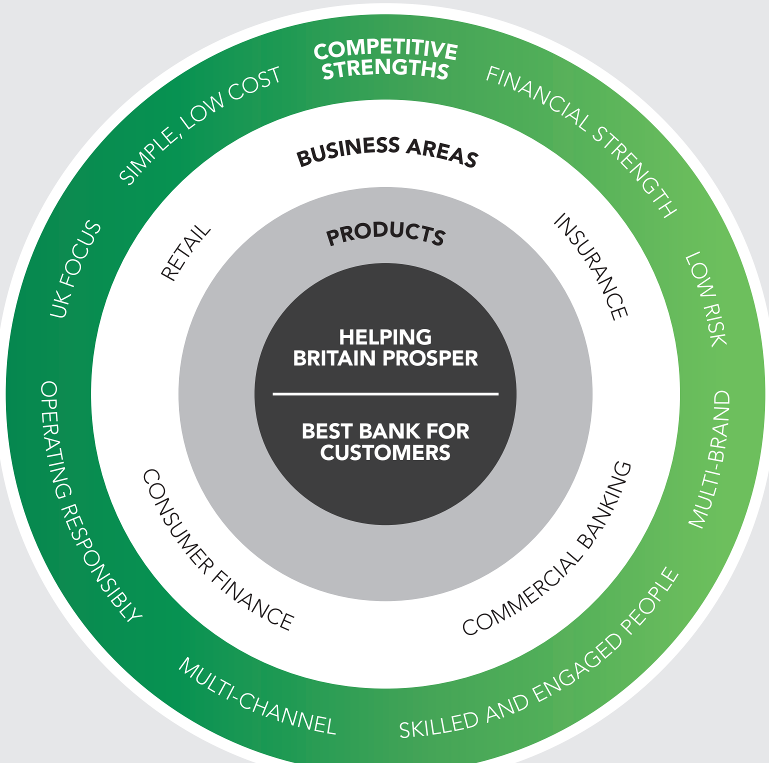
Our balance sheet and funding position have both been transformed in recent years and they are now amongst the strongest in the banking sector worldwide.

Simple, low cost operating model

Our simpler operating model and focus on operational efficiency provides a cost advantage which benefits both customers and shareholders.

Low risk business

Being a low risk bank is fundamental to our business model. Our low risk appetite is reflected through the low level of non-performing loans and non-core assets and our credit default swap spread, which is amongst the best in the banking sector worldwide.



Operating responsibly

A sustainable and responsible approach to doing business is integral to everything we do.

Multi-brand proposition

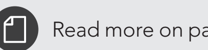
Offering our services through a number of recognised brands enables us to address the needs of different customer segments more effectively.

Multi-channel approach

Operating in an integrated way through a range of distribution channels, including the largest branch network and digital bank in the UK, ensures our customers can interact with us when and how they want.

Skilled and engaged people

Our colleagues provide real advantage. We invest in skills and training while ensuring alignment to our customer focused strategy and commitment to build the best team.


Read more on page 12

Group highlights

ANOTHER YEAR OF GOOD PROGRESS

Underlying profit of

£7.9 bn

Strong capital generation

c.190 bps

pre dividend

Statutory profit before tax more than doubled to

£4.2 bn

Acquisition of

MBNA

credit card business, announced in December

Strong balance sheet position with pro forma CET1 ratio (post dividend) of

13.8%

Progressive and sustainable ordinary dividend

2.55p per share

with an additional special dividend of 0.5p per share

Cost:income ratio of

48.7%

Our market leading cost:income ratio reduced further, reflecting our operational efficiency

Asset quality ratio of

15 bps

Asset quality remains strong with no deterioration in the underlying portfolio

Read more on pages 33 to 36
or visit www.lloydsbankinggroup.com

Divisional highlights

We operate across four business areas to execute our strategy and drive value for all our stakeholders

Read more on pages 40 to 47
or visit www.lloydsbankinggroup.com

Active online users

	m
2016	12.5
2015	11.5
2014	10.5

Business start-ups supported

	000s
2016	121
2015	103
2014	99

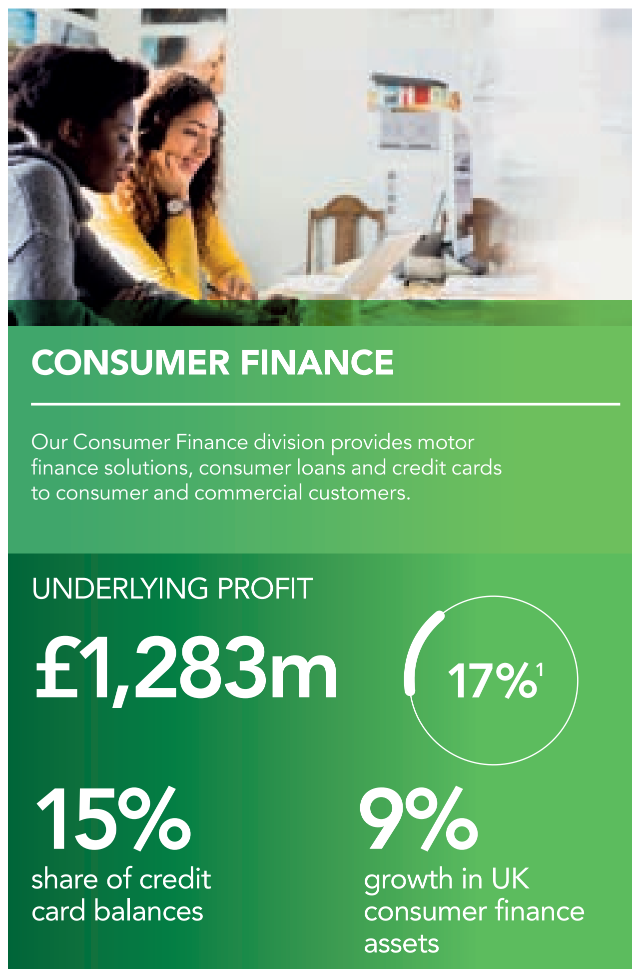
Return on risk-weighted assets

	%
2016	2.4
2015	2.4
2014	2.0

Funding for UK manufacturers

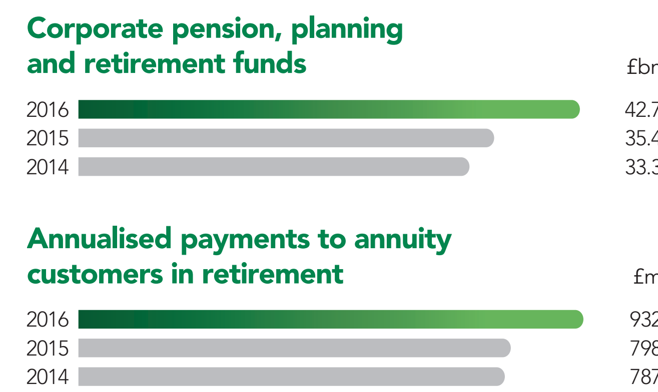
	£bn
2016	1.2
2015	1.4
2014	1.0

1 Proportion of Group underlying profit excluding run-off and central items.



Motor finance UK balances

	£bn
2016	15.6
2015	13.0
2014	10.2



1 Proportion of Group underlying profit excluding run-off and central items.

Chairman's statement

Our purpose as a UK focused bank is to help Britain prosper and we are playing a vital role in supporting people, businesses and communities across the UK.

Lord Blackwell
Chairman

Overview and strategy

2016 was another year of good progress for the Group, both financially and strategically. Our strong financial performance, the strength of our capital position and the progressive return of the Group to private ownership are testament to the hard work of our colleagues to transform and simplify our business since the depths of the financial crisis. On the back of that recovery, the agreement to acquire MBNA is a significant strategic step which reinforces our ability to deliver sustainable growth whilst helping Britain prosper. However, we recognise that future success will depend on adapting our business model to provide the cost and quality of service required to meet customer needs effectively in a rapidly evolving digital future, and we are working hard to ensure we have the strategy and plans to achieve that transformation.

Meanwhile, the UK financial services sector continues to face a number of near term challenges. The economic environment remains uncertain, the level of regulatory change remains high, competition continues to be fierce and the pace of technological change requires continuing innovation while posing new threats from data and cyber security. This reinforces our conviction that our differentiated, simple, low risk, UK retail and commercial strategy is the right approach. It has helped us deliver over the last few years and will, I believe continue to do so going forward.

As a result of our business performance and strong capital position, I am pleased to announce that the Board has recommended a final ordinary dividend of 1.7 pence per share, bringing the total ordinary dividend for 2016 to 2.55 pence per share, an increase of 13 per cent on last year. In addition the Board has felt able to propose an additional distribution of 0.5 pence per share as a special dividend after prudently holding back sufficient capital to cover the expected cost of the MBNA acquisition. This is in line with the Group's policy to deliver a progressive and sustainable ordinary dividend whilst distributing surplus capital when appropriate to do so.

Our purpose

Our purpose as the UK's largest retail and commercial bank is to help Britain prosper. This means not only providing outstanding service to our customers, but also responding to the UK's social and economic issues we believe we are best placed to address. Our investment programmes and extensive range of clear and simple products and services already support this ambition, helping to meet the needs and grow the prosperity of people, businesses and communities across the UK while building the deep, long-term customer relationships that are vital to our future. However, we want to do even more. Our Helping Britain Prosper Plan sets out our targets to support housing, growth, trade and infrastructure and to tackle social disadvantage. We are not just a British bank – we take pride in being a bank for Britain, at the heart of the UK's economy.

Corporate culture

The Board and senior management have a vital role to play in shaping and embedding a healthy corporate culture, and this continued to be a major focus in 2016. At the heart is our core value of 'doing the right thing for customers' – rebuilding trust that is the foundation for our customer franchise.

Over the last year the Group has made significant strides in removing past practices and organisational barriers that we believed were inconsistent with those values. We have also taken important steps in defining the culture and behaviours we believe we need to support our values and embedding those in the way we operate. While we still have further to go, I know that this approach is aligned with the commitment of our dedicated colleagues across the organisation who come to work every day wanting to deliver great customer service. Getting this culture right will be critical to our success in an increasingly competitive environment.

Communities

As well as their commitment to customers, I am extremely proud of the way our colleagues support communities across the country – another aspect of helping Britain prosper. I am particularly pleased that so many have once again taken the time to volunteer and raise funds for charities and community groups. Over the course of this year 34,000 of our colleagues took part in volunteering activities, contributing 240,000 hours of their time by sharing their skills and experience to help make sustainable differences to local charities, schools, colleges and businesses.

Another way we support millions of people across Britain is through the funding of our independent Foundations. Since the Foundations were set up over 30 years ago, they have donated almost £600 million to charities across the UK. This year, I have once again been delighted to meet with the Foundations and some of the amazing charitable organisations they support, and to see the huge difference our funding makes to so many local communities.

Our charity partnership provides another part of our overall approach to addressing social disadvantage throughout the UK. Over the past two years our colleagues have raised more than £12.5 million for BBC Children in Need, over £4 million more than our original target. There is no doubt that this will make a significant impact across the UK, directly benefiting more than 40,000 disadvantaged children and young people.

Our target is to raise £22 million by 2020 for our chosen charity partners. Starting this year, our new charity partner is Mental Health UK. There is a growing recognition that mental health and financial health are closely linked, and yet there is no single source of support in this area. By bringing our two organisations together we aim to create the perfect partnership to start developing this support for people across the UK.

Directors

We review the Board's composition and diversity regularly and are committed to ensuring we have the right balance of skills and experience within the Board. As announced last year, Stuart Sinclair joined the Board in January 2016 and Dyfrig John retired from the Board at our AGM in 2016. We are very grateful to Dyfrig for his contribution to the Group.

We have agreed a number of changes to our Board composition for 2017. Anthony Watson, our Senior Independent Director, will retire at the 2017 AGM after serving more than eight years on the Board. Anita Frew will succeed Anthony as Senior Independent Director, combining this with the role of Deputy Chairman, which she has held since May 2014. Nick Luff, an independent Non-Executive Director, has notified the Board that in light of his other commitments he does not intend to seek re-election at the 2017 AGM. Nick will be succeeded as Chairman of the Audit Committee by Simon Henry. Both Anthony and Nick leave with our thanks and best wishes for the future.

Remuneration

Our approach to reward aims to provide a clear link between remuneration and delivery of the Group's key strategic objectives, namely, becoming the best bank for customers whilst delivering long-term, superior and sustainable returns to shareholders. We believe in offering fair reward where colleagues are rewarded for performance aligned to the long-term sustainable success of the business, our commitment to rebuilding trust and changing the culture of the Group.

Despite the uncertain environment, the Group continued to perform strongly with good underlying profits, significantly increased statutory profits, strong capital generation and increased ordinary dividends. As a result, the Group's total bonus outcome has increased to £392.9 million. This is after a 19 per cent collective performance adjustment reflecting additional conduct-related provisions which impacted negatively on profitability and shareholder returns.

Total bonus outcome remains a small proportion of underlying profit at 4.8 per cent. Cash bonuses are capped at £2,000 with additional amounts paid in shares and subject to deferral and performance adjustment.

More information on how we ensure our approach to remuneration supports our strategy can be found in the Directors' remuneration report on page 84.

Outlook

I would like to thank all my colleagues across the Group for their continued hard work and commitment. We have made significant progress. There is always more to do and we will have further challenges to face as we transform the bank to reflect the changing environment. However, we remain committed to our strategy and believe that our customer focus and simple business model with its multi-brand, multi-channel proposition continue to provide the best opportunities for competitive advantage and future success. As we rebuild trust, my ambition is for Lloyds to earn its place as one of the great British institutions, in which both colleagues and customers can take shared pride.

Lord Blackwell
Chairman

CONTINUING TO HELP BRITAIN PROSPER IN TIMES OF CHANGE

In 2014 we launched our Helping Britain Prosper Plan, focused on the social and economic issues that we believe we are best placed to help people in Britain address. The Plan contains measurable targets to support people, businesses and communities in the UK.

Despite the uncertainty created by the political and economic events of 2016, we have continued to achieve many of our targets. Highlights include:

- provided £1.2 billion of new funding to UK manufacturing businesses
- helped more than 10,000 clients to start exporting for the first time
- helped more than 75,000 first-time buyers
- supported more than 121,000 start-up businesses
- created more than 1,000 new apprenticeship positions

We operate the UK's largest digital bank and, in response to the rapidly evolving digital environment, we have also met our overall target to create 20,000 digital champions (of which 7,000 were in 2016) to help improve the digital skills and financial capability of individuals and organisations.

Looking ahead we have set a new target to support the low carbon economy by incentivising energy efficient commercial property development through Britain's first Green Loan Initiative.

Read more about our Plan on page 18 and online at www.lloydsbankinggroup.com/ProsperPlan

A STRONG FOCUS ON CORPORATE CULTURE

The Board places great emphasis on shaping and embedding a healthy corporate culture. Our core values of 'putting customers first', 'keeping it simple' and 'making a difference together' are central to our next stage of cultural transformation.

Measurement and monitoring
The Responsible Business Committee (RBC) provides oversight of the work being done to develop measures for reporting on cultural change. The RBC is supported in particular by the work of two executive committees: the Responsible Business Management Committee and the Group Customer First Committee, who drive the development of a culture framework and a culture dashboard to enable us to monitor progress.

Quantitative components we measure include our net promoter score, complaints data, colleague engagement surveys, whistleblowing, regulatory engagement information and assurance from risk on compliance with policies and the Risk Framework. We also host breakfasts, dinners, branch visits and staff engagement events.

The culture of the Board itself is measured in the Board Effectiveness Review which is facilitated externally every three years. You can read more about this review in our corporate governance report on page 66.

Read more on corporate culture in the corporate goverance report on page 52

Group Chief Executive's review

We have delivered strong financial performance in 2016 as we continue to make good progress against our strategic priorities. We are well positioned for future success.

António Horta-Osório
Group Chief Executive

We have delivered strong financial performance in 2016 as we continue to make good progress against our strategic priorities. Underlying profit was £7.9 billion and statutory profit has more than doubled to £4.2 billion. We continue to improve our customers' experience, simplifying the business whilst growing in targeted areas and in December announced the acquisition of MBNA's prime UK credit card business. Strong capital generation, which is a consequence of our business model, has enabled us to fully cover the expected capital impact of the MBNA acquisition, increase our ordinary dividend by 13 per cent and pay a special dividend. As a simple, low risk, UK focused bank we are committed and well positioned to help Britain prosper and become the best bank for customers and shareholders.

Operating environment

Given our UK focus, our performance is inextricably linked to the health of the UK economy which has been more resilient than the market expected post referendum, with GDP growth of 2 per cent in 2016. The UK's decision to leave the European Union means the exact nature of our relationship with Europe going forward remains unclear and the economic outlook is uncertain. However, the recovery in recent years with low unemployment, reduced levels of household and corporate indebtedness and increased house prices means the UK is well positioned.

The regulatory environment also continues to evolve and there are a number of areas on which we await further clarity but, given the strength of our balance sheet and the capital generative nature of our business model, we are well placed to meet these regulatory requirements and the economic uncertainty. Following the de-risking of the balance sheet in recent years our PRA Buffer has been reduced but, in light of expected future regulatory capital developments, the Group will continue to target a CET1 ratio of around 13 per cent.

Financial performance

The Group has delivered strong financial performance in the year. Underlying profit was £7.9 billion with an underlying return on required equity of 13.2 per cent (return on tangible equity of 14.1 per cent). Income was slightly lower which was more than offset by lower operating costs, resulting in an improved cost:income ratio of 48.7 per cent. Impairment increased, primarily due to lower releases and write-backs, but asset quality remains strong with no signs of deterioration in the portfolio. The difference between underlying profit and statutory profit reduced significantly in 2016, as statutory profit before tax more than doubled to £4.2 billion, largely due to lower PPI provisions, and this enabled the Group to generate approximately 190 basis points of CET1 capital during the year.

Our balance sheet remains strong with a pro forma CET1 ratio of 13.8 per cent, a total capital ratio of 21.4 per cent and a pro forma leverage ratio of 5.0 per cent. In line with our progressive and sustainable ordinary dividend policy, the Board has recommended a final ordinary dividend of 1.7 pence per share, taking the total ordinary dividend for the year to 2.55 pence per share, an increase of 13 per cent on 2015. The Group has held back c.80 basis points of CET1 capital to cover the estimated capital impact of the MBNA acquisition; however, given our strong capital generation in the year, the Board has also recommended a special dividend of 0.5 pence per share.

Strategic progress

We have continued to make good progress on our strategic priorities in 2016.

Creating the best customer experience

We are committed to meeting our customers' evolving needs and preferences through our multi-brand and multi-channel approach. We operate the UK's largest branch network and the largest digital bank with over 12.5 million active online users. We have more than 8 million mobile banking users and for the second consecutive year, the Lloyds Bank app has been rated the best banking app of all the UK major banks for functionality.

Customer migration to digital channels continues at pace with more than 60 per cent of our simple customer needs now met online and digital is now the number one channel for new loans and credit cards. We continue to invest in our customer propositions to improve processes and the way our customers interact with us. In Commercial Banking we have continued to improve the online banking platform and in Retail Business Banking we are now able to open new customer accounts in 5-6 days, down from 21 days previously, with a best-in-class automated digital ID and verification process. In Consumer Finance, Black Horse has reduced processing times for new loans, while increasing security and protection for customers. In Insurance we have introduced online tools which will allow customers to consolidate their workplace pension assets and employers to process employee monthly pension contributions on the same day, down from 22 days in 2014.

This progress has been reflected in further reductions in the level of customer complaints and our net promoter score, which continued to improve in 2016 and is now nearly 50 per cent higher than at the end of 2011. Our latest 'Building the Best Team' survey results show that colleague engagement is at an all-time high and in line with top performing UK corporates. Our strong performance in 2016 reflects the hard work undertaken by colleagues across the Group and I would like to thank everyone for their significant efforts and commitment.

Becoming simpler and more efficient

Our cost leadership is a significant source of competitive advantage and cost management remains a strategic priority. In response to the lower rate environment we have accelerated the delivery of our cost initiatives, and announced at the half year an increase to the Simplification run-rate savings target and a reduction in our non-branch property portfolio. We remain on track to deliver both, having already achieved £0.9 billion of the increased £1.4 billion Simplification run-rate target. As a result of the continued focus on costs, our market-leading cost:income ratio has improved and we continue to target further reductions.

Delivering sustainable growth

The Group aims to deliver sustainable growth in line with its low risk business model. We have continued to make good progress in growing market share in areas where we are underrepresented, and have grown lending to SME and Mid Markets clients by around £2 billion in the year. In Consumer Finance we have continued to grow our motor finance and credit card portfolios organically and the agreement to acquire MBNA's prime UK credit card business will give us the opportunity to create a best-in-class credit card operation. In Insurance, we will continue to invest in developing the brand and the business, including our financial planning and retirement capabilities, and have also completed four bulk annuity deals. In addition, we are committed to supporting first-time home buyers and remain the largest lender to this customer group.

Helping Britain prosper

We remain committed to supporting the people, businesses and communities in the UK through our Helping Britain Prosper Plan. Notably, we have provided £1.2 billion of new funding to manufacturing businesses, supported 121,000 start-ups and helped 10,000 clients to start exporting in 2016. Our economic contribution to Britain extends beyond the products and services we offer and the funding we provide to our customers and clients. Since we launched our Apprenticeship Scheme we have created more than 4,000 roles, including 1,000 in 2016 and we have committed to creating 8,000 by 2020. We have also exceeded our target to create 20,000 digital champions, a year earlier than expected. Furthermore, we are the highest payer of UK tax in the most recent PwC Total Tax Contribution Survey for the 100 Group, having paid £1.8 billion in 2015. Our tax payment in 2016 was £2.3 billion.

The combination of the progress we have made towards our strategic priorities and our strong financial performance has enabled the UK government to further reduce its stake in the Group to less than 5 per cent, at a profit, returning over £18.5 billion to the UK taxpayer since 2009.

Outlook

Our financial targets reflect our confidence in the future prospects of the Group. In 2017 we expect the net interest margin to be greater than 2.70 per cent and the asset quality ratio to increase to around 25 basis points (before MBNA). We continue to target a cost:income ratio of around 45 per cent exiting 2019, with reductions every year. We now expect a return on required equity of between 12.0 and 13.5 per cent and a return on tangible equity of between 13.5 and 15.0 per cent in 2019. Going forward, the Group expects to generate between 170 and 200 basis points of CET1 capital per annum, pre dividend.

Summary

Following the simplification and transformation of our business in recent years, the Group is now focused on delivering the best customer experience and on continuing to develop our digital capabilities. Our cost leadership and lower risk positioning provide competitive advantage which enables us to deliver superior returns to shareholders. We continue to believe that our simple, low risk business model is the right one, and our strategic progress and strong financial performance position us well for future success.

António Horta-Osório

António Horta-Osório
Group Chief Executive

KEY EVENTS IN THE YEAR

There have been a number of notable events and achievements for the Group in 2016, both within the Group and more widely across the UK. Read our timeline for some key events of the past 12 months.

JANUARY

Ambassador programme launch
Our senior leaders represent the Group, build strategic relationships and promote our ambition to help Britain prosper across the regions

FEBRUARY

Full year 2015 results
Total ordinary dividend declared for 2015 of 2.25 pence per ordinary share as well as a special dividend of 0.5 pence per share

APRIL

Top 50 employer
The Group was named in The Times 2016 Top 50 Employers for Women for the fifth consecutive year

MAY

Help to Grow scheme
We were the first bank to take part in a scheme designed to boost lending to fast growing businesses, committing £30 million of growth loans

JUNE

EU referendum
The UK voted to leave the European Union

JULY

Euromoney awards
We won Best Bank in the UK for the fourth year running and World's Best Bank for Adapting to the Regulatory Environment

Cost guidance updated in half year results announcement
Run-rate savings target increased from £1 billion to £1.4 billion per annum

AUGUST

Interest rate cut
The Bank of England's Monetary Policy Committee cut UK interest rates to a record low of 0.25 per cent

SEPTEMBER

Commitment to helping Britain prosper
We announced our aim to provide over £60 billion of lending in the next 12 months

OCTOBER

Top 10 employer
The Group was named as one of the UK's Top 10 Employers for Working Families

DECEMBER

MBNA acquisition
The Group announced it is to buy the credit card business, MBNA, from Bank of America, subject to competition and regulatory approval

Market overview

Given our UK focus, our financial performance is inextricably linked to the performance of the UK economy and its regulatory and competitive environment

ECONOMIC ENVIRONMENT

Resilient UK economy post referendum

During 2016 the UK economy performed broadly in line with market expectations at the start of the year despite the decision to leave the European Union and significant changes in the political landscape, both in the UK and abroad.

Although post referendum most forecasters were predicting a reduction in growth, in practice growth has been resilient and the UK economy is estimated to have grown by 2 per cent in 2016, just shy of 2.2 per cent in 2015. Business and consumer confidence did fall immediately post referendum, but most of this has now been recovered and consumers' retail spending growth actually accelerated in the months after the referendum.

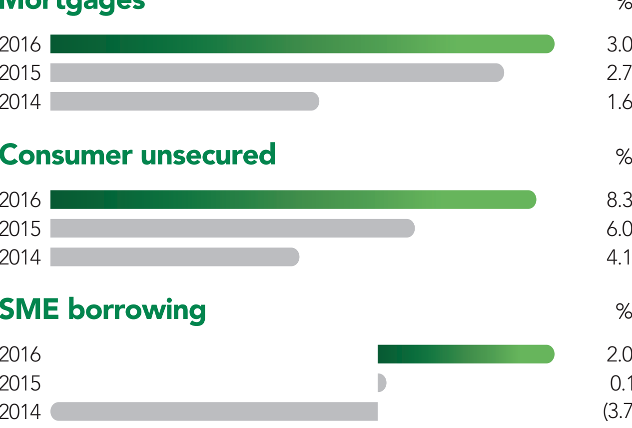
Manufacturers are expecting exports to benefit from the weaker pound, but confidence in the service sector has weakened. Towards the end of 2016 inflation started to rise and is likely to become a bigger headwind to consumers' spending growth through the coming year.

UK house prices increased by around 7 per cent during the year, largely driven by strong growth in the first quarter. Prices have continued to increase, albeit at slower rates, during the rest of the year in almost all geographic areas, although the most expensive parts of London have seen some reductions over the last six months.

Growth in our markets

Household and business deleveraging since 2009 has created capacity for an increased pace of borrowing and the markets in which we operate continued to grow in 2016. Specifically:

- Mortgage market growth increased to 3 per cent, from 2.7 per cent in 2015, the strongest since 2007, and although buy-to-let growth was impacted by the change in stamp duty policy in April, it still grew significantly faster than the market as a whole
- Unsecured consumer credit growth rose to 8 per cent led by motor finance. Although the strongest growth since before the financial crisis, the level of unsecured debt remains close to a 20 year low relative to households' income



- Business borrowing from banks increased by 2 per cent, the first growth since 2008, and SMEs by 2 per cent also
- Household deposit growth rose to 6 per cent, the strongest since 2008
- Business deposit growth weakened, to 6 per cent, but remains strong after three years of elevated growth and a very high level of liquidity

Interest rates low for longer

Interest rates remain at historical lows with the base rate having been cut to 0.25 per cent in August, and are expected to remain low in the foreseeable future. Market rates currently imply an increase to the base rate to 0.5 per cent during 2018, and to 0.75 per cent a year later. This flattening of the yield curve along with continued competition has meant bank margins remain under pressure. Significant competition has meant lending rates across the market remain low, particularly in mortgages, although deposit rates have fallen further during the year, offsetting the impact of lower lending rates.

Impairment expected to remain benign

Improving indebtedness, along with the continued low interest rate environment, is continuing to keep impairment levels low and they remain below through-the-cycle levels.

The expected mild rise in unemployment is likely to lead to an increase in impairment from the very low level of 2016, but it should remain low over the longer term.

Outlook for 2017

How the economy evolves in 2017 is highly dependent on the type of EU-exit deal that companies expect to be achieved in 2019, how deeply that impacts investment and employment plans, and how much squeezed consumer spending power is offset by improved competitiveness of exports following the fall in sterling. Each of these carries a high degree of uncertainty.

The UK economic environment will also continue to be impacted by global uncertainties including the slowdown in China, European elections and the global trade environment, particularly in light of the recent US presidential election.

The consensus expectation is that UK GDP growth will slow from 2 per cent in 2016 to 1.6 per cent in 2017, and unemployment will remain low, but will rise from 4.9 per cent at the end of 2016 to 5.2 per cent at the end of 2017. House prices are expected to continue to rise, by around 3 per cent, supported by the ongoing shortage of property for sale, low levels of housebuilding and exceptionally low interest rates, while commercial real estate prices are expected to fall by 4 per cent.

If the economy evolves in line with this consensus view, we would expect growth across our markets to remain broadly stable in aggregate, with a mild weakening in the growth of unsecured consumer credit and commercial real estate lending offset by a marginal rise in mortgages and other lending to businesses.

REGULATORY ENVIRONMENT

The regulatory landscape in which we operate continues to evolve, but the key themes of protecting consumers and small business customers, ensuring competitive markets and strengthening the prudential and capital framework remain.

Competition

During 2016 the Competition and Markets Authority (CMA) review of current accounts and SME Banking concluded that it needed to intervene in these markets only to increase levels of transparency and comparability in order to promote greater levels of customer switching. In addition, the FCA and PSR reviewed a series of individual markets ranging from credit cards to payments infrastructure. Ensuring fair competition remains a core element of regulatory reform with the mortgage market a key area of focus for 2017.

Conduct

In 2016 the Senior Manager & Certification Regimes were implemented, introducing greater clarity and accountability into decision making for financial institutions. In addition, the FCA announced in December it would extend the timetable for its announcement on a potential deadline for PPI complaints until the first quarter of 2017. We continue to work to ensure we provide appropriate and fair products with clear, simple and relevant terms.

Capital

Although the Bank of England is comfortable with the capital level for the UK banking sector as a whole, a number of changes to capital requirements, particularly with regard to credit and operational risk, have been proposed by the Basel Committee for Banking Supervision and further discussions are scheduled for March 2017. We performed well in the recent Bank of England stress tests and remain comfortably in excess of minimum requirements on our key capital and leverage ratios. Given this and our strong capital generation, we are well positioned in the event of any changes.

Ring-fencing and resolution

Good progress continues to be made towards implementation of ring-fencing in January 2019 in line with the EU Bank Recovery and Resolution Directive and additionally for UK banks, the Financial Services (Banking Reform) Act. Due to our UK retail and commercial focus the vast majority of our business will sit within the ring-fence, and we therefore expect ring-fencing to be less onerous for us than many of our UK peers.

Summary

There are a number of other regulatory changes that have been implemented or developed through 2016, several of which are relevant to our business, including caps and prohibitions on early-exit charges for pension-scheme members, the implementation of the revised Markets in Financial Instruments Directive, the application of the Interchange Fee Regulation, changes to the regulation of claims-management companies, the final report of the Financial Advice Market Review, the entry into force of the General Data Protection Regulation and the cancellation of plans to create a secondary annuities market.

Overall however, we believe our simple, low risk, UK focused strategy puts us in a strong position to adapt to the evolving regulatory landscape.

CUSTOMER TRENDS AND COMPETITION

In the competitive open markets in which we operate, customers are benefiting from an increasing range of products and services from a growing choice of providers and via a range of channels. Access through digital platforms, including via mobile devices, has increased significantly in recent years, changing customer behaviours and expectations in terms of how they shop for goods and undertake banking, and these trends are expected to accelerate.

Customers require different products and services at different stages of their lives, with many motivated by their desire to achieve better value for money, not least in the current low interest rate environment. Security and reputation remain important factors, with customers wanting clear and transparent products delivered with good service and access to relevant, expert advice.

We have seen an influx of new entrants to the market, with a variety of business models. Many of these have expertise and experience in digital product offerings, with strong funding positions, credible brands, and in some cases pre-existing customer bases and branch networks. In addition, non-banks such as technology firms and supermarkets are disrupting the banking industry.

Our strategy, which focuses on our multi-brand, multi-channel distribution model, simpler processes, customer-driven product range and expertise across insurance and banking, puts us in a unique position to respond to these market conditions and meet the needs of individual and corporate customers. Above all, it recognises that our market is competitive, additional challengers continue to emerge and that to succeed we need to focus on the ever-changing needs of our customers.

Key opportunities

- Customer needs: our differentiated customer focused strategy along with our multi-channel distribution network, in particular our evolving digital capability, position us well to address changing customer needs.
- Regulatory environment: greater clarity is emerging on regulatory requirements and our simple, low risk, UK focused strategy places us in a strong position.
- Low cost position: this enables us to provide competitive differentiation for the benefit of customers and shareholders.

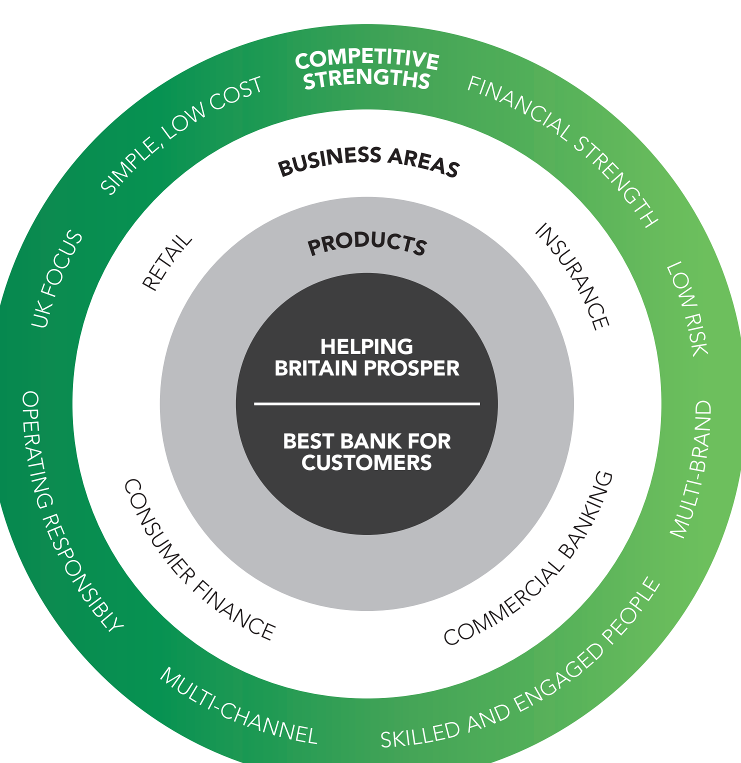
Key challenges

- Economic environment: uncertain impact of EU referendum decision and continued low interest rates.
- Regulatory environment: the level of regulatory change remains high with continued focus on ring-fencing, resolution, competition, capital and conduct.
- Competition: increased competition for lending and deposits could further impact margins.
- Digital transformation: the pace of change is significant and we will need to continue to invest to meet evolving customer needs.

Our business model

As a UK focused bank we are well placed to help Britain prosper, delivering for customers, shareholders and wider society. Our differentiated business model gives us competitive advantage, enabling us to continue to deliver for our customers in a challenging environment

EXTERNAL ENVIRONMENT



EXTERNAL ENVIRONMENT

Our business model is influenced by external factors which continue to evolve.

We are adapting to **changing customer behaviour** such as the increased adoption of digital products.

Our focus on the UK means our future is inextricably linked to the **UK economic and political environment,** so we need to be agile to adapt to the uncertainty following the vote to leave the European Union.

The level of **regulation** remains high, although we are now seeing more clarity around competition, conduct, capital and ring-fencing and resolution.

In a very **competitive market,** we continue to differentiate ourselves (see panel below for more information).

As a bank that supports millions of people, businesses and communities, we believe we are in a unique position to help tackle some of the biggest **social and economic issues** facing the UK today.

BUSINESS AREAS

Our business areas are structured according to the products and services we provide to best serve our customers' financial needs.

We currently have four business areas:

Retail

Insurance

Consumer Finance

Commercial Banking

PRODUCTS

Our product range is driven by the needs of our retail and commercial customers and informed through comprehensive customer analysis and insight.

Lending
mortgages, credit cards, personal and business loans

Deposit taking
current accounts, savings accounts

Insurance
home insurance, motor insurance, protection

Investment
pensions and investment products

Commercial financing
term lending, debt capital markets, private equity

Risk management
interest rate hedging, currency, liquidity

OUR COMPETITIVE STRENGTHS

UK focus
Operating primarily in the UK means we are focused on a single developed market that we truly understand while avoiding the complexities and costs of multi-jurisdictional operations.

Simple, low cost operating model
Our simpler operating model and focus on operational efficiency provides a cost advantage which benefits both customers and shareholders.

Low risk business
Being a low risk bank is fundamental to our business model. Our low risk appetite is reflected through the low level of non-performing loans and non-core assets and our credit default swap spread, which is amongst the best in the banking sector worldwide.

Financial strength
Our balance sheet and funding position have both been transformed in recent years and they are now amongst the strongest in the banking sector worldwide.

STRATEGIC PRIORITIES

We are adapting to the changes brought about by technology, changing customer behaviour and regulation in a competitive market environment. To achieve this, we are focusing on three strategic priorities whilst building the best team.

- Creating the best customer experience
- Becoming simpler and more efficient
- Delivering sustainable growth

Supported by our colleagues

- Building the best team

Read more on pages 14 to 15 or visit www.lloydsbankinggroup.com

CREATING VALUE

Outcomes for our stakeholders:

Best bank for customers

Doing the right thing for our customers by meeting their financial needs, helping them succeed, improving our service proposition and creating value for them, is fundamental to our business model and the long-term sustainability of the business.

Superior and sustainable returns

The successful delivery of our business model and strategy should enable delivery of superior and sustainable returns for our shareholders.

Helping Britain Prosper Plan

Our response to some of the social and economic issues facing the UK is our Helping Britain Prosper Plan which sets out clear targets to address issues where we can make a measurable and meaningful contribution. These include the shortage of affordable homes; supporting small businesses and the UK's manufacturing base; helping people and organisations acquire the digital skills and capabilities they need; and tackling disadvantage in local communities.

Multi-brand proposition
Offering our services through a number of recognised brands enables us to address the needs of different customers segments more effectively.

Multi-channel approach
Operating in an integrated way through a range of distribution channels, including the largest branch network digital bank in the UK, ensures our customers can interact with us when and how they want.

Skilled and engaged people
Our colleagues provide real advantage. We invest in skills and training while ensuring alignment to our customer focused strategy and commitment to build the best team.

Operating responsibly
A sustainable and responsible approach to doing business is integral to everything we do.

Our strategic priorities

In order to help Britain prosper and to achieve our aim of becoming the best bank for customers, we are focusing on three strategic priorities. These are supported by our commitment to building the best team

AREAS OF FOCUS

CREATING THE BEST CUSTOMER EXPERIENCE

- Improving customer experience with our multi-brand, multi-channel approach, combining digital capabilities with face-to-face services
- Transforming our digital presence, providing simpler, seamless interactions across online and mobile while sustaining extensive customer reach through our leading branch network

Progress in 2016

21%
digital market share

5-6 days
to open a business account, down from 21 days

>60%
of simple customer needs met via online and mobile

62.7 pts
customer satisfaction is increasing, up 3.4 points in the year

- Largest UK digital bank and enhanced digital offering
  - 12.5 million active online users including 8 million mobile users with more than 2 billion logons in 2016
  - Increasing market share
  - Number 1 rated UK banking app for functionality
- Faster and easier banking
  - Introduction of 'selfie' verification for account applications
  - Video meetings and live webchat support for mortgage and remortgage applicants
  - Instant mortgage lending decisions through our online Agreement in Principle
- Further investment in UK's largest branch network
  - Branches reformatted to reflect changing customer needs with the number of mobile banking vans increased
- Net promoter score of 62.7 points, an increase of nearly 50 per cent since the end of 2011
- Total customer complaints have been on a downward trend since 2012

BECOMING SIMPLER AND MORE EFFICIENT

- Creating operational capability which is simpler and more efficient through further system enhancement and integration
- Becoming more responsive to changing customer expectations while maintaining our cost leadership amongst UK high street banks

Progress in 2016

48.7%
continued reduction in cost:income ratio

£0.9bn
Simplification run-rate savings on track

c.50%
reduction in time taken to open a savings account

55%
of approved mortgage applications to offer in less than 14 days

- Cost leadership with continued reductions in cost:income ratio to 48.7 per cent
- Actively responding to lower interest rates through accelerated cost delivery and targeting further efficiency savings
- On track to deliver £1.4 billion of Simplification run-rate savings: £0.9 billion achieved to date
- Transforming our key customer journeys, making it simpler, faster and more convenient to meet our customers' financial needs
  - Time taken to open savings account in branch down from 45 minutes to 15-30 minutes
  - 55 per cent of approved mortgage applications proceed to offer in less than 14 calendar days, up from 37 per cent
  - Introduced a flexible online home insurance offering with new functionality and more choice for customers
  - Launched a new digital service for employers, significantly reducing processing times for monthly corporate pension scheme management
  - Simplification of SME on-boarding process from 15 paper application forms to 1 digital form

SUPPORTED BY

DELIVERING SUSTAINABLE GROWTH

- Further developing Group-wide growth opportunities within our prudent risk appetite
- Helping Britain prosper
  - maintaining market leadership in our main retail businesses, making the most of our multi-brand, multi-channel strategy
  - leverage Group strengths to capture growth in underrepresented areas

Progress in 2016

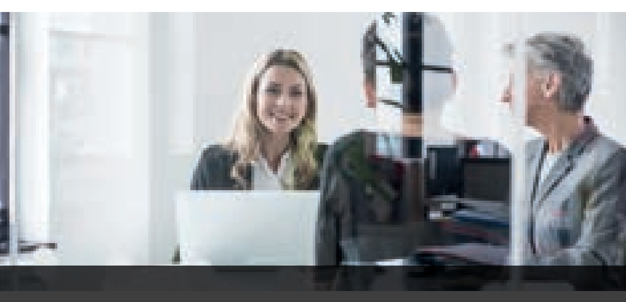
3%
SME lending growth, ahead of the market

£2.8bn
Consumer Finance UK customer asset growth

121,000
new business start-ups supported

75,000
first-time buyers supported

- Growth in targeted areas
  - SME lending growth of 3 per cent, ahead of the market
  - Consumer Finance UK customer asset growth of £2.8 billion
  - Black Horse motor finance growth of 20 per cent
  - Completion of four bulk annuity transactions, taking external deal size to more than £1.85 billion since our entry into the market in 2015
  - Announced the acquisition of MBNA, a prime UK credit card business, in line with strategic goal to grow in consumer finance
- Maintain market leadership in key retail business lines
  - Market leadership retained in current accounts and deposits
  - Focus on protecting margin in current competitive low growth mortgage market. £39 billion of gross new mortgage lending in 2016 and remain largest lender to first-time buyers



BUILDING THE BEST TEAM

- Committed to building a business our colleagues are proud to work for by creating the best environment for our colleagues to succeed
- Providing colleagues with the right skills and tools; and giving them the opportunity to share their views

Progress in 2016

71pts
employee engagement at an all-time high

32.4%
of senior roles held by women

No.1
private sector employer for LGBT people

6 days
formal training per colleague on average per year

- Employee engagement at 71 points, equalling our highest ever score
- Line Manager Index at 86 points, our highest score ever
- Our Line Manager Academy, launched in 2015, won the 'Most effective cultural transformation initiative' award at the London Institute of Banking & Finance's Financial Innovation Awards 2016
- Average of 6 days formal training per colleague per year
- 32.4 per cent of senior roles now held by women
- Number 1 private sector employer in the Stonewall Top 100
- Launch of Families Matter, a network for parents and carers
- 40,000 colleagues on boarded to HIVE, a new collaboration platform; 59 per cent are active users against industry benchmarks of 20-24 per cent
- Provided new opportunities for colleagues to become shareholders; over 80 per cent now have an ownership interest

Key performance indicators

Delivering for customers and shareholders

Our key performance indicators have been considered by the Board and identify the most effective output measures for assessing financial performance and progress towards becoming the best bank for customers. As a result of strategic progress in 2016, we have reported good underlying profits, significantly increased statutory profit, strong capital generation, increased ordinary dividends and a special dividend.

Customer relationships are key to our strategy and we specifically measure customer satisfaction and complaint levels. We also track our performance against the targets of our Helping Britain Prosper Plan, about which you can read more on page 17.

This year an additional key performance indicator has been included to reflect our performance on employee engagement, a key metric for becoming the best bank for customers.

Remuneration aligned with performance

To ensure our employees act in the best interests of customers and shareholders, remuneration at all levels of the organisation is aligned to the strategic priorities and financial performance of the business and also takes into account specific risk management controls. Variable remuneration including bonuses for all colleagues, including our Executive Directors, is based on the performance of the individual, the business area and the Group as a whole.

Performance is assessed against a balanced scorecard of objectives across five areas (customer, people, control environment, building the business, finance) which are reviewed on a regular basis. Executive management are also eligible to participate in a long-term incentive plan, which encourages delivery of superior and sustainable long-term returns for shareholders, whilst supporting the Group's aim of becoming the best bank for customers and helping Britain prosper. KPIs that are directly linked to remuneration are marked with this symbol REM.

Underlying profit before tax REM

£m

Underlying profit decreased slightly in 2016, largely due to slightly lower income and higher impairments, partly offset by lower costs.

Statutory profit before tax

£m

Pre-tax statutory profit increased significantly to £4,238 million in 2016 compared to £1,644 million in 2015, with the increase largely driven by lower PPI charges.

Ordinary dividend

p

An increased ordinary dividend of 2.55 pence per share, in line with our progressive and sustainable dividend policy. In addition, the Board has recommended a special dividend of 0.5 pence per share.

Underlying return on required equity

%

The underlying return on required equity reduced in 2016, reflecting lower underlying profit and a higher tax charge.

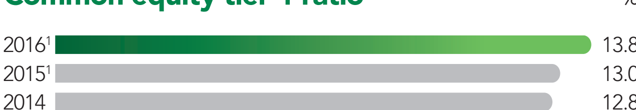
Earnings per share

p

Earnings per share increased in the year, largely due to the significant increase in statutory profit.

Common equity tier 1 ratio

%



Our common equity tier 1 ratio remains strong at 13.8 per cent despite increased dividends. It also remains one of the strongest compared to our major UK banking peers.

1 Pro forma

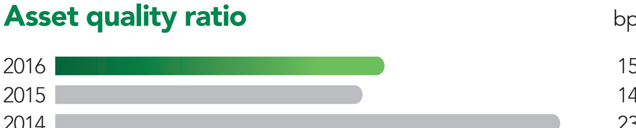
Cost:income ratio REM

%

Our cost:income ratio further improved to 48.7 per cent and remains the lowest of our major UK banking peers.

Asset quality ratio

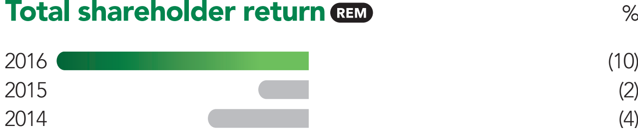
bp



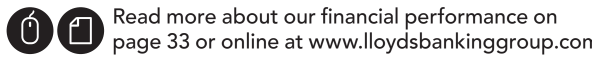
Our asset quality ratio remains low at 15 basis points, reflecting our effective risk management and continued low interest rates.

Total shareholder return REM

%



Our share price fell by 13 per cent in 2016, and although dividends increased in the year, our total shareholder return still fell by 10 per cent.


Read more about our financial performance on page 33 or online at www.lloydsbankinggroup.com

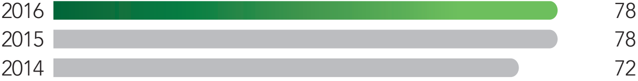
Customer satisfaction REM

2016	62.7
2015	59.3
2014	59.2

Our net promoter score is the measure of customer service at key touch points and the likelihood of customers recommending us. It has continued to improve in the year and is now nearly 50 per cent higher than at the end of 2011.

Best bank for customers index

% favourable

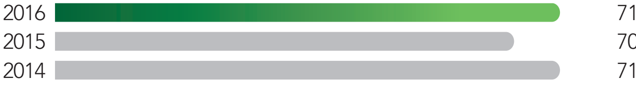


2016	78
2015	78
2014	72

The index is the outcome of a survey of more than 70,000 colleagues which shows how strongly they believe we are committed to becoming the best bank for customers. Our score remained the same as in 2015.

Employee engagement index REM

% favourable



2016	71
2015	70
2014	71

Colleague engagement remains high with our employee engagement index at 71, equalling our previous highest score. Our performance excellence and line management indices both reached their highest ever scores. These results indicate our colleagues have a sense of pride and are motivated to succeed while believing we are committed to delivering great products and services for customers.

Digital active customer base REM

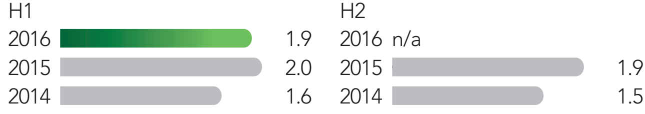
m

2016	12.5
2015	11.5
2014	10.4

Reflecting the pace of digital adoption, our number of active digital customers increased in the year, from 11.5 million to 12.5 million.

Customer complaints REM

(FCA reportable complaints per 1,000 accounts[1])



H1		H2	
2016	1.9	2016	n/a
2015	2.0	2015	1.9
2014	1.6	2014	1.5

The FCA changed the approach to complaint classification and reporting from 30 June 2016. Updated complaint data is not yet available on the new basis but will be available by the end of the first quarter. Total customer complaints have been on a downward trend since 2012 and have continued to fall in the second half of 2016.

1 Excluding PPI.

Helping Britain Prosper Plan performance 2016

This is the third year we have tracked and reported performance against all our Plan metrics and targets.

	NUMBER OF TARGETS	ACHIEVED	NOT ACHIEVED
People	9	6	3
Businesses	8	7	1
Communities	7	7	0

This year we made good progress and achieved 20 of our 24 targets.

Apprenticeships: we created more than 1,000 new apprenticeship places, with a third of them being offered to candidates from the UK's most disadvantaged areas

Manufacturing: we provided £1.2 billion in new funding to Britain's manufacturing businesses – helping support a crucial sector of the UK economy

Trade: we helped business grow and trade – we supported 121,000 start-up businesses and helped more than 10,000 clients export for the first time

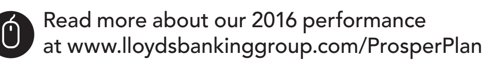
Digital: we reached our target to recruit more digital champions in local communities – we now have 23,000 colleagues helping to build Britain's digital capability

First-time buyers: we helped 75,000 first-time buyers, and remained one of the largest lenders to this market in the UK but fell short of our target to support 1 in 4 of all first-time buyers this year. We want to remain a leading provider in this market

Lending: we increased our net lending to SME and Mid Markets companies by £1.6 billion, despite the challenging market conditions, meaning we missed our £2 billion Plan target[1] this year. We remain open for business and committed to helping businesses prosper in the UK and globally

Disabled colleagues: we maintained the engagement scores of disabled colleagues at 2015 levels but didn't increase them – so we'll do more to help them in 2017 through training, development and our award-winning workplace adjustment programme

Senior women: our 2016 progress was below our 33 per cent target. However we remain committed to our 2020 goal of 40 per cent women in senior roles. Our 2016 focus was on improving our internal female talent pipeline



Read more about our 2016 performance at www.lloydsbankinggroup.com/ProsperPlan

1 The Plan target excludes net lending to the Social Housing and CRE sectors. Social Housing is included under a separate target in the 2016 Plan: we delivered £955 million of new funding support.

Strategic report
Financial results
Governance
Risk management
Financial statements
Other information

Our Helping Britain Prosper Plan

People, businesses and communities across Britain are facing significant challenges. We're helping to address them through our Helping Britain Prosper Plan

A plan to help Britain

We believe no other bank is better placed to help Britain prosper. We serve approximately 25 million customers and 1 million small businesses but we want to be more than just a bank. We want to go beyond business as usual and help address social and economic challenges such as Britain's housing shortage, the skills gap in key industries, social mobility and social disadvantage.

We are part of the fabric of Britain, visible on almost every high street through our iconic brands. The challenges Britain faces affect us directly, our operations and our colleagues.

Through our independent charitable Foundations, which support thousands of charities, we help some of the most disadvantaged people in Britain. In 2016 we invested £18.5 million in our Foundations and our colleagues donated their skills and expertise to help the charities they support become more sustainable.

The Plan is core to our strategy: we know from long experience that when Britain prospers, so do we. So the Plan is an investment in our collective long-term success. It supports our strategy to become the best bank for customers and it's fundamental to rebuilding trust in our brands and the sector.

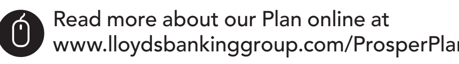
Evolving the Plan

We launched the Plan in 2014, drawing on advice from our senior leaders and many external stakeholders, including our Independent Stakeholder Panel and Foundations, to help us shape it. These stakeholders play a role in its continuing evolution.

Since the launch of the Plan we have achieved a lot, meeting 20 of our 25 targets in 2014, and 27 of our 28 targets in 2015. In 2016, we adjusted the Plan to make it more focused on what we can do best for Britain, more ambitious and more measurable in terms of the outcomes we want to achieve. In 2016 we achieved 20 out of our 24 targets.

Helping Britain prosper is about creating opportunities for all to share in the economic and social benefits of a successful UK. As a sustainable, low-risk business we can support this success in many ways

Sara Weller
Independent Director and
Chairman, Responsible Business Committee



Read more about our Plan online at www.lloydsbankinggroup.com/ProsperPlan

OUR FOCUS AREAS

HELPING PEOPLE PROSPER

We are providing more support for individuals and families whether they are buying a home, planning for later life or looking for a rewarding job. We are making our Group more diverse and inclusive to reflect the Britain we serve.

Key actions

We have made good progress against our People targets. Recognising the potential shortfall in many people's pension provisions, we have exceeded our target and had over 280,000 visits to our retirement planning website.

We supported 75,000 first-time homebuyers, but missed our target to support 1 in 4. We want to do more to support the whole housing market by making first-time buyer mortgages easier to access and by being a leading supporter of new build mortgages. Our 2017 Plan reflects this ambition. Our new mortgage lending totalled £38.7 billion in 2016 and we are a leading supporter of the government's Help to Buy scheme, having advanced £5.3 billion under the mortgage guarantee element since 2013.

We continue to make progress against our target that women hold 40 per cent of our senior roles by 2020. In 2016, despite focusing on building a talent pipeline of female managers, we fell slightly short of our 33 per cent senior management goal. We also fell just short of our target to fully engage more of our disabled colleagues but we will continue to support them through our award-winning workplace adjustment programme and our colleague network.

Progress in 2016

1 in 4
new build mortgages provided in 2016

32.4%
of senior roles now held by women

Supporting mental health

We have launched a mental health awareness campaign for colleagues and are introducing training so that line managers can understand and help those affected.

HELPING BUSINESSES PROSPER

We are helping businesses of all types and sizes to prosper by offering them the funding, support and encouragement they need to grow at home or abroad. We are supporting the transition to a low carbon economy.

Key actions

We have provided £1.2 billion of new funding support to manufacturing businesses and, through our £5 million investment in the Lloyds Bank Advanced Manufacturing Training Centre in Coventry, we are helping to train the next generation of highly skilled manufacturing apprentices, graduates and engineers.

We have helped more than 10,000 of our clients to start exporting for the first time, exceeding our Helping Britain Prosper Plan target of 5,000 businesses a year. This puts us on course to exceed our target of helping 25,000 businesses export for the first time, by 2020.

We increased net lending to SME and Mid Markets companies by £1.6 billion, but fell short of our £2 billion Plan target[1]. Since 2011, our net lending to SMEs has increased by 30 per cent whilst the market has contracted 11 per cent, and since 2012 our lending to Mid Markets companies has increased by 15 per cent, compared to a market that has declined 3 per cent. We aim to increase lending to the sector by £2 billion in 2017.

We also want to do more to support green business initiatives, so we've set a new environmental target to provide funding to help 10 million square feet of commercial real estate, equivalent to 10 London Shards, become more energy efficient by 2020.

Progress in 2016

£10bn
of infrastructure projects supported

121,000
start-up businesses helped

Housing Growth Partnership

Mike and Ali Afshar of AMA Homes are one of many smaller house building businesses benefiting from our £30 million Partnership with the government.

HELPING COMMUNITIES PROSPER

We are helping communities by addressing inequality, supporting disadvantaged people and championing Britain's diversity.

Key actions

By working with our independent charitable Foundations we have continued to support communities across the UK. In 2016 we gave £18.5 million to our Foundations and have supported 3,700 charities, which reach some of the most disadvantaged people in Britain today.

Our colleagues completed more than 260,000 hours of volunteering putting us on track to deliver 2.3 million hours by 2020. We are doing more to encourage colleagues to use their skills and expertise, though mentoring and skills-based volunteering, which accounted for 35 per cent of all colleague volunteering hours in 2016.

In 2016 the number of Digital Champions reached 23,000 and we have trained almost 10,000 of these to offer digital support to people and organisations in their local communities. This means we have achieved our Helping Britain Prosper Plan target of 20,000 Digital Champions early. We've set a new target for 2017 to train 700,000 individuals, SMEs and charities in digital skills, including internet banking.

Progress in 2016

£955m
new funding support for social housing

23,000
colleague digital champions

Helping the homeless

Edinburgh charity Fresh Start helps previously homeless people to resettle when they find a home. A Bank of Scotland Foundation grant helped them to pay an Operations Manager's salary and fund project work.

1 The Plan target excludes net lending to the Social Housing and CRE sectors. Social Housing is included under a separate target in the 2016 Plan: we delivered £955 million of new funding support.

Doing business responsibly

A sustainable and responsible approach to doing business is integral to everything we do

Responding to a changing Britain

2016 was a year of significant change in Britain and considerable change worldwide. As Britain faces an uncertain period it is vitally important that we help people, businesses and communities to address the challenges they face: challenges related to housing, employability, savings, business growth, international trade, financial exclusion and disadvantage.

A responsible approach

Doing business responsibly is fundamental to our strategy to become the best bank for customers, our Helping Britain Prosper Plan, our Code of Responsibility and all of our Group policies and standards and the future success of the business.

We are committed to sustainable development and delivering a prosperous Britain for all. This includes working with others to deliver relevant areas of the United Nation's agenda, such as the Sustainable Development Goals. As signatories to the UN Global Compact we have pledged to embed their 10 principles, including human rights, labour, environment and anti-corruption, into the way we operate. Our first annual Communication on Progress will be published online in April 2017.

We aspire to conduct business in a way that values and respects the human rights of our colleagues, suppliers, customers and the communities we operate in.

Our responsible approach is reflected by our continued presence in the FTSE4Good Index and our position in the CDP Climate A list in recognition of our transparent reporting and efforts to reduce our emissions.

Focusing on what matters most

In 2016 we undertook a comprehensive materiality survey to analyse and rank the responsible business issues that our stakeholders deem most important to our business. Using a range of internal and external sources, we identified 30 economic, social, environmental and governance issues across eight key categories and asked stakeholder groups to share their views: colleagues, customers, investors, community groups, government and legislators and special interest groups and opinion formers.

In 2016 many of the same issues as 2015 emerged as the most material, with human rights, colleague diversity and wellbeing, economic impact, and data privacy and security growing in importance. The top material issues are as follows:

1. HOW WE RUN OUR BUSINESS
2. BUILDING TRUST
3. ECONOMIC IMPACT
4. SERVING OUR CUSTOMERS FAIRLY
5. HUMAN RIGHTS, DIVERSITY AND WELLBEING

Visit www.lloydsbankinggroup.com/responsible-business for more information

1. HOW WE RUN OUR BUSINESS

We must run our business in a responsible and sustainable manner, complying with laws and regulations, managing and mitigating risks and delivering sustainable returns for customers and shareholders.

Ensuring good governance

We have an effective top-to-bottom governance structure, providing an environment in which colleagues are encouraged and supported to do the right thing and to work responsibly. This governance structure includes our Group Board and the Board-level Responsible Business Committee and cascades to every part of our business. In 2016 we established an Executive level Responsible Business Management Committee which reports to the Chief Executive and is responsible for recommending and implementing the Group's Responsible Business strategy. Read more about the Responsible Business Committee's activity in 2016 on page 79.

Beyond regulatory compliance

Operating responsibly requires running our business in ways that meet relevant legal and regulatory requirements. In addition, we have a number of internal policies and procedures related to doing business responsibly including our Ethics Policy. We support the UN's wider development agenda, including the Guiding Principles on Business and Human Rights. We welcome the Modern Slavery Act and increased transparency and will publish our first Transparency Statement on or before 30 June 2017.

Engaging with stakeholders

We know that engaging with different stakeholder groups is extremely important. It enables us to understand the issues they face and their expectations of the Group. Their contributions influence our strategic thinking and also help us to shape our corporate reporting.

We held more than 1,100 meetings with investors in 2016. We regularly engage SRI/ESG investors as well as mainstream investors and investment analysts to provide them with information on our performance, strategic plans and how we do business responsibly. This year we held a number of responsible business webinars and roadshows with investors and analysts and undertook a governance lunch for major investors at which responsible business was actively discussed. We also briefed ratings agencies about our performance against our Conduct Risk Appetite Metrics. Read more on page 145.

OUR STAKEHOLDER PANEL

We've had a Panel in place since 2012 but in 2016 we established a smaller and more focused Independent Stakeholder Advisory Panel. It will provide informed and constructive external challenge and advice on our Responsible Business strategy and programmes, including the Helping Britain Prosper Plan.

'The Stakeholder Panel will be powerful in helping us to stay focused on our priorities, to advise us and to challenge us to think innovatively about emerging issues.'

Sara Weller, Chairman, Responsible Business Committee

2. BUILDING TRUST

Our Group strategy highlights our intention to build the best team in a responsible culture where colleagues put customers first. To embed this culture, we need to be clear about how we expect colleagues to behave at work.

Building a more responsible culture

We have established a clear and simple view of the culture we want to build, which is based on our Values. Throughout 2016, we continued to reinforce these Values and the behaviours that define them, through our Group Culture plan. We have created a Culture Dashboard, which helps us to monitor progress and a Group Customer First Committee, which ensures that 'Customer, Culture and Conduct' remain key considerations. We also encourage colleagues to share their concerns, without fear of reprisal, if they believe the codes, policies and procedures that support our culture are being contravened. They can do this in a number of ways, including through our Speak Up service which is managed independently of the Group. During 2016, 286 concerns were raised with the Speak Up team and 171 progressed to investigations. Of the investigations completed by year end 57 per cent were upheld and remedial action was taken where appropriate.

We have a comprehensive Anti-Bribery Policy in place which complies with laws and regulations wherever we operate, and which applies to all directors, colleagues, and anyone else acting on our behalf. All colleagues, including contractors, complete annual anti-bribery training and are encouraged to report confidentially any instances of suspected bribery. The Group is a member of Transparency International UK's Business Integrity Forum, a network of major international companies committed to anti-corruption and high ethical standards in business practices.

Making our business more transparent

We are committed to conducting our business responsibly and dealing transparently and fairly with any queries or concerns our stakeholders may have about our business.

We maintain regular dialogue with colleagues to assess their views. We measure our progress in building our culture along with colleagues' pride in the Group through our colleague surveys. The 'Best Bank for Customers' and the 'Building the Best Team' surveys are conducted by an independent third party and provide a clear view of colleagues' thoughts and feelings. We use the results to inform decisions about the Group's future direction and to support improvement of each team's performance. The 2016 results show that colleagues are engaged and they believe collaboration and working in an agile way are improving. We asked colleagues if they think Lloyds Banking Group is a responsible business. 87 per cent of them agreed that 'The behaviour of the people I work with is consistent with Lloyds Banking Group's Values and Codes of Responsibility'.

We regularly provide colleagues with information on the Group's performance and matters that concern their role, such as changes in the economic and regulatory environment, organisational changes and reward and remuneration. Colleagues are offered share schemes as part of wider incentive arrangements, to encourage shared ownership of the business. Details of how rights relating to the control of the company attaching to such shares are exercised, which are incorporated by reference in the strategic report, are available on page 234.

Responsible lending and investment

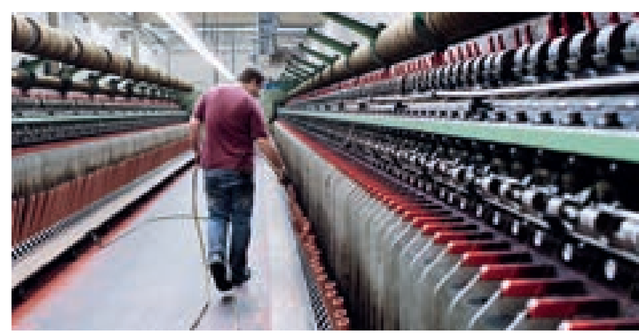
We recognise the need to address climate change, protect biodiversity, support local communities and ensure human rights are protected. We assess and manage social, ethical and environmental risk in our lending activity and the Group is a signatory to the Equator Principles, which provide a framework for determining, assessing and managing environmental and social risk in project finance transactions.

We do not finance any activities prohibited by international conventions supported by the UK government, such as the Oslo Convention on Cluster Munitions and the Ottawa Treaty on Anti-Personnel Landmines. Consequently, we will not enter into credit or investment relationships with businesses believed to be in breach of these conventions.

The management of risk for investment funds offered to customers by Scottish Widows is effected through a robust and comprehensive end to end governance and oversight reporting process, including a Responsible Investment Governance Framework. This covers the ongoing engagement process with fund managers, monitoring of mandate adherence and onward reporting through Investment Committees and Boards. The Group is a signatory of the Stewardship Code and the UN Principles of Responsible Investment.

3. ECONOMIC IMPACT

We contribute to the UK economy through our products and services, and through the commitments in our Helping Britain Prosper Plan. We also make a positive economic impact as a major employer and purchaser.



Sustainable business performance and growth

During 2016 we have made good progress against our strategic priorities whilst delivering strong financial performance. Our cost leadership and lower risk positioning provide competitive advantage. Our differentiated, UK focused business model continued to deliver for customers and shareholders.

Operating sustainably and responsibly is critical to the long-term success of the business and creating value for our stakeholders, and benefits the wider UK economy.

Making an economic contribution to Britain

We make a significant direct and indirect contribution to the economy. We employ approximately 75,000 colleagues (full time equivalent). We are helping to create additional jobs and bring talented people into our business through our Graduate and Apprenticeship Schemes. We've created more than 4,000 apprenticeships since we launched our Apprenticeship scheme in October 2012. We run a sector-leading and award-winning programme, offering a broad range of apprenticeships at all levels, including a degree-level apprenticeship in IT and Digital. In 2016, we provided a further 1,000 new roles, a third of which have been offered to external candidates from the UK's most disadvantaged areas. We have committed to create 8,000 new apprenticeships by 2020, as part of our Helping Britain Prosper Plan.

Doing business responsibly continued

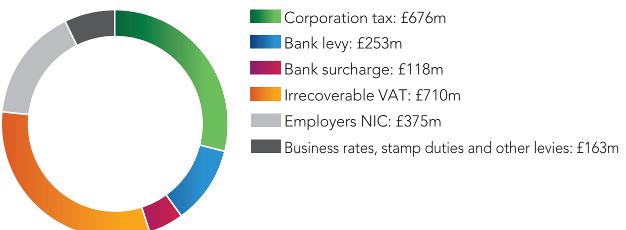
Our approach to tax

The Group continues to be one of the largest contributors to UK tax revenues. We were ranked as the highest payer of UK taxes in the most recent PwC Total Tax Contribution Survey for the 100 Group which is broadly the FTSE100 and some large UK private companies, having paid £1.8 billion in 2015.

In 2016, we paid £2.3 billlion in tax. We are also a major tax collector, gathering £2 billion on behalf of HMRC in 2016 (2015: £2.2 billion).

Our approach to tax is governed by a Board-approved Tax Policy which we have discussed with HMRC. We comply with the HMRC Code of Practice on Taxation for Banks and the Confederation of British Industry's Statement of tax principles. We do not interpret tax laws in a way that we believe is contrary to the intention of Parliament, and we do not promote tax avoidance products to our customers.

Tax paid in 2016: £2.3 billion



Helping businesses trade

During 2016, we helped more than 10,000 of our clients to start exporting for the first time, exceeding our Helping Britain Prosper Plan target of 5,000 businesses a year. This puts us on course to exceed our target of helping 25,000 businesses export for the first time, by 2020.

OUR TRADE PORTAL

Businesses who want to trade internationally can use our new International Trade Portal to access a wealth of practical information and advice. We also make it easy for them by linking with 100 partner banks outside the UK and we have launched a marketing campaign promoting the benefits of doing business internationally.

Supporting manufacturing and infrastructure

In 2016 we exceeded our target to support £10 billion of infrastructure projects within the government's National Infrastructure Plan. Projects supported include finance provision for the Port of Dover, with the creation of its new cargo terminal, the Beatrice Offshore Windfarm, one of the largest private investments ever made in Scottish infrastructure, and the creation of a wood pellet power plant in Teesside which will generate enough electricity to power 600,000 homes.

We've provided £1.2 billion of new funding support to UK manufacturing businesses in 2016. We have also committed a £5 million sponsorship over five years to the Lloyds Bank Advanced Manufacturing Training Centre, where over 1,000 apprentices, graduates and engineers will acquire valuable specialist manufacturing skills by 2020, to help secure a pipeline of new talent into UK manufacturing.

4. SERVING OUR CUSTOMERS FAIRLY

We serve a diverse customer base through many different channels. Ensuring our products and services are accessible and suitable to the individual needs of our customers is at the heart of everything we do; consistently offering the best experience, providing products and services when they need our support.

Protecting our customers

We protect our 25 million customers including those who bank digitally, using state of the art security measures, including secure log-on and log-off features as well as systems that detect possible anomalies in calls we receive and highlight fraudulent payments in real time. We help customers keep themselves safe by providing best practice information and championing public information campaigns, such as Take 5.

We are a strategic partner of Get Safe Online, a joint initiative between the government, the National Crime agency and many public and private sector organisations. In 2016, we made a significant contribution to the Joint Fraud Task Force, which brings together government, law enforcement and industry partners to set a strategic direction for fraud prevention measures. In London, the Task Force has spearheaded the Banking Protocol, enabling bank colleagues to request immediate police support when they believe that customers are being targeted by fraudsters. We will champion the Protocol's national rollout in 2017.

Tackling money laundering and terrorist financing

We take steps to make sure our products are not used for criminal purposes such as money laundering and terrorist financing, in liaison with legislators and regulators. We undertake due diligence on customers throughout the duration of their relationship with us, and monitor unusual activity on all accounts using advanced technology to detect potential criminal activity. If we spot anything suspicious we take immediate and appropriate action. All our colleagues are aware of our Anti-Money Laundering and Counter Terrorist Policy and have access to training to help them understand what is required of them.

Widening financial inclusion and supporting vulnerable customers

We want to do more to help customers who are financially excluded or at risk of becoming so. Our financial inclusion strategy, launched in 2014, focuses on four themes: providing accessible products and services that meet customers' needs; improving awareness and understanding of the impacts of financial exclusion across the bank; working in partnership with and signposting to other organisations that might be better suited to meet customer needs; and continuing to invest in financial education.

Opening a basic bank account can be the first step towards financial inclusion for many customers. In 2016, we provided almost 350,000 (2015: over 300,000) new basic bank accounts and also helped 70,000 customers upgrade from basic to more mainstream products. We also recognise that not having the right ID can be a major barrier to opening an account, so we aim to treat each customer as an individual, and ensure our colleagues have ways to accept many different forms of ID, in order to help them onto the banking platform. We know we have more to do to achieve this level of personal service.

CREDIT UNIONS

As part of our commitment to help financially disadvantaged people across Britain, we announced a further £1 million to support 21 credit unions in January 2016, the third stage of our £4 million four year commitment. Our support should allow each credit union to lend additional funds, resulting in an increase in sustainable sector lending of around £20 million from 2014 to 2017.

Digital technology also offers an important opportunity to make financial services more accessible. Almost 6 million adults in the UK have never used the internet and just under 50 per cent of charities and more than 1 million small and medium-sized businesses lack basic digital skills. Increasing digital capability is one of the most important factors that will drive financial inclusion over the coming years, so we aim to use our expertise and reach to promote wider understanding and access, as shown in our Lloyds Bank Consumer Digital Index which surveys 1 million customers.

We have improved our services for customers who are disabled or have suffered bereavement and work with third sector organisations such as Macmillan to support customers affected by cancer. We provide assistance for customers with mental health problems or dementia, and run dementia awareness training for branch and telephony colleagues. This year, we also reviewed our digital services, together with the charity Abilitynet, to ensure we provide the best service for our 4 million vulnerable customers who bank with us online.

Improving customer experience and satisfaction

Improving our customers' experience of and satisfaction with our products and services is central to our Customer Journey Transformation (CJT) initiative. CJT involves rethinking and redesigning customer journeys to meet our customers' evolving needs, particularly as digital becomes more mainstream in the way people and businesses bank.

We have improved the customer experience in branch and online using digital. We opened more than 40,000 savings accounts in our branches using digital technology this year, saving customers as much as 20 minutes of their time. We introduced processes to make banking faster and easier, including 'selfie' verification for account applications and video meetings and live webchat support for mortgage and remortgage applicants. Our in-house customer innovation labs tested more than 30 new technologies and services with our customers in 2016 including 'smart' customer alert services and new ways to upload documents digitally.

Dealing with customer complaints

In 2016 we emphasised the need to identify, understand and eradicate the root causes of customer complaints. We encourage colleagues to share ideas about how to remove the issues that drive complaints and improve customers' experience. When customers do complain, we resolve complaints as quickly as possible, focusing on achieving fair outcomes. Where a complaint is referred to the Financial Ombudsman Service, they tend to agree with our decisions in the majority of cases.

We welcome the changes the Financial Conduct Authority has made to complaint classification and reporting, which came into effect from 30 June 2016. These changes ensure a transparent approach to complaints reporting, ensuring that businesses are clear on the root causes of customer dissatisfaction, and that the volume of complaints that businesses receive are contextualised to the size of the organisation.

The impact we're making

Gold rated

by the Business Disability Forum for our work with customers and colleagues

5. HUMAN RIGHTS, DIVERSITY AND WELLBEING

We believe that everyone should have the opportunity to reach their full potential at Lloyds Banking Group – whatever their role or background. Our aim is to build a bank that represents modern Britain where colleagues' talents are recognised, and their human rights are respected. We aim to align our activity and policies with international best practice and recognised standards, such as the UN Declaration on Human Rights.

Promoting equal opportunities and Inclusion & Diversity

We widen and promote Inclusion & Diversity (I&D) through our Group Executive Committee, executive level I&D sponsors, quarterly I&D forum and I&D Operational committee, which oversees implementation of our strategy. During 2016, we launched a new Group-wide 'everyone' campaign to explain the relevance and importance of inclusion to all colleagues, introduced our new 'Family Matters' network for parents and carers and re-launched our REACH (Race, Ethnicity and Cultural Heritage) network.

We became the first UK company to include gender dysphoria in our Private Medical Benefit provision and were ranked number one private sector employer in the Stonewall Top 100. The Group was also named a Times Top 50 Employer for Women and Top 10 Employer for Working Families.

Occupational health, safety and wellbeing

We provide access to comprehensive online tools to support common health topics, such as fitness, smoking, diet and mental health. We also issue monthly colleague newsletters on relevant issues and support national health and wellbeing campaigns such as National Worklife Balance Week. In November we held a Mental Health and Wellbeing week. We are now working with our new charity partner, Mental Health UK, to create an environment which is fully inclusive and supportive of colleagues living with mental health conditions.

Working in partnership with external, market leading specialists, we support colleagues' health and wellbeing by providing access to an Occupational Health Service, an Employee Assistance Programme (EAP) and company paid private medical cover. Colleagues can obtain independent advice through the EAP and also have access to our award-winning Issue Resolution Scheme.

The impact we're making

86%

of colleagues believe the Group is an inclusive place to work

25,000

members of our five colleague diversity networks

Strategic report
Financial results
Governance
Risk management
Financial statements
Other information

Doing business responsibly continued

Our inclusion and diversity data

		2016	2015
Gender			
Board members	Male	**10**	10
	Female	**3**	3
Senior managers[1]	Male	**5,019**	5,561
	Female	**2,317**	2,405
Colleagues[1]	Male	**32,669**	34,602
	Female	**43,519**	46,920
Ethnicity			
Percentages of colleagues from an ethnic minority		**7.9%**	6.8%
Ethnic minority managers		**6.4%**	6.4%
Ethnic minority senior managers		**4.8%**	3.7%
Disability			
Percentage of colleagues who disclose they have a disability		**2.2%**	1.1%
Sexual orientation			
Percentage of colleagues who disclose they are lesbian, gay, bisexual or transgender		**1.5%**	1.2%

1 Colleague scope of reporting: UK payroll headcount includes established and fixed term contract colleagues. Excludes parental leavers, Non-Executive Directors, contractors, temp, agency and internationals.

Seniors Managers: Grades F+

Managers: Grade D-E

Data source: HR system (HR Online). Apart from gender data, all diversity information is based on colleagues' voluntary self-declaration. As a result this data is not 100 percent representative; our systems do not record diversity data for the proportion of colleagues who have not declared this information.

RESPONSIBLE BUSINESS PERFORMANCE

In addition to the issues highlighted as most material by our stakeholders, we also report annually on other aspects of responsible business, which we regard as integral to our operations.

Developing and rewarding our colleagues

We want to ensure that every colleague feels valued and empowered to thrive in a truly inclusive business. We offer a competitive and fair reward package that supports our aims as a responsible business. After a detailed review in 2015 of the variable pay arrangements used to incentivise customer-facing colleagues, variable pay for colleagues in the Retail division is no longer linked to individual or branch level sales or product targets. To build on these changes, a single variable pay arrangement was introduced for these colleagues in 2016. Customer-facing colleagues in Retail are now incentivised by reference to balanced scorecard metrics with clearly identified performance descriptors, in line with the Group annual bonus plan approach. These changes ensure that colleagues are rewarded for action and behaviour which puts customers first. We have recognition agreements with two trade unions, Accord and Unite, which collectively negotiate and consult on behalf of around 95 per cent of our colleagues.

Learning and development

All colleagues have access to our learning management system, Discover Learning, and with the launch of our Career Development Resource Centre it is now even easier for them to access learning materials to develop in their current roles or for career moves. During 2016, colleagues logged-in more than 11 million times; overall, almost 480,000 days of formal training were undertaken, an average of 6 days per colleague. In addition, 30,000 active learners use e-learning provided by one of our partners, Skillsoft.

We launched the Group's Digital Academy, a suite of learning modules available to all colleagues supporting our aim of creating the most digitally capable workforce in Financial Services. In the first six months this received 15,500 colleague visits. We also launched a Personal Learning Calendar which focuses on a relevant topic each month such as delivering the best customer experience.

An average of 77 per cent of the colleagues who participated in this year's 'Building the Best Team Survey', responded favourably to questions about training confirming that they believe they get the training and development needed to do their job effectively and meet customer demands. This is an increase of 2 per cent from last year, putting us 15 per cent above the UK average.

Throughout 2016, we continued to support colleagues studying for professional qualifications and contributed to the developing work of the Banking Standards Board, including their independent research into, and subsequent Report on, 'Professionalism in Banking'.

Supporting line managers and senior leaders

We have continued to develop our Line Manager Academy to meet the changing needs of our line manager population. During the year colleagues attended Academy training programmes more than 3,200 times. Our Leadership Academy provides senior leaders with relevant development solutions. In 2016 we developed five new Programmes for the Academy which together attracted almost 300 attendees. In March 2016 we launched our Strategic Leaders Programme which supports our senior 175 leaders in the Group with the aim of driving the culture we need to be the best bank for customers.

Support for disabled colleagues

We are committed to being a more disability confident employer. More than 5,000 colleagues disclosed a disability in our most recent colleague survey. We also potentially serve around 6 million customers affected by disability or long-term health issues. We are recognised as a leading employer for disabled people with cutting edge practices for customers and colleagues; in 2016 we won a Business Disability SMART Award for the third year running for our workplace adjustments process and were highly commended for our colleague disability network. We have a range of programmes to support colleagues who become disabled or develop a long-term health condition. Our workplace adjustments process, which includes physical equipment, has supported over 18,000 colleagues to date.

Since 2002 we have been running Personal Development and Career Development Programmes for disabled colleagues. 1,500 of our colleagues have completed this programme to date.

We aim to appoint the best person available into any role and to attract talented people from diverse backgrounds. We encourage and give full and fair consideration to job applications from people with a disability and are unbiased in the way we assess, select, appoint, train and promote people. We offer a guaranteed interview scheme for candidates who declare a disability and meet the minimum requirements of the role. We continue to run a work a Disability Work Experience Programme in partnership with Remploy. This is one of the largest disability-focused work experience initiatives in the financial services sector.

Agile working

As a founder member of a group of leading employers supporting workforce agility in the UK, we've been looking closely at ways to become more agile as an organisation over the past 18 months. To bring agile working to life we launched a 'Getting Smart about Agile Working' campaign, which had a high profile across the whole Group. Our most recent survey indicates that over 26,000 of our colleagues work in an agile way. In 2016 we've also implemented a new job sharing website, a new approach to agile hiring and agile working training for all colleagues.

The impact we're making

26,000
colleagues work in an agile way

4,000
members of our colleague disability network 'Access'

Managing and reducing our environmental impacts

Our ability to help Britain prosper is inextricably linked to wider environmental issues. Man-made climate change and global trends, such as resource scarcity, extreme weather and rising energy and commodity prices, have an impact on our stakeholders and our own operations. We are committed to managing our direct environmental impact and reducing our greenhouse gas emissions. We manage our impacts through our Environmental Action Plan, which focuses on reducing risk and creating value through improved efficiency.

Our emissions

This year our overall carbon emissions, measured in CO_2 equivalent tonnes (CO_2e), have decreased by 12.95 per cent year-on-year and by 38.83 per cent against our 2009 baseline. This is mainly attributable to the reduction in consumption of gas and electricity (which make up the largest proportion of our emissions) and our energy optimisation programme. Read more about our emissions in the Directors' report on page 81.

CO_2e emissions

	Oct 2015 – Sept 2016	Oct 2014 – Sept 2015[1]	Oct 2013 – Sept 2014[1]
Total CO_2e tonnes	**344,316** ✔	395,554	437,721
Total scope 1	**52,438** ✔	57,255	59,856
Total scope 2	**205,127** ✔	239,721	261,623
Total scope 3	**86,752** ✔	98,579	116,242

1 Restated 2013/2014 and 2014/2015 emissions data to improve the accuracy of reporting, using actual data to replace estimations.

Emissions in tonnes CO_2e in line with the GHG Protocol Corporate Standard (2004). We are in the process of transitioning to the revised Scope 2 guidance.

Criteria used to measure and report Scope 1, 2, 3 emissions is provided in the Lloyds Banking Group Reporting Criteria statement available online at www.lloydsbankinggroup.com/responsible-business

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

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

Supporting the low carbon economy

We continue to develop products and services to support customers' transition to a lower carbon, more resource efficient economy. Since 2014 we have launched two Environmental, Social and Governance (ESG) bonds totalling £500 million. Lloyds Bank became the first UK bank to develop an ESG deposit scheme in response to client demand to invest in products that create positive impacts.

In March 2016 Lloyds Bank launched its innovative £1 billion Green Loan Initiative for commercial real estate lending. The initiative – the first of its kind in the UK – provides clients with loans at discounted margins to help incentivise energy efficiency and finance investment in green buildings. We completed the first tranche of deals in the second half of 2016, totalling £72 million, and have helped borrowers like HPH, a Bath-based property company with a diverse property portfolio, to fund energy efficiency projects. We have now set a target in our Helping Britain Prosper Plan to fund 10 million square feet of commercial real estate to become more energy efficient by 2020, the equivalent of 10 London Shards.

In 2016 our UK-based team was responsible for financing renewable projects with a combined capacity of more than 1.78GW. Globally, our investments in renewable energy are in excess of 7.4GW in capacity and cover solar, offshore and onshore wind, waste to energy and biomass.

In 2016 Lloyds Bank played a key part in financing a major offshore wind farm off the Norfolk coast, with operations in Grimsby. Race Bank will provide enough energy to power 400,000 homes with a potential capacity of 573MW. It is anticipated the project, when in operation, will create more than 100 jobs associated with building and maintaining turbines for the Humber region.

✔ Indicator is subject to limited ISAE3000 (revised) assurance by Deloitte LLP for the 2016 Annual Responsible Business Reporting. Deloitte's 2016 assurance statement and the 2016 Reporting Criteria are available online at www.lloydsbankinggroup.com/rbdownloads

Supporting communities and tackling social disadvantage

We are an integral part of communities across the UK and believe we are in a unique position to help them prosper through our community programmes and investment. These programmes are focused on three themes: education, employability and enterprise. Our total community investment in 2016 was over £63 million ✔ which includes our colleagues' time, direct donations and the money we give to our independent charitable Foundations. The Foundations receive a share of the Group's profits annually.

THE FOUNDATIONS

We want to do more to help tackle disadvantage through our independent charitable Foundations. Our England and Wales Foundation is the UK's largest corporate foundation. Since 1985, we have given almost £600 million to tackle disadvantage in communities across the UK.

£18.5m

given to our Foundations in 2016

Our charity of the year

In 2016 we raised £6.1 million ✔ for our charity of the year, BBC Children in Need. This brings the total raised over our two year partnership to more than £12.5 million. The money we have raised will make a significant impact across the UK.

In 2017 we will begin a two year partnership with Mental Health UK, a collaboration of four national mental health charities. Our target is to raise £4 million to help develop and launch the first helpline dedicated to supporting people experiencing mental health and money management issues. We plan to use the partnership to further improve the awareness and management of mental health within the organisation, and to help our frontline colleagues to improve their service to customers.

Engaging with our stakeholders

Working with our suppliers

We are working together with our suppliers and others in our supply chain to ensure we source goods and services in ways that are responsible, sustainable and mutually beneficial. Our supply base comprises around 4,000 companies supplying us mainly with services, ranging from HR and recruitment through to marketing and legal advice. We also buy products to enable us to operate our banking services such as IT hardware and property-related goods. In 2016, we reduced our supplier expenditure to £5.3 billion from £5.8 billion in 2015. 94 per cent of this was spent with suppliers based in the UK.

Supporting regional prosperity

Our Group Ambassador Programme supports our ambition to enable social and economic prosperity in all parts of the UK. Our ten Ambassadors, who are all senior colleagues, have a mandate from the Group Chief Executive to support economic and social development across the whole of the UK. They work with politicians, government officials, regional development agencies and local enterprise partnerships as well as local councils to help achieve this. In 2016 the Ambassadors have worked on three core themes: housing, the rural economy and agriculture, and education and skills with a supporting focus on digital.

The impact we're making

97%

of supplier invoices paid within 30 days

Risk overview

Effective risk management, governance and control

As a Group, managing risk effectively is fundamental to our strategy and to operating successfully. We are a simple, low risk, UK focused, retail and commercial bank with a culture founded on a prudent through-the-economic-cycle appetite for risk.

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

Our approach to risk is founded on an effective control framework which guides how our colleagues approach their work, the way they behave and the decisions they make. Risk appetite – defined as the amount and type of risk that we are prepared to seek, accept or tolerate – is approved by the Board and is embedded within policies, authorities and limits across the Group.

Achievements in 2016

As a Group we have continued to deliver against our strategic priorities in 2016, simplifying and strengthening the business whilst growing in targeted areas. Risk has created a strong foundation to enable this progress, ensuring we react appropriately to the ever changing macro-economic and regulatory environment. Our prudent risk culture and appetite, along with close collaboration with the business, has enabled effective decision making and the achievement of a number of risk related deliverables in the year. These included:

Conduct

The Group's conduct strategy programme was fully implemented in 2016, embedding conduct into the everyday management of our business, ensuring that we retain a consistent and relentless focus on delivering improved customer outcomes through an open transparent culture.

Capital strength

The Group continues to maintain a strong capital position, with a pro forma CET1 ratio of 13.8 per cent, through a combination of strong statutory profit driven by good underlying profit and lower PPI, along with lower risk-weighted assets. Risk-weighted assets reduced by 3 per cent to £216 billion, reflecting the continued de-risking of the portfolio, and were primarily driven by active portfolio management including asset sales, an improvement in asset quality and capital efficient securitisation activity.

The Group was also subject to the UK stress testing run by the Bank of England; passing on all levels, with no capital inadequacies identified.

Asset quality

Effective risk management ensured asset quality remained strong with no deterioration in the underlying portfolio. The impairment charge increased to £645 million (2015: £568 million) with the asset quality ratio increasing slightly to 15 basis points, but this was largely due to lower provision releases and write-backs. The gross asset quality ratio remained unchanged at 28 basis points. Our prudent risk appetite and robust risk management framework were also reflected in impaired loans, which reduced by over £1 billion to £8.5 billion, and the impaired loans ratio, which continued to fall and is now below 2 per cent.

RISK AS A STRATEGIC DIFFERENTIATOR

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

Risks are identified, managed and mitigated using our comprehensive Risk Management Framework (RMF), (see page 27) and our clearly defined risk appetite, embedded in policies, authorities and limits provides a clear framework for effective business decision making. The principal risks we face, which could significantly impact the delivery of our strategy, are discussed on pages 28 to 31.

We believe effective risk management can be a strategic differentiator, in particular:

Prudent approach to risk
Implementing a prudent approach to risk appetite across the Group, aligned to the embedding of a strong risk culture, driven both from the top and across the wider business, ensures we operate within risk appetite.

Strong control framework
The Group's RMF acts as the foundation for the delivery of effective risk control and ensures that the Group risk appetite is continually developed and adhered to.

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

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

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

Risk governance

The Board approves the Group's overall RMF and sets risk appetite, both of which are designed to ensure that we manage our risks in the right way to achieve our agreed strategic objectives. It has a dedicated Risk Committee of Non-Executive Directors who keep the design and performance of the Group's RMF under close and regular scrutiny and interact closely with the executive risk management committee operating at Group Executive Committee level. The Board and senior management encourage a culture of transparency and openness to ensure that issues are escalated promptly to them where required.

The Board approved RMF and risk appetite are put into effect using an enterprise-wide framework which applies to every area of the business and covers all types of risk. The framework is designed to ensure we follow a consistent approach to risk management and reporting throughout the Group, so that all risks are fully understood and managed in relation to our agreed risk appetite. It includes our policies, procedures, controls and reporting.

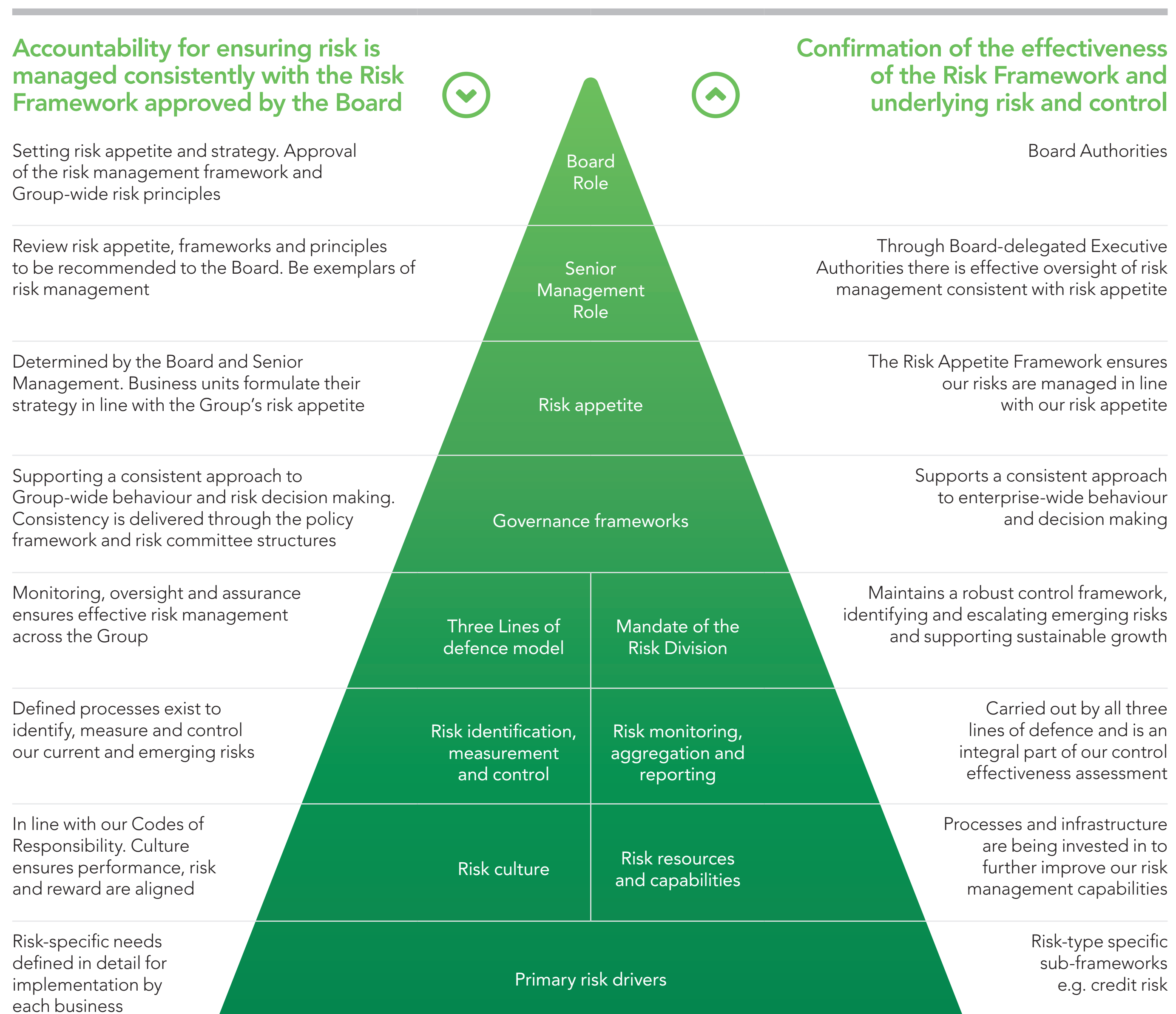
A high level structure is shown in the diagram below.

The framework is reviewed, updated and approved by the Board at least annually to reflect any changes in the nature of our business and external regulations, law, corporate governance and industry best practice. This helps us to ensure we continue to meet our responsibilities to our customers, shareholders and regulators.

Our risk appetite and the policy framework define clear parameters within which our business units must operate in order to deliver the best outcome for customers and stakeholders. An updated risk appetite statement was approved by the Board in 2016.

The Board delegates authorities for risk management through the Group Chief Executive and the management hierarchy to individuals, an approach which is consistent with the focus of the Senior Managers and Certification Regime (SM&CR) on the principle of individual accountability. At a senior level, executives are supported in their decision making by a committee-based governance structure. The concept of individual accountability for risk management is embedded in the RMF and culture at every level, and guides the way all employees approach their work, behave and make decisions.

An important element of the framework is the maintenance of strong internal controls which are owned and operated by individual business areas. The Group's risk governance arrangements supported the effective implementation of the requirements of the SM&CR which came into force in 2016.



Risk overview continued

The most significant risks which could impact the delivery of our long-term strategic objectives and our response, are detailed below

The Group has considered many of the potential implications following the UK's vote to leave the European Union and the impact to its customers, colleagues and products – as well as legal, regulatory, tax, finance and capital implications.

Continued uncertainty surrounding the political and macroeconomic environment remains but the potential impacts of external factors have been considered in all principal risks and uncertainties to ensure any material uncertainties continue to be monitored and are appropriately mitigated.

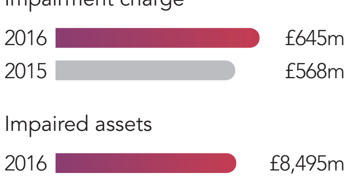
Principal risks and uncertainties are reviewed and reported regularly and no new risks have been identified in the year.

PRINCIPAL RISKS	KEY MITIGATING ACTIONS
Credit risk The risk that customers and/or other counterparties whom we have either lent money to or entered into a financial contract with, or other counterparties with whom we have contracted, fail to meet their financial obligations, resulting in loss to the Group. Adverse changes in the economic and market environment we operate in or the credit quality and/or behaviour of our customers and counterparties could reduce the value of our assets and potentially increase our write downs and allowances for impairment losses, adversely impacting profitability. **Example:** – Whilst we have a deep understanding of credit risks across our commercial, mortgage and other portfolios; a changing economic environment, e.g. interest rate rises, can impact on customer affordability and therefore our performance.	– Credit policy, incorporating prudent lending criteria, aligned with Board approved risk appetite, to effectively manage risk. – Robust risk assessment and credit sanctioning to ensure we lend appropriately and responsibly. – Extensive and thorough credit processes and controls to ensure effective risk identification, management and oversight. – Effective, well-established governance process supported by independent credit risk assurance. – Early identification of signs of stress leading to prompt action in engaging the customer.
Regulatory and legal risk The risks of changing legislation, regulation, policies, voluntary codes of practice and their interpretation in the markets in which we operate can have a significant impact on the Group's operations, business prospects, structure, costs and/or capital requirements and ability to enforce contractual obligations. **Examples:** – Increased regulatory oversight and Prudential regulatory requirements. – Increased legislative requirements, such as ring-fencing legislation.	– Ensure we develop comprehensive plans for delivery of all legal and regulatory changes and track their progress. Group-wide projects implemented to address significant impacts. – Continued investment in people, processes, training and IT to assess impact and help meet our legal and regulatory commitments. – Engage with regulatory authorities and industry bodies on forthcoming regulatory changes, market reviews and investigations.
Conduct risk Conduct risk can arise from a number of areas including selling products to customers which do not meet their needs; failing to deal with customers' complaints effectively; not meeting customers' expectations; and exhibiting behaviours which do not meet market or regulatory standards. **Example:** – The most significant conduct cost in recent years has been PPI mis-selling.	– Conduct risk appetite metrics provide a granular view on how our products and services are performing for customers. – Product approval, review processes and outcome testing supported by conduct management information. – Learning from past mistakes through root cause analysis and clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics. – The development of a refined framework for addressing thematic issues impacting customers in vulnerable circumstances.
Operational risk We face significant operational risks which may result in financial loss, disruption of services to customers, and damage to our reputation. These include the availability, resilience and security of our core IT systems and the potential for failings in our customer processes. **Examples:** – A resilient IT environment is critical to providing reliable services to customers and enabling sustainable growth. – The dynamic threat posed by cyber risk on the integrity of electronic data or the availability of systems.	– Continual review of our IT environment to ensure that systems and processes can effectively support customers' requirements. – Enhancing the resilience of systems that support critical business processes with independent verification of progress on an annual basis. – Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems and responding to findings from third party industry testing.
People risk Key people risks include the risk that we fail to maintain organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change. **Example:** – Inability to attract or retain colleagues with key skills could impact the achievement of business objectives.	– Focused action to attract, retain and develop high calibre people. Delivering initiatives which reinforce behaviours to generate the best outcomes for customers and colleagues. – Managing organisational capability and capacity to ensure there are the right skills and resources to meet our customers' needs. – Effective remuneration arrangements to promote appropriate colleague behaviours and meet regulatory expectations.

KEY RISK INDICATORS

ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS

Impairment charge



2016 £645m
2015 £568m

Impaired assets

2016 £8,495m
2015 £9,590m

Delivering sustainable growth

Read more on page 124

We have a conservative and well balanced UK credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.

Credit risk decisions are consistent, fair and responsible, taking account of customers' circumstances. We support sustainable growth and meet our targets in the Helping Britain Prosper Plan while staying within prudent risk appetite.

Impairments remain below long term levels and are expected to increase as the level of write-backs and releases normalise. Emerging credit risks that have the potential to increase impairment include the global and UK economic environment, in particular increasing interest rates, as it can impact customer and counterparties' affordability.

Mandatory, legal and regulatory investment spend

2016 £555m
2015 £454m

Delivering sustainable growth

Read more on page 166

We are committed to operating sustainably and responsibly, and commit significant resource and expense to ensure we meet our legal and regulatory obligations.

We respond as appropriate to impending legislation and regulation and associated consultations and participate in industry bodies. We continue to be subject to significant ongoing and new legislation, regulation and court proceedings.

Conduct risk appetite metric performance-Group

2016 92.1%
2015 87.4%

Creating the best customer experience

Read more on page 145

As we transform and simplify our business, minimising conduct risk is critical to achieving our strategic goals and meeting market and regulatory standards.

The successful transition of our customer-focused Conduct Strategy into Business as Usual, following robust review by the Group Customer First Committee, supports our vision of being the best bank for customers, enabling the creation of the best customer experience through learning from past mistakes.

Availability of core systems

2016 99.97%
2015 99.97%

Creating the best customer experience

Read more on page 152

We recognise that resilient and secure technology is critical to creating the best customer experience and maintaining trust across the wider industry.

The availability and resilience of IT systems remains a key strategic priority and the Cyber programme continues to focus on enhancing cyber security controls. The control environment is regularly assessed through internal and third party testing.

Best bank for customers index

2016 78%
2015 78%

Creating the best customer experience

Read more on page 168

Continued regulatory change relating to personal accountability and remuneration rules could affect the Group's ability to attract and retain the calibre of colleagues required to meet our changing customer needs. We continue to focus on developing colleagues, their capabilities and skills in order to create the best customer experience and to respond quickly to the rapidly evolving change in customers' decision making, in an increasingly digital marketplace.

1 This key risk indicator is also a key performance indicator (KPI).

Risk overview continued

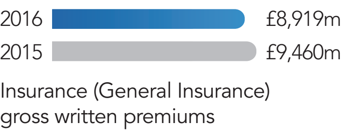
PRINCIPAL RISKS	KEY MITIGATING ACTIONS
Insurance risk Key insurance risks within the Insurance business are longevity, persistency and property insurance. Longevity risk is expected to increase as our presence in the bulk annuity market increases. Longevity is also the key insurance risk in the Group's Defined Benefit Pension Schemes. **Examples:** – Increases in life expectancy (longevity) beyond current assumptions will increase the cost of annuities and pension scheme benefits. – Uncertain property insurance claims impact Insurance earnings and capital, e.g. extreme weather conditions, such as flooding, can result in high property damage claims.	– Processes for underwriting, claims management, pricing and product design seek to control exposure. Longevity and bulk pricing experts support the bulk annuity proposition. – The merits of longevity risk transfer and hedging solutions are regularly reviewed for both the Insurance business and the Group's Defined Benefit Pension Schemes. – Property insurance exposures are mitigated by a broad reinsurance programme.
Capital risk The risk that we have a sub-optimal quantity or quality of capital or that capital is inefficiently deployed across the Group. **Example:** – A worsening macroeconomic environment could lead to adverse financial performance, which could deplete capital resources and/or increase capital requirements due to a deterioration in customers' creditworthiness.	– A comprehensive capital management framework that sets and monitors capital risk appetite, including dividend policy appropriately. – Close monitoring of capital and leverage ratios to ensure we meet current and future regulatory requirements. – Comprehensive stress testing analysis to evidence capital adequacy under various adverse scenarios.
Funding and liquidity risk The risk that we have insufficient financial resources to meet our commitments as they fall due, or can only secure them at excessive cost. **Example:** – Our funding and liquidity position is underpinned by a significant and stable customer deposit base and is supported by strong relationships with corporate customers and certain wholesale market segments. A deterioration in either the Group's or the UK's credit rating, or a sudden and significant withdrawal of customer deposits, would adversely impact our funding and liquidity position.	– Holding liquid assets to meet potential cash and collateral outflows, regulatory requirements and maintaining a further pool of secondary assets that can be used to access central bank liquidity facilities. – Undertaking daily monitoring against a number of market and Group-specific early warning indicators, maintaining a contingency funding plan detailing actions and strategies available in stressed conditions.
Governance risk Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the requirement to improve the resolvability of the Group and to ring-fence core UK financial services and activities from January 2019 and further requirements under the SM&CR which come into force from March 2017. **Example:** – Non-compliance with or breaches of ring-fencing, resolution and SM&CR requirements will result in legal and regulatory consequences.	– Leveraging our considerable change experience to meet ring-fencing and resolution planning requirements and the continuing evolution of SM&CR. – Programme in place to address ring-fencing and resolution planning. In close and regular contact with regulators to develop plans for our anticipated operating and legal structure. – Evolving risk and governance arrangements that continue to be appropriate to comply with regulatory objectives.
Market risk The risk that our capital or earnings profile is affected by adverse market rates, in particular interest rates and credit spreads in the Banking business, equity and credit spreads in the Insurance business, and credit spreads in the Group's Defined Benefit Pension Schemes. **Examples:** – Earnings are impacted by our ability to forecast and model customer behaviour accurately and establish appropriate hedging strategies. – The Insurance business is exposed indirectly to equity through the value of future management charges on policyholder funds. Credit spread risk within the Insurance business primarily arises from bonds and loans used to back annuities. Credit spreads affect the value of the Group's Defined Benefit Pension Schemes' liabilities.	– Structural hedge programmes implemented to manage liability margins and margin compression, and the Group's exposure to Bank Base Rate. – Equity and credit spread risks are closely monitored and, where appropriate, asset liability matching is undertaken to mitigate risk. – The Group's Defined Benefit Pension Schemes have increased their credit allocation and hedged against nominal rate/inflation movements. – Stress and scenario testing of Group risk exposures.

KEY RISK INDICATORS	ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS

Creating the best customer experience

Read more on page 167

Insurance (Life and Pensions) present value of new business premiums



2016	£8,919m
2015	£9,460m

Insurance (General Insurance) gross written premiums

2016	£1,108m
2015	£1,148m

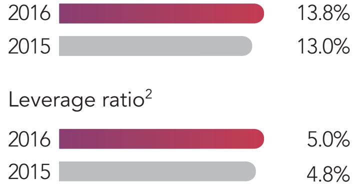
We are committed to meeting the changing needs of customers by working to provide a range of insurance products via multiple channels. The focus is on creating the best customer experience by helping customers protect themselves today whilst preparing for a secure financial future.

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

Delivering sustainable growth

Read more on page 159

Common equity tier 1 ratio[1,2]



2016	13.8%
2015	13.0%

Leverage ratio[2]

2016	5.0%
2015	4.8%

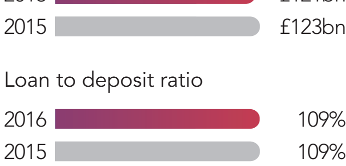
Ensuring we hold an appropriate level of capital to maintain financial resilience and market confidence, underpins our strategic objectives of supporting the UK economy and delivering sustainable growth.

Looking ahead, there are a number of regulatory capital framework changes which are yet to be finalised. These changes are being monitored closely as there is a risk that these could lead to higher capital requirements in the longer term.

Delivering sustainable growth

Read more on page 154

Regulatory liquidity



2016	£121bn
2015	£123bn

Loan to deposit ratio

2016	109%
2015	109%

We maintain a strong funding position in line with our low risk strategy. Our funding position has been significantly strengthened in recent years and our loan to deposit ratio remains within our target range.

Liquid assets now exceed our total wholesale funding. This provides a substantial buffer in the event of a market-wide stress which could reduce our options to fund our balance sheet in future.

Delivering sustainable growth

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N/A

Ring-fencing will ensure we become safer and continue to create the best customer experience by providing further protection to core Retail and SME deposits, increasing transparency of our operations and facilitating the options available in resolution.

Resolution planning is intended to reduce the probability of failure and, through ensuring continuity of critical banking services, the impact on customers should we fail.

Our Governance framework and strong culture of ownership and accountability enabled effective, on time, compliance with the SM&CR requirements which came into force from March 2016 and preparation for the SM&CR Certification requirements effective from March 2017.

Delivering sustainable growth

Read more on page 146

Pension surplus/(deficit)

2016	(£244m)
2015	£736m

We manage our exposure to movements in market rates throughout the year, leading us to promote low volatility earnings and offer a comprehensive customer proposition with market risk hedging strategies to support strategic aims, including delivering sustainable growth.

Mitigating actions are implemented to reduce the impact of market movements, resulting in a more stable capital position. This allows us to more efficiently utilise available capital resources to deliver sustainable growth.

Consistent with similar pension schemes, the Group's Defined Benefit Pension Schemes were adversely impacted by the credit spread volatility in the third quarter of 2016. The interest rate and inflation hedging programmes remain effective.

1 This key risk indicator is also a key performance indicator (KPI).
2 The CET1 and leverage ratios at 31 December 2016 and 31 December 2015 are reported on a pro forma basis, including dividends paid by the Insurance business in February 2017 and February 2016 respectively, in relation to prior year earnings.

FINANCIAL RESULTS

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BUILDING BRITAIN'S CONSTRUCTION SKILLS

Afaque Quareshi is retraining for a career in construction thanks to the collaboration between Lloyds Bank, London Borough of Newham and Lendlease. The Group has provided £1 million to support training and recruitment through its Construction Skills Fund, which was established to address the skills gap in the construction sector.

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industry recognised qualifications delivered in 2016 thanks to the Skills Fund

Summary of Group results

Good underlying performance with strong improvement in statutory profit

The Group's underlying profit was £7,867 million, 3 per cent lower than 2015, with slightly lower income and higher impairments, partly offset by lower costs. The underlying return on required equity was 13.2 per cent and the underlying return on tangible equity was 14.1 per cent. Statutory profit before tax more than doubled to £4,238 million, compared with £1,644 million in 2015, as the level of PPI provisions reduced significantly.

Total loans and advances to customers were £450 billion, compared with £455 billion at 31 December 2015, and customer deposits were similarly £5 billion lower than a year ago at £413 billion.

The balance sheet remains strong and the CET1 ratio at 31 December 2016 was 13.8 per cent on a pro forma basis and reflects the retention of c.80 basis points of CET1 capital to cover the estimated capital impact of the MBNA acquisition. The Group generated c.190 basis points of CET1 capital, pre dividends, in the period and tangible net asset value per share increased to 54.8 pence (31 December 2015: 52.3 pence).

Given the significant amount of capital generated in the year, the Board has recommended a final ordinary dividend of 1.7 pence per share, making a total ordinary dividend of 2.55 pence per share, an increase of 13 per cent on 2015 and in line with our progressive and sustainable ordinary dividend policy. In addition, the Board has recommended a special dividend of 0.5 pence per share.

Total income

	2016 £ million	2015 £ million	Change %
Net interest income	**11,435**	11,482	–
Other income	**6,065**	6,155	(1)
Total income	**17,500**	17,637	(1)
Operating lease depreciation[1]	**(895)**	(764)	(17)
Net income	**16,605**	16,873	(2)
Banking net interest margin	**2.71%**	2.63%	8bp
Average interest-earning banking assets	**£435.9bn**	£441.9bn	(1)

1 Net of gains on disposal of leased assets.

Total income of £17,500 million was 1 per cent lower than 2015, with a small reduction in net interest income and a 1 per cent fall in other income.

Net interest income fell by £47 million to £11,435 million. The net interest margin increased to 2.71 per cent (2015: 2.63 per cent), with lower deposit and wholesale funding costs, including the benefit from the ECN redemptions in the first quarter, more than offsetting the continuing pressure on asset pricing. Average interest-earning banking assets reduced by 1 per cent with growth in SME and Consumer Finance balances more than offset by reductions in the mortgage and run-off portfolios. The Group expects that the net interest margin for 2017 will be greater than 2.70 per cent (before MBNA).

The Group manages the risk to its capital and earnings from adverse movements in interest rates centrally by hedging liabilities which are deemed to be stable or less sensitive to change in market interest rates. As at 31 December 2016, the balance hedged was c.£111 billion with an average duration of c.3 years and an earning rate of approximately 1.6 per cent over LIBOR. In 2016, the benefit from the structural hedge totalled £1.7 billion over LIBOR (2015: £1.8 billion).

Other income was £6,065 million in 2016 (2015: £6,155 million). Other income increased in the fourth quarter compared with the same period last year largely as a result of improved Insurance income and was higher than the third quarter of 2016, largely due to increased Commercial Banking fees and commissions and improved Insurance income. The year-on-year reduction of 1 per cent was largely due to continued pressure on fees and commissions, including the impact of the market-wide cap on card interchange fees introduced in late 2015, lower returns in the Insurance business and reduced income from the run-off portfolio.

Operating lease depreciation increased 17 per cent to £895 million due to continued growth in the Lex Autolease business and additional charges in Commercial Banking related to certain leasing assets.

Operating costs

	2016 £ million	2015 £ million	Change %
Operating costs	**8,093**	8,311	3
Cost:income ratio	**48.7%**	49.3%	(0.6)pp
Operating jaws	**1.0%**	1.0%	–
Simplification savings annual run-rate	**947**	373	

Operating costs were £8,093 million, 3 per cent lower than 2015, driven by the continued focus on cost management and actions to simplify the business. Investment in the business continues to increase, particularly in digital, and in 2016 the Group made further improvements to the branch network to meet changing customer preferences, investing in new distribution technology, designing new branch formats and upgrading call centre technology.

The Simplification programme remains on track to deliver the increased target of £1.4 billion of annual run-rate savings by the end of 2017, with £0.9 billion of run-rate savings delivered to date. The total spent on the Simplification programme to date is £1.6 billion with an expected further spend of £0.6 billion by the end of 2017, of which around £0.2 billion will be included in restructuring costs.

The Group's market-leading cost:income ratio improved to 48.7 per cent (2015: 49.3 per cent) with positive operating jaws of 1 per cent. The Group remains committed to achieving annual improvements in the cost:income ratio and continues to target a cost:income ratio of around 45 per cent exiting 2019.

Summary of Group results continued

Impairment

	2016 £ million	2015 £ million	Change %
Total impairment charge	**645**	568	(14)
Asset quality ratio	**0.15%**	0.14%	1bp
Gross asset quality ratio	**0.28%**	0.28%	–
Impaired loans as a % of closing advances	**1.8%**	2.1%	(0.3)pp
Provisions as a % of impaired loans	**43.4%**	46.1%	(2.7)pp
Provisions as a % of impaired loans excluding run-off	**41.2%**	43.0%	(1.8)pp

Asset quality remains strong with no deterioration in the underlying portfolio. The impairment charge increased to £645 million from £568 million in 2015 with the asset quality ratio increasing slightly to 15 basis points. This increase was largely due, as expected, to a reduction in the level of provision releases and write-backs. The gross asset quality ratio (excluding releases and write-backs) remained unchanged at 28 basis points. Looking forward the Group expects a further reduction in releases and write-backs in 2017 and, as a result, the asset quality ratio to increase to around 25 basis points.

The average indexed loan to value (LTV) of the Retail mortgage portfolio improved to 44.0 per cent (31 December 2015: 46.1 per cent) and the percentage of lending with an indexed LTV of greater than 100 per cent improved to 0.7 per cent (31 December 2015: 1.1 per cent).

Impaired loans continued to fall and at 31 December 2016 were £8.5 billion, 1.8 per cent of total loans and advances compared with £9.6 billion, and 2.1 per cent at 31 December 2015.

Statutory profit

	2016 £ million	2015 £ million	Change %
Underlying profit	**7,867**	8,112	(3)
Volatility and other items			
Enhanced Capital Notes	**(790)**	(101)	
Market volatility and asset sales	**439**	(81)	
Amortisation of purchased intangibles	**(340)**	(342)	
Restructuring costs	**(622)**	(170)	
Fair value unwind and other items	**(231)**	(192)	
TSB costs	**–**	(745)	
	(1,544)	(1,631)	
Payment protection insurance provision	**(1,000)**	(4,000)	
Other conduct provisions	**(1,085)**	(837)	
Statutory profit before tax	**4,238**	1,644	158
Taxation	**(1,724)**	(688)	
Profit for the year	**2,514**	956	163

Statutory profit before tax more than doubled to £4,238 million (2015: £1,644 million) primarily due to lower PPI provisions of £1,000 million (2015: £4,000 million).

The charge of £790 million for Enhanced Capital Notes in 2016 represented the write-off of the embedded derivative and the premium paid on the redemption of the remaining notes in the first quarter.

Market volatility and asset sales of £439 million included a gain on sale of the Group's interest in Visa Europe of £484 million and negative insurance volatility of £91 million. The main item in the 2015 charge of £81 million was negative insurance volatility of £105 million.

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

A provision of £1 billion to cover further operating costs and redress relating to PPI was recognised in the third quarter and complaint levels in the second half have been around 8,300 per week on average. The Group's current PPI provision reflects our interpretation of the Financial Conduct Authority's (FCA) consultation paper regarding a potential time bar of the end of June 2019 and the Plevin case.

In addition there was a charge of £1,085 million to cover a range of other conduct issues of which £475 million was recognised in the fourth quarter. The charge for the year included £280 million in respect of complaints relating to packaged bank accounts, £261 million in respect of arrears-related activities on secured and unsecured retail products and £94 million related to insurance products sold in Germany, together with a number of other conduct risk provisions totalling £450 million across all divisions.

Statutory profit in 2015 included a charge of £745 million, comprising £660 million relating to the sale of TSB and £85 million of TSB dual-running costs.

Taxation

The tax charge was £1,724 million (2015: £688 million) representing an effective tax rate of 41 per cent (2015: 42 per cent). The high effective tax rate in 2016 was due to the banking surcharge, restrictions on the deductibility of conduct provisions, and the negative impact on the net deferred tax asset of both the change in corporation tax rate and the expected utilisation by the insurance business. The Group continues to expect a medium term effective tax rate of around 27 per cent.

Return on required equity and tangible equity

The underlying return on required equity was 13.2 per cent (2015: 15.0 per cent) and the underlying return on tangible equity was 14.1 per cent (2015: 16.0 per cent). The reduction in both return measures reflects the lower underlying profit and higher underlying tax charge following implementation of the banking tax surcharge.

The return on required equity increased to 5.3 per cent (2015: 1.5 per cent) and the return on tangible equity increased to 6.6 per cent (2015: 2.6 per cent) both largely reflecting the lower PPI provision made in the year.

Going forward, the Group remains confident in its future prospects and now expects to deliver a return on required equity of between 12.0 and 13.5 per cent and a return on tangible equity of between 13.5 and 15.0 per cent in 2019.

Balance sheet

	At 31 Dec 2016	At 31 Dec 2015	Change %
Loans and advances to customers[1]	**£450bn**	£455bn	(1)
Customer deposits[2]	**£413bn**	£418bn	(1)
Loan to deposit ratio	**109%**	109%	–
Wholesale funding	**£111bn**	£120bn	(8)
Wholesale funding <1 year maturity	**£35bn**	£38bn	(7)
Of which money-market funding <1 year maturity[3]	**£14bn**	£22bn	(36)
Liquidity coverage ratio – eligible assets	**£121bn**	£123bn	(2)

1 Excludes reverse repos of £8.3 billion (31 December 2015: £nil).

2 Excludes repos of £2.5 billion (31 December 2015: £nil).

3 Excludes balances relating to margins of £3.2 billion (31 December 2015: £2.5 billion) and settlement accounts of £1.8 billion (31 December 2015: £1.4 billion).

Loans and advances to customers were £450 billion compared with £455 billion at 31 December 2015. The reduction reflects continued strong growth in Consumer Finance, up 11 per cent, and SME lending, up 3 per cent, with both segments outperforming the market. This was offset by further reductions in 'closed' portfolios, reduced lending to financial institutions and lower 'open book' mortgage balances, reflecting the Group's prudent stance on risk and its focus on protecting margin in the current competitive low growth market. Mortgage open book balances fell by £4.5 billion to £266 billion during the year, of which £3.4 billion was in the first half and £1.1 billion was in the second half. Mortgage open book balances are expected to be broadly stable in 2017.

Deposits fell 1 per cent to £413 billion, with increased high quality deposits from Commercial clients offset by lower Retail and Consumer Finance tactical balances, largely in response to the active management of deposit and funding requirements. The Group has maintained its strong funding position with a loan to deposit ratio of 109 per cent (2015: 109 per cent).

Wholesale funding decreased by £9 billion to £111 billion as excess liquidity is managed down. Wholesale funding with a residual maturity of less than one year was £35 billion (2015: £38 billion), and the Group's term funding ratio was unchanged at 68 per cent.

The Group's liquidity position remains strong, with the liquidity coverage ratio comfortably meeting regulatory requirements.

Capital ratios and risk-weighted assets

	At 31 Dec 2016	At 31 Dec 2015	Change %
Pro forma common equity tier 1 ratio[1]	**13.8%**	13.0%	0.8pp
Pro forma common equity tier 1 ratio pre dividend[1]	**14.9%**		
Transitional tier 1 capital ratio	**17.0%**	16.4%	0.6pp
Transitional total capital ratio	**21.4%**	21.5%	(0.1)pp
Pro forma leverage ratio[1]	**5.0%**	4.8%	0.2pp
Risk-weighted assets	**£216bn**	£223bn	(3)
Shareholders' equity	**£43bn**	£41bn	4
Tangible net assets per share	**54.8p**	52.3p	2.5p

1 The CET1 and leverage ratios at 31 December 2016 and 31 December 2015 are reported on a pro forma basis, including dividends paid by the Insurance business in February 2017 and February 2016 respectively, in relation to prior year earnings.

The CET1 ratio improved to 13.8 per cent (2015: 13.0 per cent) on a pro forma basis and reflects the retention of c.80 basis points of CET1 capital to cover the estimated capital impact of the MBNA acquisition. The pro forma ratio includes the 2016 dividend paid by the Insurance business in February 2017.

The Group continues to be strongly capital generative and over the year generated c.190 basis points of CET1 capital, pre dividend. This largely comprised c.220 basis points of underlying capital generation, along with benefits from a reduction in risk-weighted assets (c.40 basis points) and the insurance dividend (c.20 basis points) partially offset by conduct (c.100 basis points) and other items. This strong capital generation has enabled us to fully cover the expected CET1 capital impact of the MBNA acquisition, increase the ordinary dividend and pay a special dividend. Going forward we now expect to generate 170 to 200 basis points of capital per annum pre dividends. This will enable us to support sustainable growth in the business and help Britain prosper whilst delivering sustainable returns to shareholders.

The Group is pleased to announce that following their annual review the PRA has reduced our PRA Buffer to reflect the significant de-risking undertaken by the Group in recent years. Going forward however, there remain a number of potential regulatory capital developments (including the introduction of the systemic risk buffer in 2019) and as a result the Board's view of the current level of CET1 capital required to grow the business, meet regulatory requirements and cover uncertainties remains unchanged at around 13 per cent.

The amount of capital we believe is appropriate to hold is likely to vary from time to time depending on circumstances and the Board will continue to give due consideration, subject to the situation at the time, to the distribution of any surplus capital through the use of special dividends or share buy backs.

Summary of Group results continued

The Group's total capital ratio remains strong at 21.4 per cent, significantly in excess of regulatory requirements.

Risk-weighted assets fell by 3 per cent to £216 billion with the reduction mainly arising in the fourth quarter primarily as a result of active balance sheet management including securitisations.

The leverage ratio on a pro forma basis increased to 5.0 per cent (2015: 4.8 per cent), largely reflecting the increase in tier 1 capital.

The tangible net asset value per share increased to 54.8 pence (31 December 2015: 52.3 pence) after payment of the 2015 final and 2016 interim dividends totalling 2.85 pence. The increase reflects good underlying profitability partly offset by tax and other statutory items.

Dividend

The Board has recommended a final ordinary dividend of 1.7 pence per share, together with a capital distribution in the form of a special dividend of 0.5 pence per share. This is in addition to the interim ordinary dividend of 0.85 pence per share that was announced at the 2016 half year results.

The total ordinary dividend per share for 2016 of 2.55 pence per share has increased by 13 per cent, from 2.25 pence per share in 2015 and is in line with our progressive and sustainable ordinary dividend policy. We continue to expect ordinary dividends to increase over the medium term with a dividend payout ratio of at least 50 per cent of sustainable earnings.

The special dividend of 0.5 pence per share represents the distribution of capital over and above the Board's view of the current level of capital required to grow the business, meet regulatory requirements and cover uncertainties, and allows for the estimated capital impact of the MBNA acquisition.

Underlying basis – segmental analysis

2016	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	Run-off and Central items £m	Group £m
Net interest income	6,497	2,735	1,941	(146)	408	11,435
Other income	1,053	1,987	1,338	1,755	(68)	6,065
Total income	7,550	4,722	3,279	1,609	340	17,500
Operating lease depreciation	–	(105)	(775)	–	(15)	(895)
Net income	7,550	4,617	2,504	1,609	325	16,605
Operating costs	(4,174)	(2,133)	(939)	(772)	(75)	(8,093)
Impairment	(373)	(16)	(282)	–	26	(645)
Underlying profit	3,003	2,468	1,283	837	276	7,867
Banking net interest margin	2.20%	3.26%	5.88%			2.71%
Average interest-earning banking assets	£302.7bn	£88.6bn	£33.9bn		£10.7bn	£435.9bn
Asset quality ratio	0.12%	0.02%	0.83%			0.15%
Return on risk-weighted assets	5.45%	2.44%	4.09%			3.55%
Loans and advances to customers[1]	£297.7bn	£100.4bn	£35.1bn		£16.5bn	£449.7bn
Customer deposits[2]	£271.0bn	£132.6bn	£7.9bn		£1.5bn	£413.0bn

2015	Retail[3] £m	Commercial Banking[3] £m	Consumer Finance[3] £m	Insurance £m	Run-off and Central items £m	Group £m
Net interest income	6,664	2,576	1,954	(163)	451	11,482
Other income	1,115	2,072	1,359	1,827	(218)	6,155
Total income	7,779	4,648	3,313	1,664	233	17,637
Operating lease depreciation	–	(30)	(720)	–	(14)	(764)
Net income	7,779	4,618	2,593	1,664	219	16,873
Operating costs	(4,339)	(2,162)	(977)	(702)	(131)	(8,311)
Impairment	(349)	22	(235)	–	(6)	(568)
TSB	–	–	–	–	118	118
Underlying profit	3,091	2,478	1,381	962	200	8,112
Banking net interest margin	2.22%	2.98%	6.61%			2.63%
Average interest-earning banking assets	£307.0bn	£90.0bn	£30.5bn		£14.4bn	£441.9bn
Asset quality ratio	0.11%	0.01%	0.77%			0.14%
Return on risk-weighted assets	5.71%	2.36%	4.27%			3.53%
Loans and advances to customers	£305.6bn	£102.0bn	£31.5bn		£16.1bn	£455.2bn
Customer deposits	£273.7bn	£131.9bn	£11.1bn		£1.6bn	£418.3bn

1 Excludes reverse repos of £8.3 billion (31 December 2015: £nil).
2 Excludes repos of £2.5 billion (31 December 2015: £nil).
3 Restated.

Alternative performance measures

The Group uses a number of alternative performance measures, including underlying profit, in the discussion of its business performance and financial position. Further information is provided on page 289.

Underlying basis

In order to allow a comparison of the Group's underlying performance, the results are adjusted for certain items including losses on redemption of the Enhanced Capital Notes and the volatility in the value of the embedded equity conversion feature; market volatility and asset sales, which includes the effects of certain asset sales, the volatility relating to the Group's own debt and hedging arrangements and that arising in the insurance businesses and insurance gross up; the amortisation of purchased intangible assets; restructuring costs, comprising severance related costs relating to the Simplification programme, the costs of implementing regulatory reform and ring-fencing and the rationalisation of the non-branch property portfolio; the unwind of acquisition-related fair value adjustments; TSB build and dual-running costs and the loss relating to the TSB sale in 2015; and payment protection insurance and other conduct provisions.

Summary of Group results continued

Consolidated income statement – underlying basis

	2016 £ million	2015 £ million	Change %
Net interest income	**11,435**	11,482	–
Other income	**6,065**	6,155	(1)
Total income	**17,500**	17,637	(1)
Operating lease depreciation	**(895)**	(764)	(17)
Net income	**16,605**	16,873	(2)
Operating costs	**(8,093)**	(8,311)	3
Impairment	**(645)**	(568)	(14)
TSB	**–**	118	
Underlying profit	**7,867**	8,112	(3)
Volatility and other items	**(1,544)**	(1,631)	
Payment protection insurance provision	**(1,000)**	(4,000)	
Other conduct provisions	**(1,085)**	(837)	
Statutory profit before tax	**4,238**	1,644	158
Taxation	**(1,724)**	(688)	
Profit for the year	**2,514**	956	163
Earnings per share	**2.9p**	0.8p	263
Dividends per share – ordinary	**2.55p**	2.25p	13
– special	**0.5p**	0.5p	
Total dividends	**3.05p**	2.75p	11

	2016	2015	Change
Banking net interest margin	**2.71%**	2.63%	8bp
Average interest-earning banking assets	**£436bn**	£442bn	(1)
Cost:income ratio	**48.7%**	49.3%	(0.6)pp
Asset quality ratio	**0.15%**	0.14%	1bp
Return on risk-weighted assets	**3.55%**	3.53%	2bp
Underlying return on required equity	**13.2%**	15.0%	(1.8)pp
Return on required equity	**5.3%**	1.5%	3.8pp
Underlying return on tangible equity	**14.1%**	16.0%	(1.9)pp
Return on tangible equity	**6.6%**	2.6%	4.0pp

Balance sheet and key ratios

	At 31 Dec 2016	At 31 Dec 2015	Change %
Loans and advances to customers[1]	**£450bn**	£455bn	(1)
Customer deposits[2]	**£413bn**	£418bn	(1)
Loan to deposit ratio	**109%**	109%	–
Total assets	**£818bn**	£807bn	1
Pro forma common equity tier 1 ratio[3]	**13.8%**	13.0%	0.8pp
Pro forma common equity tier 1 ratio pre dividend[3]	**14.9%**		
Transitional total capital ratio	**21.4%**	21.5%	(0.1)pp
Pro forma leverage ratio[3]	**5.0%**	4.8%	0.2pp
Risk-weighted assets	**£216bn**	£223bn	(3)
Tangible net assets per share	**54.8p**	52.3p	2.5p

1 Excludes reverse repos of £8.3 billion (31 December 2015: £nil).

2 Excludes repos of £2.5 billion (31 December 2015: £nil).

3 The common equity tier 1 and leverage ratios at 31 December 2016 and 2015 are reported on a pro forma basis, including the dividends paid by the Insurance business in February 2017 and February 2016 respectively, in relation to prior year earnings.

Five year financial summary

The financial statements (statutory basis) for each of the years presented have been audited by PricewaterhouseCoopers LLP, independent auditors.

	2016	2015	2014	2013	2012[1]
Income statement data for the year ended 31 December (£m)					
Total income, net of insurance claims	**17,267**	17,421	16,399	18,478	20,517
Operating expenses	**(12,277)**	(15,387)	(13,885)	(15,322)	(15,974)
Trading surplus	**4,990**	2,034	2,514	3,156	4,543
Impairment	**(752)**	(390)	(752)	(2,741)	(5,149)
Profit (loss) before tax	**4,238**	1,644	1,762	415	(606)
Profit (loss) after tax for the year	**2,514**	956	1,499	(802)	(1,387)
Profit (loss) for the year attributable to ordinary shareholders	**2,001**	466	1,125	(838)	(1,471)

	31 December 2016	31 December 2015	31 December 2014	31 December 2013	31 December 2012[1]
Balance sheet data (£m)					
Share capital	**7,146**	7,146	7,146	7,145	7,042
Shareholders' equity	**43,020**	41,234	43,335	38,989	41,896
Other equity instruments	**5,355**	5,355	5,355	–	–
Net asset value per ordinary share	**60.2p**	57.9p	60.7p	54.6p	59.5p
Customer deposits	**415,460**	418,326	447,067	439,467	426,216
Subordinated liabilities	**19,831**	23,312	26,042	32,312	34,092
Loans and advances to customers	**457,958**	455,175	482,704	492,952	516,764
Total assets	**817,793**	806,688	854,896	842,380	933,064

	2016	2015	2014	2013	2012[1]
Share information					
Basic earnings (loss) per ordinary share	**2.9p**	0.8p	1.7p	(1.2)p	(2.1)p
Diluted earnings (loss) per ordinary share	**2.9p**	0.8p	1.6p	(1.2)p	(2.1)p
Dividends per ordinary share[2,3]	**3.05p**	2.75p	0.75p	–	–
Market price (year end)	**62.5p**	73.1p	75.8p	78.9p	47.9p
Number of shareholders (thousands)	**2,510**	2,563	2,626	2,681	2,733
Number of ordinary shares in issue (millions)[4]	**71,374**	71,374	71,374	71,368	70,343

	2016	2015	2014	2013	2012[1]
Financial ratios (%)[5]					
Dividend payout ratio[6]	**104.0**	359.3	45.1	–	–
Post-tax return on average shareholders' equity	**4.9**	1.3	2.9	(2.0)	(3.3)
Post-tax return on average assets	**0.30**	0.11	0.17	(0.09)	(0.14)
Cost:income ratio[7]	**71.1**	88.3	84.7	82.9	77.9

	31 December 2016	31 December 2015	31 December 2014	31 December 2013	31 December 2012
Capital ratios (%)[8, 9]					
Total capital	**21.4**	21.5	22.0	20.8	17.3
Tier 1 capital	**17.0**	16.4	16.5	14.5	13.8
Common equity tier 1 capital/Core tier 1 capital	**13.6**	12.8	12.8	14.0	12.0

1 Restated in 2013 for IAS 19 (Revised) and IFRS 10.

2 Annual dividends comprise both interim and final dividend payments. Under IFRS, the total dividend for the year represents the interim dividend paid during the year and the final dividend which will be paid and accounted for during the following year.

3 Dividends per ordinary share in 2016 include a recommended special dividend of 0.5 pence; and in 2015 included a special dividend of 0.5 pence.

4 This figure excludes the limited voting ordinary shares owed by the Lloyds Bank Foundations.

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

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

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

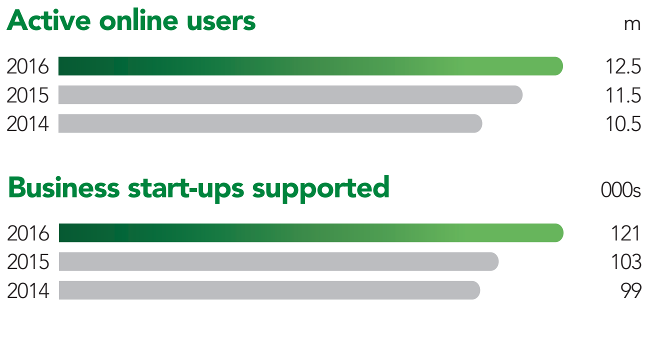
8 Capital ratios for 2014 reflected CRD IV transitional rules as implemented by the PRA on 1 January 2014. Capital ratios for 2013 and earlier years have not been restated to reflect the implementation of CRD IV.

9 Capital ratios for 2012 were not restated to reflect the adoption of IAS 19 (Revised).

Divisional results – Retail

Retail offers a broad range of financial service products, including current accounts, savings and mortgages, to UK personal customers, including Wealth and small business customers

It is also a distributor of insurance, and a range of long-term savings and investment products. Its aim is to be the best bank for customers in the UK, by building deep and enduring relationships that deliver value to customers, and by providing them with greater choice and flexibility. It will maintain its multi-brand and multi-channel strategy, and continue to simplify the business and provide more transparent products, helping to improve service levels and reduce conduct risks.



24%

market share of current account switchers

£11.7bn

of lending to first-time buyers

Progress against strategic initiatives

The division has made good progress against its strategic objectives; improving the customer experience and realigning branch and other capabilities in line with changing customer needs.

Creating the best customer experience

- Largest UK digital bank with over 12.5 million active online users including over 8 million mobile users.
- 55 per cent of approved mortgage applications proceed to offer within 14 days compared to 37 per cent in 2015.
- Instant mortgage lending decisions through the online Agreement in Principle.
- Customers can now complete their full remortgage application online.
- Reduced appointment times for opening a new savings account by 44 per cent and matured savings accounts can now be renewed in just a few minutes.
- Extended online and mobile phone application processes to all current accounts.
- Lloyds Bank and Bank of Scotland current account online journeys have been rated #1 and #2 respectively by industry researcher eBenchmarkers.

Becoming simpler and more efficient

- Continued the branch network optimisation programme in response to changing customer behaviour.
  - Investing in new distribution technology and rolling out WIFI and tablet solutions.
  - Designing new branch formats and upgrading call centre technology.
  - Closed further branches, but maintaining the UK's largest branch network with a 21 per cent market share.

Delivering sustainable growth

- Continued to attract new customers through positive switching activity, accounting for more than 1 in 5 switchers in 2016.
- Since the launch of the Group's Helping Britain Prosper Plan in 2014 the Group has continued to be the leading supporter of first-time house buyers, with £11.7 billion lent in 2016.
- Exceeded Helping Britain Prosper target by supporting over 121,000 start-up businesses whilst also launching a range of new products and services to improve the customer experience for small businesses.

Financial performance

- Underlying profit decreased 3 per cent to £3,003 million reflecting the challenging interest rate environment, continued pressure on other operating income and increased investment in the business.
- Net interest income decreased 3 per cent driven largely by a reduction in mortgage balances reflecting the focus on protecting margins. Banking margin fell by just 2 basis points despite the continuing low interest rate environment.
- Other income was 6 per cent lower than 2015 driven by changing customer behaviour and improvements to the customer proposition.
- Operating costs decreased 4 per cent to £4,174 million as efficiency savings more than covered an increase in investment. Staff numbers have reduced by 11 per cent in the year.
- Impairment charge increased 7 per cent to £373 million, however underlying credit quality remains stable.
- Loans and advances to customers fell 3 per cent to £297.7 billion, with the open mortgage book (excluding specialist mortgage books and Intelligent Finance) reducing by £4.5 billion to £266 billion during the year, of which £3.4 billion was in the first half and £1.1 billion in the second half. The fall reflects the decision to protect net interest margin in the current competitive low growth market.
- Customer deposits decreased 1 per cent to £271.0 billion, driven by the decision to reduce tactical balances.
- Risk-weighted assets increased £0.6 billion to £55.2 billion reflecting the Group's focus on balancing margin and risk considerations offset by a more prudent approach to secured risk-weighted asset modelling.

Performance summary

	2016 £m	2015[1] £m	Change %
Net interest income	**6,497**	6,664	(3)
Other income	**1,053**	1,115	(6)
Total income	**7,550**	7,779	(3)
Operating lease depreciation	**–**	–	
Net income	**7,550**	7,779	(3)
Operating costs	**(4,174)**	(4,339)	4
Impairment	**(373)**	(349)	(7)
Underlying profit	**3,003**	3,091	(3)
Banking net interest margin	**2.20%**	2.22%	(2)bp
Average interest-earning banking assets	**£302.7bn**	£307.0bn	(1)
Asset quality ratio	**0.12%**	0.11%	1bp
Impaired loans as % of closing advances	**1.5%**	1.3%	0.2pp
Return on risk-weighted assets	**5.45%**	5.71%	(26)bp
Return on assets	**0.99%**	1.00%	(1)bp

Key balance sheet items

	At 31 Dec 2016 £bn	At 31 Dec[1] 2015 £bn	Change %
Loans and advances excluding closed portfolios	**271.0**	275.5	(2)
Closed portfolios	**26.7**	30.1	(11)
Loans and advances to customers	**297.7**	305.6	(3)
Relationship balances	**253.8**	249.3	2
Tactical balances	**17.2**	24.4	(30)
Customer deposits	**271.0**	273.7	(1)
Risk-weighted assets	**55.2**	54.6	1

1 Restated.

Divisional results – Commercial Banking

Commercial Banking has a client-led, low risk, capital efficient strategy, helping UK-based clients and international clients with a link to the UK

Through its four customer facing divisions – SME, Mid Markets, Global Corporates and Financial Institutions – it provides clients with a range of products and services such as lending, transactional banking, working capital management, risk management, debt capital markets services, as well as access to private equity through Lloyds Development Capital.

3%

growth in SME lending

17%

share of mid-market banking relationships

Progress against strategic initiatives

The division has made significant progress against its strategic objectives; delivering a return on risk-weighted assets of 2.44 per cent, exceeding the investor commitment of returns greater than 2.40 per cent by the end of 2017 while continuing to grow lending in key client segments.

Creating the best customer experience

- Awarded Business Bank of the Year at the FD's Excellence Awards for the 12th consecutive year.
- Increased net promoter scores across all client divisions surveyed in 2016.
- Supported over 10,000 first time exporters which is helping the UK government achieve its ambition to deliver 100,000 new exporters by 2020.

Becoming simpler and more efficient

- Reduced SME relationship manager hours spent on business account opening from seven to two hours, enabling more time to be spent face to face with clients.
- Continued to invest in next generation digital capabilities and client analytics to transform clients' experiences. The 'CB Online' transaction banking platform now has over 2,000 clients registered.

Delivering sustainable growth

- Increased lending in SME and Mid Markets by around £2 billion in 2016 and provided UK manufacturers with over £1 billion of funding support in 2016.
- Facilitated over £10.5 billion of financing to support UK government infrastructure projects, including the creation of a wood pellet power plant in Teesside which will provide energy to 600,000 homes and Race Bank Offshore Windfarm which will play a key part in the UK's green energy future.

Financial performance

- Underlying profit in line with prior year at £2,468 million.
- Return on risk-weighted assets of 2.44 per cent with a 7 per cent reduction in risk-weighted assets, total income growth and disciplined cost management.
- Total income up 2 per cent with growth across SME, Mid Markets and Financial Institutions.
- Net interest income up 6 per cent with a 28 basis points improvement in net interest margin, supported by high quality deposit growth, disciplined deposit pricing and reduced funding costs. Other income down 4 per cent due to non-recurring income recognised in 2015 relating to refinancing support of Global Corporates clients. This has been partially offset by growth in CB Markets of 8 per cent and increased momentum in the second half of the year with other income up 9 per cent against the first half of 2016.
- Operating lease depreciation increased due to additional charges relating to certain leasing assets.
- Operating costs down 1 per cent with performance reflecting disciplined cost management and headcount rationalisation, supported by efficiency initiatives resulting in positive jaws.
- Impairment charge of £16 million reflects the benefit of active risk management and the continued low interest rate environment. Asset quality ratio remains low at 2 basis points.
- Risk-weighted assets decreased by £7.2 billion, reflecting the disciplined approach to capital, including capital efficient securitisation activity and credit management. This has received global recognition through the award of Credit Portfolio Manager of the Year at the 2016 Risk Awards.
- Loans and advances to customers fell by 2 per cent to £100.4 billion. Above market growth in SME lending and increases in Mid Markets and Global Corporates offset by lower lending in Financial Institutions.
- Deposits increased 1 per cent to £132.6 billion. Strong momentum in attracting high quality deposits with Global Transactional Banking balances up 10 per cent, further optimising the portfolio and strengthening the Group balance sheet.

Performance summary

	2016 £m	2015[1] £m	Change %
Net interest income	2,735	2,576	6
Other income	1,987	2,072	(4)
Total income	4,722	4,648	2
Operating lease depreciation	(105)	(30)	
Net income	4,617	4,618	–
Operating costs	(2,133)	(2,162)	1
Impairment (charge) release	(16)	22	
Underlying profit	2,468	2,478	–
Banking net interest margin	3.26%	2.98%	28bp
Average interest-earning banking assets	£88.6bn	£90.0bn	(2)
Asset quality ratio	0.02%	0.01%	1bp
Impaired loans as % of closing advances	2.2%	2.5%	(0.3)pp
Return on risk-weighted assets	2.44%	2.36%	8bp
Return on assets	1.29%	1.18%	11bp

Key balance sheet items

	At 31 Dec 2016 £bn	At 31 Dec[1] 2015 £bn	Change %
Loans and advances to customers	100.4	102.0	(2)
Customer deposits	132.6	131.9	1
Risk-weighted assets	96.0	103.2	(7)

1 Restated.

Divisional results – Consumer Finance

Consumer Finance comprises all the Group's consumer lending products including motor finance, credit cards, and unsecured personal loans along with its European business

Its aim is to deliver sustainable growth, within a prudent risk appetite, in these markets through its multi-brand, multi-channel distribution model.

15%

share of credit card balances

9%

growth in UK consumer finance assets

Progress against strategic initiatives

The division continues to make significant progress against its strategic objectives, and has delivered its original target of increasing UK customer assets by £6 billion a year ahead of target, whilst maintaining a prudent approach to new business and managing residual value risk conservatively. In line with its strategy to grow in consumer finance the Group has entered into an agreement to acquire MBNA's prime UK credit card business with £7.0 billion of assets and c.2.8 million customers, which will give us the opportunity to create a best-in-class credit card operation.

Creating the best customer experience

- Credit Cards launched the innovative Halifax FlexiCard, giving customers more control, with dedicated repayment plans.
- In the Motor business, Black Horse launched a personal contract purchase (PCP) product for caravans and motorhomes, which now accounts for 11 per cent of applications in this sector.
- Lex Autolease built a bespoke system to manage vehicle servicing and maintenance, including online self-service functionality and has been used by over 10,000 customers since May.
- Loans have significantly enhanced the digital sales process with the introduction of an upfront eligibility checker.

Becoming simpler and more efficient

- Consumer Finance continues to focus on efficiency with further significant improvements to processes implemented in the year. This has also helped reduce customer complaints by 11 per cent.
- Lex Autolease simplified the way it sells c.80,000 vehicles per annum at end of contract, reducing the number of operating sites and associated costs, whilst increasing speed of vehicle disposals.
- Black Horse launched the Mobile Finance Calculator across the dealer network, allowing dealers to provide more accurate indicative customer pricing early on in the process.

Delivering sustainable growth

- Black Horse balances have grown by 20 per cent in the year, ahead of market growth, and continue to benefit from partnerships with key manufacturers such as Jaguar Land Rover.
- Credit card balances grew broadly in line with the market at 4 per cent, and the Group was the number one issuer of new cards in the UK.
- The acquisition of MBNA will enable the Group to enhance its position and offering within the UK prime credit card market and brings capabilities including data analytics and digital expertise in addition to a well-recognised brand. This will be complementary to the Group's existing operation and provides further opportunities for growth and delivering excellent customer service.
- Unsecured loan balances contracted marginally in the year as the Group continues to focus on low risk franchise customers.

Financial performance

- Underlying profit at £1,283 million was down 7 per cent, driven by slightly lower income and increased impairment, but return on risk-weighted assets remained strong at 4.09 per cent.
- Net interest income at £1,941 million was down 1 per cent with strong asset growth offset by the 73 basis point reduction in net interest margin. This was largely due to the focus on high quality, lower margin motor finance business, with the margin also impacted by lower Euribor and planned reductions in deposits, in line with the Group's funding strategy.
- Other income was down 2 per cent at £1,338 million due to the market-wide reduction in card interchange fees. Excluding this, other income was 3 per cent higher driven by continued fleet growth in Lex Autolease.
- Operating costs fell 4 per cent to £939 million with continued investment in the business more than offset by underlying efficiency savings. The division maintained a strong cost:income ratio, in line with 2015 at 37.4 per cent.
- The impairment charge of £282 million increased by £47 million, primarily due to overall growth and the non-recurrence of a favourable one-off release in 2015. Credit quality remains good with new business written within the Group's prudent credit and conduct appetite.
- UK customer assets were up 9 per cent year-on-year, driven primarily by growth in Black Horse.
- Customer deposits were down 29 per cent to £7.9 billion driven by re-pricing activity and the Group's deposit strategy.

Performance summary

	2016 £m	2015[1] £m	Change %
Net interest income	**1,941**	1,954	(1)
Other income	**1,338**	1,359	(2)
Total income	**3,279**	3,313	(1)
Operating lease depreciation	**(775)**	(720)	(8)
Net income	**2,504**	2,593	(3)
Operating costs	**(939)**	(977)	4
Impairment	**(282)**	(235)	(20)
Underlying profit	**1,283**	1,381	(7)

Banking net interest margin	**5.88%**	6.61%	(73)bp
Average interest-earning banking assets	**£33.9bn**	£30.5bn	11
Asset quality ratio	**0.83%**	0.77%	6bp
Impaired loans as % of closing advances	**2.1%**	2.9%	(0.8)pp
Return on risk-weighted assets	**4.09%**	4.27%	(18)bp
Return on assets	**3.29%**	3.95%	(66)bp

Key balance sheet items

	At 31 Dec 2016 £bn	At 31 Dec[1] 2015 £bn	Change %
Loans and advances to customers	**35.1**	31.5	11
Operating lease assets	**4.1**	3.5	17
Total customer assets	**39.2**	35.0	12
Of which UK	**32.8**	30.0	9
Customer deposits	**7.9**	11.1	(29)
Risk-weighted assets	**32.1**	30.7	5

1 Restated.

Divisional results – Insurance

The Insurance division is committed to providing a range of trusted and value-for-money protection, pension and investment products to meet the needs of its customers

With over £110 billion of funds under management, Scottish Widows is helping 6 million customers protect what they value most and plan financially for the future. In addition, the general insurance business is protecting the homes, belongings, cars and businesses of over three million customers.

Corporate pension, planning and retirement funds

	£bn
2016	42.7
2015	35.4
2014	33.3

Annualised payments to annuity customers in retirement

	£m
2016	932
2015	798
2014	787

6m

life, pensions and investments customers

14%

share of the home insurance market

Progress against strategic initiatives

The Group will continue to invest in developing the Insurance business and will seek to grow in areas where it has competitive advantage and is underrepresented, for the benefit of both customers and shareholders.

Creating the best customer experience

- Regained '5 star' Service Awards in both Life & Pensions and Investment categories at the 2016 Financial Adviser Service Awards together with 'Most Improved Provider' award. These accolades are voted on by 5,000 UK financial advisers and reflect improved customer service alongside simplified and streamlined processes.
- Strengthened the general insurance business with the launch of a flexible online home insurance offering, delivering increased direct sales, significant new functionality and more choice for customers.
- A founder member of the UK government's Flood Re initiative and played a lead role in setting up the scheme, which has enabled customers in high flood risk areas to secure affordable home insurance.

Becoming simpler and more efficient

- Launched a new digital service for employers, significantly reducing processing times for monthly corporate pension scheme management.
- Introduced an online tool allowing customers to consolidate other workplace pensions assets into the Group. This builds on the existing '5 Steps to Retirement' website, enabling customers to take control of their retirement plans.

Delivering sustainable growth

- Successfully completed four bulk annuity transactions in 2016, taking the combined external deal size to over £1.85 billion since entering the market in late 2015.
- Continued to leverage Group capabilities to source attractive, low risk, higher yielding assets to back annuity liabilities. Total assets acquired to date are £7 billion.
- Growth in corporate pension sales in a competitive environment, driven by increased uptake of new schemes.
- Scottish Widows Protect monthly applications have increased tenfold, providing £2.4 billion of life assurance and critical illness cover to individuals and businesses across the UK.
- Corporate pension, planning and retirement funds under management increased to over £42 billion reflecting net inflows and positive market movements.

Financial performance

- Underlying profit decreased by 13 per cent to £837 million. A 17 per cent increase in new business income was more than offset by adverse economics impacting existing business income together with increased investment costs.
- Life and pensions sales (PVNBP) decreased by 6 per cent. Excluding the internal With-Profits fund bulk annuity transfers in 2015 and 2016, PVNBP increased 23 per cent reflecting the four bulk annuity deals secured, growth in corporate pensions and increased momentum in both planning and retirement and protection.
- General insurance gross written premiums (GWP) decreased by 3 per cent, reflecting the continued softening of the Home market and the run off of legacy products.
- Costs increased by 10 per cent to £772 million, reflecting increased investment and £28 million annual levy associated with the Flood Re scheme.

Capital

- The estimated pre dividend Solvency II ratio of 160 per cent (1 January 2016 pre dividend position: 160 per cent) represents the shareholder view of Solvency II surplus. Benefits from capital optimisation initiatives have been offset by adverse interest rate volatility and the payment of a £500 million dividend in February 2016.
- Paid a further £500 million to the Group in February 2017, bringing total dividends paid since the formation of the Group in 2009, to £7.1 billion.

Performance summary

	2016 £m	2015 £m	Change %
Net interest income	(146)	(163)	10
Other income	1,755	1,827	(4)
Total income	**1,609**	1,664	(3)
Operating costs	(772)	(702)	(10)
Underlying profit	**837**	962	(13)
Life and pensions sales (PVNBP)[1]	8,919	9,460	(6)
New business income	381	326	17
General Insurance total GWP	1,108	1,148	(3)
General Insurance combined ratio	85%	83%	2pp
Solvency II ratio (pre dividend)	160%	160%	–

1 Present value of new business premiums. With-Profit fund bulk annuity transfer sales were £2,386 million in 2015 and £243 million in 2016. Excluding these transfers, LP&I sales have improved 23 per cent in 2016.

Profit by product group

	2016			2015		
	New business income £m	Existing business income £m	Total income £m	New business income £m	Existing business income £m	Total income £m
Corporate pensions	123	135	258	140	175	315
Bulk annuities	121	16	137	125	–	125
Planning and retirement	109	95	204	40	94	134
Protection	19	33	52	12	37	49
Longstanding LP&I	9	393	402	9	467	476
	381	672	1,053	326	773	1,099
Life and pensions experience and other items			223			235
General insurance			354			323
Net interest income and free asset return			(21)			7
Total costs			(772)			(702)
Underlying profit			**837**			962

New business income has increased by £55 million, or 17 per cent, driven by growth in planning and retirement and protection propositions. This has more than offset lower income from corporate pensions.

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

There was a net benefit of £223 million (2015: £235 million) as a result of experience and other items. This included one off benefits following an update to the methodology for calculating the illiquidity premium and the addition of a new death benefit to legacy pension contracts, to align terms with other pensions products. These were partly offset by the effect of recent reforms on activity within the pensions market.

General insurance income net of claims has increased by £31 million primarily driven by lower weather related claims.

Divisional results – Run-off and Central items

Run-off

	2016 £m	2015 £m	Change %
Net interest income	(110)	(88)	(25)
Other income	120	145	(17)
Total income	10	57	(82)
Operating lease depreciation	(15)	(14)	(7)
Net income	(5)	43	
Operating costs	(77)	(150)	49
Impairment release / (charge)	26	(8)	
Underlying loss	(56)	(115)	51

	2016 £bn	2015 £bn	Change %
Loans and advances to customers	9.6	10.3	(7)
Total assets	11.3	12.2	(7)
Risk-weighted assets	8.5	10.2	(17)

The lower income and costs reflect further reductions in the run-off portfolios.

Central items

	2016 £m	2015 £m
Total income	330	176
Costs	2	19
Impairment release	–	2
TSB	–	118
Underlying profit	332	315

Central items includes income and expenditure not attributed to divisions, including the costs of certain central and head office functions.

Total income increased to £330 million (2015: £176 million) largely as a result of sales of liquid assets including gilts, and the timing of dividends from the Group's strategic investments.

The results in 2015 include TSB for the first quarter only.

Other financial information

Banking net interest margin

The banking net interest margin is calculated by dividing banking net interest income by average interest-earning banking assets. Non-banking net interest income includes the net interest expense reported by the Insurance business, net interest income earned from non-banking assets, negative fair value adjustments relating to certain past liability management exercises and consolidation adjustments between net interest and other income to eliminate the impact of certain intragroup transactions. Non-banking assets include loans and advances within Commercial Banking where the predominant income stream is fees rather than net interest, and loans sold by Commercial Banking and Retail to Insurance to back annuitant liabilities.

The table below shows the reconciliation between the statutory net interest income and the underlying net interest income.

	2016 £m	2015 £m
Group net interest income – statutory basis	**9,274**	11,318
Insurance gross up	**1,898**	38
Volatility and other items	**263**	318
TSB	**–**	(192)
Group net interest income – underlying basis	**11,435**	11,482
Insurance division net interest expense	**146**	163
Other non-banking net interest expense / (income)	**245**	(15)
Banking net interest income – underlying basis	**11,826**	11,630
Average interest-earning banking assets	**£435.9bn**	£441.9bn
Banking net interest margin	**2.71%**	2.63%

Other non-banking net interest expense was £245 million (2015: net interest income £15 million). The change in the year was largely driven by a reduction in the net interest income reported by the non-banking businesses, the continued reduction in run-off non-banking assets together with a change to the funding cost charged to the remaining run-off non-banking assets to better reflect their maturity profile.

The insurance gross up of £1,898 million (2015: £38 million) largely represents amounts payable to unitholders in consolidated open-ended investment vehicles managed by the Insurance business. The increased expense in the year reflects strong market performance in the second half of 2016.

The table below shows the reconciliation between loans and advances and average interest-earning banking assets.

	Quarter ended 31 Dec 2016 £bn	Quarter ended 30 Sept 2016 £bn	Quarter ended 30 June 2016 £bn	Quarter ended 31 Mar 2016 £bn
Net loans and advances to customers	**449.7**	**451.7**	**453.0**	**456.7**
Impairment provision and fair value adjustments	**3.7**	**3.8**	**4.1**	**4.3**
Non-banking items:				
Fee based loans and advances	**(9.4)**	**(8.7)**	**(9.1)**	**(10.9)**
Sale of assets to Insurance	**(6.7)**	**(6.2)**	**(6.1)**	**(5.7)**
Other non-banking	**(5.0)**	**(5.5)**	**(4.9)**	**(5.3)**
Gross banking loans and advances	**432.3**	**435.1**	**437.0**	**439.1**
Averaging	**1.7**	**0.8**	**(1.4)**	**(0.9)**
Average interest-earning banking assets (quarter)	**434.0**	**435.9**	**435.6**	**438.2**
Average interest-earning banking assets (year-to-date)	**435.9**	**436.6**	**436.9**	**438.2**

Volatility arising in insurance businesses

Volatility included in the Group's statutory results before tax comprises the following:

	2016 £m	2015 £m
Insurance volatility	**(152)**	(303)
Policyholder interests volatility	**241**	87
Total volatility	**89**	(216)
Insurance hedging arrangements	**(180)**	111
Total	**(91)**	(105)

Insurance volatility

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

Other financial information continued

Return measures

The Group's underlying return on required equity for 2016 was 13.2 per cent (2015: 15.0 per cent) and the underlying return on tangible equity was 14.1 per cent (2015: 16.0 per cent). The reduction in both return measures was as a result of lower underlying profit and higher tax.

	2016 £bn	2015 £bn
Underlying return on required equity		
Average shareholders' equity	42.7	42.8
Average non-controlling interests	0.4	0.6
Excess equity based on 12 per cent CET 1 requirement	(2.4)	(2.7)
Average required equity	40.7	40.7
Underlying profit after tax and profits attributable to other equity holders (£m)	5,410	6,155
Notional earnings on excess equity (£m)	(24)	(37)
	5,386	6,118
Underlying return on required equity	13.2%	15.0%
Underlying return on tangible equity		
Average shareholders' equity	42.7	42.8
Average intangible assets	(3.8)	(4.0)
Average tangible equity	38.9	38.8
Underlying profit after tax and profits attributable to other equity holders (£m)	5,410	6,155
Amortisation of intangible assets (post tax) (£m)	174	156
Profit attributable to non-controlling interests (£m)	(101)	(96)
	5,483	6,215
Underlying return on tangible equity	14.1%	16.0%

Tangible net assets per share

The table below sets out a reconciliation of the Group's shareholders' equity to its tangible net assets.

	2016 £m	2015 £m
Shareholders' equity	43,020	41,234
Goodwill	(2,016)	(2,016)
Intangible assets	(1,681)	(1,838)
Purchased value of in-force business	(340)	(377)
Other, including deferred tax effects	170	264
Tangible net assets	39,153	37,267
Ordinary shares in issue, excluding Own shares	71,413m	71,263m
Tangible net assets per share	54.8p	52.3p

GOVERNANCE

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HELPING RECENTLY HOMELESS PEOPLE REBUILD THEIR LIVES

With a grant from the Bank of Scotland Foundation, the charity Fresh Start helps recently homeless people in Edinburgh to rebuild their lives in secure, well-equipped accommodation. Fresh Start is one of thousands of charities supported by our four Foundations and by colleagues who volunteer their expertise to help them.

£18.5 million

given to support our Foundations in 2016

Letter from the Chairman

Dear Shareholders

I am pleased to present our corporate governance report for 2016. This report sets out our approach to governance in practice, the work of the Board and includes reports from each of the Board's Committees.

The Board's approach, led by me, your Chairman, is to ensure corporate governance is embedded into the thinking and processes of the business. This is vitally important because we believe a commitment to good governance ensures we continually challenge our assumptions and risks, and underpins the delivery of our strategy to become the best bank for customers and generate sustainable returns for shareholders.

Board changes

There were two changes to the Board in 2016. Stuart Sinclair joined the Board in January 2016 and Dyfrig John retired from the Board in May 2016.

The Board has agreed the following changes to our Board composition. Anthony Watson, our Senior Independent Director, will retire at the 2017 annual general meeting (AGM) after serving more than eight years on the Board. Anita Frew will succeed Anthony as Senior Independent Director. Anita will combine the role of Senior Independent Director with the role of Deputy Chairman, which she has held since May 2014. Anita's significant board, financial and investment management experience, including as a Senior Independent Director, make her ideally suited to take on this role. Nick Luff, an independent Non-Executive Director, has notified the Board that in light of his other commitments he does not intend to seek re-election at the 2017 AGM. Nick will be succeeded as Chairman of the Audit Committee by Simon Henry. Simon has significant financial experience in the UK listed environment, retiring as Chief Financial Officer of Royal Dutch Shell plc in March 2017. His background and experience enable him to fulfil the role of Audit Committee Chairman and for SEC purposes the role of Audit Committee financial expert. Both Anthony and Nick leave with our thanks and best wishes for the future.

The structure, size and composition of the Board and its Committees will continue to be kept under review.

Culture and values

One of my goals as Chairman is to ensure we continue to build a culture in which our colleagues are empowered, inspired and rewarded to do the right thing for customers. Our approach to culture and values is led by the Board, where there is a clear emphasis on setting the 'tone from the top'. This is reflected in the focus we give in the Board to ensuring every aspect of our management approach – including targets and incentives, organisational structures, values and behaviours – helps support the right culture, and is cascaded through our governance structure to every part of the business. We recognise that everyone is different and a key element to achieving our vision is having a diverse and inclusive workforce that reflects the diversity of modern Britain.

Diversity and succession planning

The Board has always placed great emphasis on seeking membership that reflects diversity in its broadest sense while maintaining the necessary levels of skills and experience required to oversee a major financial institution. During the year, we reviewed our Board Diversity Policy and agreed a specific target to maintain at least three female Board members and, recognising the emerging target for FTSE companies to move towards 33 per cent female representation, to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements.

The Board also places high emphasis on ensuring the development of diversity in the senior management roles within the Group and supports and oversees the Group's objective of achieving 40 per cent of senior roles held by female executives by 2020, along with other metrics which promote the engagement of other underrepresented groups within the business. The role of succession planning in promoting diversity is recognised and the Group has a range of policies to help provide mentoring and development opportunities.

Corporate governance framework

The Board recognises that governance is not static but must adapt to continually changing risks and changes in the regulatory environment. The corporate governance arrangements are therefore regularly reviewed to ensure they remain effective.

In 2016 we established two further sub-committees of the Board Risk Committee to focus on Financial Markets and IT Resilience & Cyber, in addition to an existing Stress Testing & Recovery Planning sub-committee. The sub-committees were constituted to enable members of the Board Risk Committee to dedicate additional time and resource to better understand and to enable fuller review and challenge of these risks. Additionally, a Cyber Security Advisory Panel was established to bring an industry perspective and allow for discussion of the key cyber related activities and threats.

Building stakeholder relationships

Understanding our stakeholders' concerns supports us in the delivery of our strategy to become the best bank for customers as it helps us to focus on what is important.

We define our stakeholders as 'those who affect and are affected by our operations'. In addition to our shareholders, customers and colleagues, they include government, regulatory bodies, suppliers and wider society.

Stakeholder engagement takes many different forms, both through formal updates at Board and through more in-formal channels, such as site and branch visits. You can read more on page 64. We place great importance on colleague surveys and customer satisfaction measures, which help inform our decisions and track progress.

We engage with our shareholders through a full calendar of meetings and events, including the AGM and webcasts. The Board is briefed regularly through the year on both retail shareholder and institutional investor issues and concerns. More details of our shareholder relationship programme can be found on page 68.

As reported in 2015, we established a board-level Responsible Business Committee, underlining the Group's commitment to being a responsible business. The Committee focuses its work on the three areas of People, Businesses and Communities and reports on its first full year of activities on page 79.

We have had an independent Stakeholder Panel for a number of years who represent the views of a range of stakeholders.

In September 2016 the Chairman and members of the Scottish Widows Board visited the Financial Planning & Retirement Lab in Edinburgh, to learn about innovative solutions for meeting the evolving needs of customers as they plan for retirement.

Board effectiveness review

The Board carries out an annual evaluation of its effectiveness. Having undertaken an external review in 2015, in 2016 this was conducted internally and was overseen by the Nomination and Governance Committee. The results of the review are set out on page 66, together with information about our progress against the 2015 review actions.

Remuneration

Our approach to reward aims to provide a clear link between remuneration and delivery of the Group's key strategic objectives, supporting the aim of becoming the best bank for customers, whilst delivering long-term, superior and sustainable returns to shareholders. This year, we will be seeking shareholder support for a new remuneration policy, which will formally apply, subject to shareholder approval, from the date of the AGM in 2017.

Strategy

As well as reviewing progress in implementing the Group's 2015-2017 strategic review, the Board spent considerable time in 2016 exploring the challenges arising from the rapidly emerging digital environment. There were several meetings which focused on Group strategy, including a two day offsite which debated the transformation required to be 'Bank of the Future' in order to underpin continued competitive success. This will provide the backdrop to the next phase of our strategic development, on which we will report later this year.

The announcement in December 2016 that we had agreed to acquire MBNA is a significant step which reinforces our ability to deliver sustainable growth whilst helping Britain prosper.

Looking forward to 2017, our corporate governance priorities will be completing the Group's strategic review and ensuring we are equipped to deliver the key programmes; implementing the actions from the 2016 Board Effectiveness Review; and taking forward the necessary changes to implement our ring-fencing preparations.

Managing extensive change while maintaining high levels of current performance and managing continually changing risks is an immensely challenging task. I would like to thank the Board and all our colleagues for their tremendous support and commitment throughout the year in meeting these challenges.

Lord Blackwell
Chairman

OUR CULTURE AND VALUES

It is important to define culture in a way that makes it actionable. This is why we have defined our culture based on behaviours we expect to see from all colleagues in their day-to-day work

The Board and senior leaders have a vital role to play in shaping and embedding a healthy corporate culture, and this has been a major focus for the Board's attention over the last year. As a Group we are clear that our Values of 'putting customers first', 'keeping it simple' and 'making a difference together', remain central to the next stage of our cultural evolution. Our Group Values are core to our strategy and are at the heart of what we do and how we work.

We have established a clear and simple approach to our culture that sets out how our purpose of helping Britain prosper and our vision of becoming the best bank for customers will be achieved by all colleagues living the Values in everything they do. We believe it is important to define culture in a way that makes it actionable, so we have described it based on behaviours we expect to see from all colleagues in their day-to-day work.

In 2017 we are embedding these behaviours in our key people processes, so our Values will be reinforced across all colleague experiences such as recruitment, performance management and career development. We want to ensure colleagues are empowered, inspired and incentivised to do the right thing for our customers. Our colleague surveys show continued strong engagement and commitment to helping us be the best bank for customers.

Governance and oversight

We have an effective top-to-bottom governance structure providing active oversight of our Culture, Conduct and Customer objectives, which cascades to every part of the business.

We have a Group Customer First Committee to provide senior level active oversight and governance to upgrade and accelerate our customer focus, embed our target culture and conduct agenda. This committee drives our focus on culture and has encouraged the creation of a culture dashboard, to enable us to monitor our progress. Colleague feedback is combined alongside regular metrics to provide a view that is truly representative.

The Group Executive Committee, the Responsible Business Committee and the Board receive regular updates on progress. The culture dashboard is also shared with the Board to ensure further opportunity for oversight. During the June Board strategy offsite, the Group Chief Executive led the presentation of a 'deep dive' session on culture, providing the Board with an opportunity to offer feedback on our culture plans.

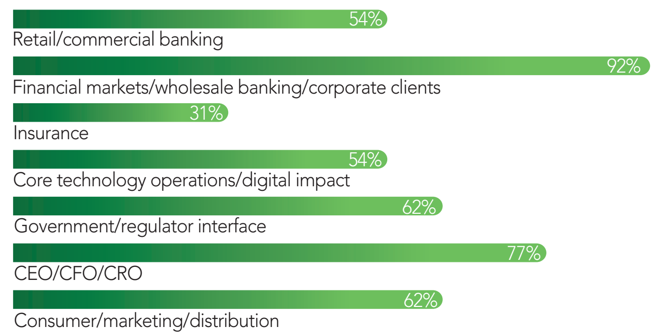
Board of Directors

Comprising Directors with the right mix of skills and experience, the Board is collectively responsible for overseeing delivery of the Group's strategy

BOARD DIVERSITY

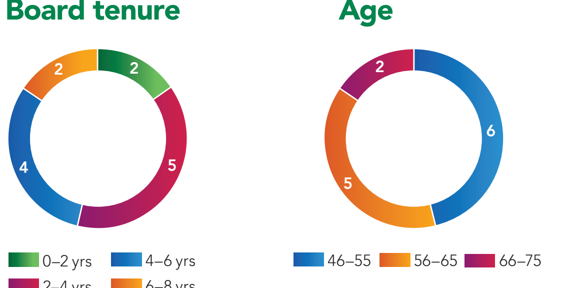
Gender diversity

Skills and experience



Board tenure

Age



This information is provided at 31 December 2016

01 Lord Blackwell
NG Re RB Ri
Chairman
Appointed: June 2012 (Board), April 2014 (Chairman)

Skills and experience: Lord Blackwell has deep financial services knowledge including in insurance and banking, as well as regulatory and public policy experience gained from senior positions in a wide range of industries. His breadth of experience, credibility with key stakeholders and strong leadership qualities make him an effective Chairman. Lord Blackwell was previously the Chairman of Scottish Widows Group, and Interserve plc, Director of Group Development at NatWest Group, a Senior Independent Director of Standard Life and also chaired their UK Life and Pensions Board. His past Non-Executive Directorships have included Halma plc, Dixons Group, SEGRO and Ofcom. He was Head of the Prime Minister's Policy Unit from 1995 to 1997 and was appointed a Life Peer in 1997. He has an MA in Natural Sciences from the University of Cambridge, a Ph.D in Finance and Economics and an MBA from the University of Pennsylvania.

External appointments: Governor of the Yehudi Menuhin School.

02 Anita Frew
A NG Re RB Ri
Deputy Chairman and Independent Director
Appointed: December 2010 (Board), May 2014 (Deputy Chairman)

Skills and experience: Anita has significant board, financial and general management experience across a range of sectors, including banking, asset and investment management, manufacturing and utilities. She was previously Chairman of Victrex plc, the Senior Independent Director of Aberdeen Asset Management and IMI plc, an Executive Director of Abbott Mead Vickers, a Non-Executive Director of Northumbrian Water and has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland. Her extensive board level, asset and investment management experience makes her a strong Deputy Chairman and Chairman of the Remuneration Committee. She has a BA (Hons) in International Business from the University of Strathclyde, a MRes in Humanities and Philosophy from the University of London and an Honorary DSc for contribution to industry and finance from the University of Cranfield.

External appointments: Chairman of Croda International Plc and a Non-Executive Director of BHP Billiton.

03 Alan Dickinson

A NG Re Ri

Independent Director

Appointed: September 2014

Skills and experience: Alan is a highly regarded retail and commercial banker having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK. More recently, he was a Non-Executive Director of Willis Limited and Chairman of its Risk Committee. He was formerly Chairman of Brown, Shipley & Co. Limited and a Non-Executive Director of Nationwide Building Society where he was Chairman of its Risk Committee. Alan's strategic focus and core banking experience complements the balance of skills on our Board and makes him ideal for the role of Chairman of the Board Risk Committee. He is a Fellow of the Chartered Institute of Bankers and the Royal Statistical Society and has an MBA from the Manchester Business School and a Bachelor of Science from the University of Birmingham.

External appointments: Chairman of Urban & Civic plc and a Governor of Motability.

04 Simon Henry

A Ri

Independent Director

Appointed: June 2014

Skills and experience: Simon has deep international experience in board level strategy and execution. His extensive knowledge of financial markets, treasury and risk management and his qualification as an Audit Committee Financial Expert is of particular value in our Board Risk and Audit Committees. Simon has a BA in Mathematics, an MA from the University of Cambridge and is a fellow of the Chartered Institute of Management Accountants.

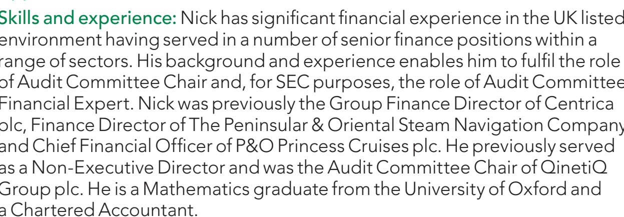
External appointments: Chief Financial Officer and an Executive Director of Royal Dutch Shell plc with responsibility for Shell's Finance, IT, Strategy and Planning functions (until 9 March 2017). Non-Executive Director of Rio Tinto plc and Rio Tinto Limited (from 1 July 2017). Chair of the European Round Table CFO Taskforce, Member of the Main Committee of the 100 Group of UK FTSE CFOs, the Advisory Panel of CIMA and of the Advisory Board of the Centre for European Reform.

05 Nick Luff

A NG Ri

Independent Director

Appointed: March 2013



Skills and experience: Nick has significant financial experience in the UK listed environment having served in a number of senior finance positions within a range of sectors. His background and experience enables him to fulfil the role of Audit Committee Chair and, for SEC purposes, the role of Audit Committee Financial Expert. Nick was previously the Group Finance Director of Centrica plc, Finance Director of The Peninsular & Oriental Steam Navigation Company and Chief Financial Officer of P&O Princess Cruises plc. He previously served as a Non-Executive Director and was the Audit Committee Chair of QinetiQ Group plc. He is a Mathematics graduate from the University of Oxford and a Chartered Accountant.

External appointments: Executive Director and Chief Financial Officer of RELX Group.

06 Deborah McWhinney

A Ri

Independent Director

Appointed: December 2015

Skills and experience: Deborah has an extensive executive background in managing technology, operations and new digital innovations across banking, payments and institutional investment. She broadens the Board's diversity from a global market perspective. Deborah is a former Chief Executive Officer, Global Enterprise Payments and President, Personal Banking and Wealth Management at Citibank. She was previously President of Institutional Services at Charles Schwab Corporation and held executive roles at Engage Media Services Group, Visa International and Bank of America, where she held senior roles in Consumer Banking. She holds a BSc in Communications from the University of Montana.

External appointments: Member of the Supervisory Board of Fresenius Medical Care AG & Co. KGaA, Independent Director of Fluor Corporation and IHS Markit Ltd, a Trustee of the California Institute of Technology and of the Institute for Defense Analyses.

KEY

Member of Audit Committee	A
Member of Nomination and Governance Committee	NG
Member of Remuneration Committee	Re
Member of Responsible Business Committee	RB
Member of Risk Committee	Ri
Committee Chairman	●

BOARD OF DIRECTORS KEY

Board of Directors continued

07 Nick Prettejohn

Independent Director and Chairman of Scottish Widows Group

Appointed: June 2014

Skills and experience: Nick has significant financial services experience, particularly in insurance where he has served as Chief Executive of Lloyd's of London and Prudential UK and Europe as well as Chairman of Brit Insurance. He is a former Non-Executive Director of the Prudential Regulation Authority and of Legal & General Group Plc as well as Chairman of the Financial Services Practitioner Panel. He has the knowledge and experience to provide valuable insight and contribute effectively as a Non-Executive Director and Member of the Audit Committee and Risk Committee as well as the governance experience and leadership qualities to chair Scottish Widows Group. Nick has a First Class Degree in Philosophy, Politics and Economics from Balliol College, University of Oxford.

External appointments: Member of the BBC Trust (until 31 March 2017), Chairman of the Britten-Pears Foundation, the Royal Northern College of Music and the Financial Conduct Authority's Financial Advice Working Group.

08 Stuart Sinclair

Independent Director

Appointed: January 2016

Skills and experience: Stuart has extensive experience in retail banking, insurance and consumer finance. He is a former Non-Executive Director of TSB Banking Group plc, TSB Bank plc, LV Group and Virgin Direct. In his executive career, he was President and Chief Operating Officer of Aspen Insurance after spending nine years with General Electric, as Chief Executive Officer of the UK Consumer Finance business then President of GE Capital China. Before that he was Chief Executive Officer of Tesco Personal Finance and Director of UK Retail Banking at the Royal Bank of Scotland. He was a Council member of The Royal Institute for International Affairs (Chatham House). He has an MA in Economics from the University of Aberdeen and an MBA from the University of California.

External Appointments: Non-Executive Director and Chair of the Risk Committee at Provident Financial plc; Senior Independent Director and Chair of Risk at QBE Insurance (Europe) Limited and Senior Independent Director and Chair of Risk at Swinton Group Limited.

09 Anthony Watson CBE

Senior Independent Director

Appointed: April 2009 (Board), May 2012 (Senior Independent Director)

Skills and experience: Tony is our Senior Independent Director and with over 40 years of experience in the investment management industry and related sectors, he is well placed to carry out this role. His former positions include Chief Executive of Hermes Pensions Management and Chairman of the Asian Infrastructure Fund, MEPC, the Marks & Spencer Pension Trustees and of the Strategic Investment Board (Northern Ireland). He is also a former Member of the Financial Reporting Council, a Senior Independent Director of Hammerson and a Non-Executive Director of the Shareholder Executive and Vodafone Group. He has a BSc (Hons) in Economics from Queen's University Belfast, a Diploma in Security Analysis from the New York Institute of Finance and is a Barrister at Law, England and Wales.

External appointments: Senior Independent Director of Witan Investment Trust, Chairman of the Lincoln's Inn Investment Committee and a member of the Norges Bank Investment Management Corporate Governance Advisory Board.

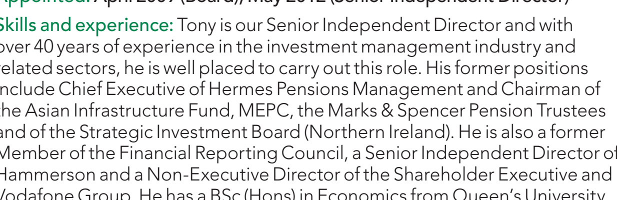
10 Sara Weller CBE

Independent Director

Appointed: February 2012

Skills and experience: With a background in retail and associated sectors, including financial services, Sara brings a broad perspective to the Board. She is a passionate advocate of customers, the community, financial inclusion and the development of digital skills which directly support Lloyds Banking Group's strategy and her role as Chairman of the Responsible Business Committee. Sara has considerable experience of boards at both executive and non-executive level. Her previous appointments include Managing Director of Argos, various senior positions at J Sainsbury including Deputy Managing Director, Lead Non-Executive Director at the Department of Communities and Local Government, a Non-Executive Director of Mitchells & Butlers as well as a number of senior management roles for Abbey National and Mars Confectionery. She has an MA in Chemistry from Oxford University.

External appointments: Non-Executive Director of United Utilities Group and Chair of their Remuneration Committee, a Governing Council Member of Cambridge University, Chairman of the Planning Inspectorate and Board member at the Higher Education Funding Council.



BOARD OF DIRECTORS KEY

03 02 05

13 12 11 04

11 António Horta-Osório
Executive Director and Group Chief Executive
Appointed: January 2011 (Board), March 2011 (Group Chief Executive)

Skills and experience: António brings extensive experience in, and understanding of, both retail and commercial banking. This has been built over a period of more than 30 years, working both internationally as well as in the UK. António's drive, enthusiasm and commitment to customers, along with his proven ability to build and lead strong management teams, brings significant value to all stakeholders of Lloyds Banking Group. Previously he worked for Goldman Sachs, Citibank and held various senior management positions at Grupo Santander before becoming its Executive Vice President. He was a Non-Executive Director of Santander UK and subsequently its Chief Executive. He is also a former Non-Executive Director of the Court of the Bank of England and Governor of the London Business School. António has a Degree in Management & Business Administration from the Universidade Católica Portuguesa, an MBA from INSEAD and has completed the Advanced Management Program at Harvard Business School.

External appointments: Non-Executive Director of EXOR N.V., Fundação Champalimaud and Sociedade Francisco Manuel dos Santos in Portugal, a member of the Board of Stichting INPAR and Chairman of the Wallace Collection.

12 George Culmer
Executive Director and Chief Financial Officer
Appointed: May 2012 (Board)

Skills and experience: George has extensive operational and financial expertise including strategic and financial planning and control. He has worked in financial services in the UK and overseas for over 25 years. George was an Executive Director and Chief Financial Officer of RSA Insurance Group, the former Head of Capital Management of Zurich Financial Services and Chief Financial Officer of its UK operations as well as holding various senior management positions at Prudential. He is a Non-Executive Director of Scottish Widows. George is a Chartered Accountant and has a history degree from the University of Cambridge.

External appointments: None.

13 Juan Colombás
Executive Director and Chief Risk Officer
Appointed: January 2011 (Chief Risk Officer), November 2013 (Board)

Skills and experience: Juan has significant banking and risk management experience, having spent 31 years working in these fields both internationally and in the UK. Juan is responsible for developing the Group's risk framework, recommending its risk appetite and ensuring that all risks generated by the business are measured, reviewed and monitored on an ongoing basis. He was previously the Chief Risk Officer and an Executive Director of Santander's UK business. Prior to this position, he held a number of senior risk, control and business management roles across the Corporate, Investment, Retail and Risk Divisions of the Santander Group. He has served as the Group's Chief Risk Officer and as a member of the Group Executive Committee since January 2011. Juan has a BSc in Industrial Chemical Engineering from the Universidad Politécnica de Madrid, a Financial Management degree from ICADE School of Business and Economics and an MBA from the Institute de Empresa Business School.

External appointments: Vice Chairman of the International Financial Risk Institute.

14 Malcolm Wood
Company Secretary
Appointed: November 2014

Skills and experience: Malcolm was previously General Counsel and Company Secretary of Standard Life after a career as a corporate lawyer in private practice in London and Edinburgh. He has a wealth of experience in governance, policy and regulation. He is a Fellow of the Institute of Chartered Secretaries and Administrators and a Member of the Chartered Institute for Securities and Investment and the GC100.

Directors' biographies can be found at www.lloydsbankinggroup.com/our-group/directors

Group Executive Committee

Delivering our vision and managing a more agile organisation

The depth of diverse experience and complementary skills in our management team strengthens our ability to adjust to changing market environments and deliver our strategy to become the best bank for customers.

01 António Horta-Osório

Executive Director and Group Chief Executive

António joined the Board in January 2011 as an Executive Director and became Group Chief Executive in March 2011. Full biography on page 57.

02 George Culmer

Executive Director and Chief Financial Officer

George joined the Board as an Executive Director in May 2012. Full biography on page 57.

03 Juan Colombás

Executive Director and Chief Risk Officer

Juan joined the Group as Chief Risk Officer in January 2011 and joined the Board as an Executive Director in November 2013. Full biography on page 57.

04 Andrew Bester

Group Director and CEO, Commercial Banking

Andrew joined the Group in 2012 from Standard Chartered Bank where he held a variety of senior roles including Global COO and, later, Chief Financial Officer of Consumer Banking. Previously, Andrew worked at Xchanging Plc and Deutsche Bank and trained as a Chartered Accountant. Andrew sits on the Board of the Global Financial Markets Association (GFMA) and the Advisory Board of the University of Cambridge Programme for Sustainability Leadership and is a member of The Prince of Wales's UK Corporate Leaders' Group. Andrew is Executive Sponsor for Inclusion & Diversity and the Group's Ambassador's programme.

05 Karin Cook

Group Director, Operations

Karin joined the Group in 2013 as Chief Operating Officer, Commercial Banking and became Group Director, Operations in 2015. Karin joined from HSBC where she was Global Chief Operating Officer for Private Banking and previously, Global Head of OTC Derivative Operations. Prior to HSBC, Karin spent nine years at Morgan Stanley in London and five years at Goldman Sachs in Paris, in a variety of Operations and Finance roles. She holds a degree in Modern Languages from Cambridge University. Karin is a Non-Executive Director of Scottish Widows Ltd and is also the Group's Executive Sponsor for Sexual Orientation and Gender Identity.

06 Simon Davies

Chief People, Legal and Strategy Officer

Simon joined the Group in 2016 from Linklaters LLP where he was Firmwide Managing Partner, a position he held from January 2008. Prior to this, Simon spent 12 years in Asia, specialising in M&A and securities advice, serving terms in each of Hong Kong and Tokyo and was Managing Partner for Asia from 2003-2007. He is a Solicitor of the High Court of the Hong Kong Special Administrative Region, as well as a Solicitor of the Senior Courts of England and Wales. Simon joined Linklaters in London in 1990, having studied at Emmanuel College, Cambridge. Simon is Group Executive sponsor for Ethnicity. He is also a member of TheCityUK China Market Advisory Group and a trustee of the National Youth Theatre of Great Britain.

07 Antonio Lorenzo

Chief Executive, Scottish Widows and Group Director, Insurance

Antonio joined the Group in 2011 as head of the Wealth and International division and Group Corporate Development, leading a strategic review and subsequent programme of reducing non-core assets and exiting international locations. From 2013, he assumed the role of Group Director, Consumer Finance & Group Corporate Development, leading the division's growth strategy whilst completing the sale of TSB, before being appointed as Chief Executive, Scottish Widows and Group Director, Insurance. Antonio is also Group Executive Sponsor for Emerging Talent.

Antonio joined the Group from Santander, where he had worked in a number of different leadership roles and jurisdictions since 1998. He was part of the management team that completed the take-overs of Abbey National in 2004 then Bradford & Bingley and Alliance & Leicester in 2008, and was Chief Financial Officer of Santander UK. Before Santander, Antonio spent over nine years at Arthur Andersen.

08 Vim Maru
Group Director, Customer Products and Marketing
Vim is the Group Director for the Customer Products and Marketing division responsible for Retail customer products and all marketing across Lloyds Banking Group. Vim joined the Group in June 2011 as Managing Director, Customer Products, responsible for Retail product design and management across all of the Group's brands. He was appointed to the Group Executive Committee in August 2013. Vim is a non-executive member of the Group's Insurance Board. Previously Vim worked for over 12 years at Santander, in a range of roles in Corporate Strategy, Mergers & Acquisitions, the Life Division and most recently held the position of Director, Retail Products. Vim holds an Economics degree from the London School of Economics and is a member of the Institute of Chartered Accountants.

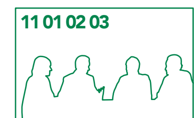
09 Zaka Mian
Group Director, Digital and Transformation
Zak joined the Group in 1989 as a Business Analyst in IT. He was appointed Group Director, Digital and Transformation in 2016 and is responsible for the Group-wide digital business across Retail, Consumer Finance, Insurance and Commercial divisions, and the associated Transformation programmes. Before his current role, Zak led the Digital Transformation programme for a number of years and was also Retail CIO and head of IT architecture. Zak has a computer science degree from York University.

10 David Oldfield
Group Director, Retail and Consumer Finance
David was appointed in June 2015 as Group Director for the Retail division responsible for the retail branch network across Lloyds, Halifax and Bank of Scotland brands, along with UK Wealth and Business Banking. Additionally, in February 2016, David assumed responsibility for the Consumer Finance division. David started his career with Lloyds Bank 32 years ago on the graduate entrant programme and has held a number of key leadership roles across all divisions of the Group since that time. Immediately prior to this role he was appointed to the Group Executive Committee in May 2014 as Group Director, Operations. David is a Fellow of the Chartered Institute of Bankers. He is also Group Executive Sponsor for Disability.

11 Janet Pope
Chief of Staff (GEC attendee)
Janet joined the Group in 2008 to run the Savings business. She was previously Chief Executive at Alliance Trust Savings, prior to which she was EVP Global Strategy at Visa International. Janet spent 10 years at Standard Chartered Bank where she held a variety of roles including Retail Banking MD for Africa and non-executive directorships at Standard Chartered Bank Zimbabwe, Kenya, Zambia and Botswana. Janet has held non-executive positions on the audit committees of the Department for Communities and Local Government, The Rent Service (Department for Work and Pensions) and the Office of the Deputy Prime Minister. Janet studied at the London School of Economics. She has a Master's degree in Economics and holds an MBA from Cass Business School.

12 Matthew Young
Group Corporate Affairs Director
Matt joined the Group as Corporate Affairs Director in 2011. Prior to Lloyds, he was Communications Director at Santander during a period when the bank made a successful entry into the UK market following the acquisition and subsequent rebranding of Abbey National, Alliance & Leicester, and Bradford & Bingley. Matt joined Santander from NatWest in 1999 where he held a number of senior communications roles. Matt has a degree in Political Science and a postgraduate certificate in Education. He is a Board member of the British Bankers Association, a member of the PR Guild, and a former trustee of the Prince of Wales sponsored charity, In Kind Direct.

GROUP EXECUTIVE COMMITTEE KEY



Corporate governance report

This report sets out our approach to governance in practice, the work of the Board and its committees and explains how the Group applied the principles of the UK Corporate Governance Code (the Code) during 2016

LEADERSHIP

The Board

The Group is led by an effective, committed and unitary Board, which is collectively responsible for the long-term success of the Company. The Board comprises a Chairman (who was independent on appointment), independent Non-Executive Directors and Executive Directors. The names and biographies of current Directors are set out on pages 54 to 57.

There is a clear division of responsibility at the head of the Company, which is documented in the Group's Corporate Governance Framework. The Chairman has overall responsibility for the leadership of the Board and for ensuring its effectiveness while the Group Chief Executive manages and leads the business.

The Corporate Governance Framework, which is reviewed annually by the Board, sets out a number of key decisions and matters that are reserved for the Board's approval.

The Board sets the strategy, oversees its delivery and establishes the culture, values and standards of the Group.

The Board ensures that the Group manages risk effectively, monitors financial performance and reporting and ensures that appropriate and effective succession planning arrangements and remuneration policies are in place. It provides and encourages entrepreneurial leadership across the Group within this framework.

Key roles and responsibilities

Chairman

Lord Blackwell

Lord Blackwell leads the Board and promotes the highest standards of corporate governance. He sets the Board's agenda and builds an effective and complementary Board. The Chairman leads Board succession planning and ensures effective communication with shareholders.

Senior Independent Director

Anthony Watson

As the Senior Independent Director, Anthony Watson is a sounding board for the Chairman and Group Chief Executive. He acts as a conduit for the views of other Non-Executive Directors and conducts the Chairman's annual performance appraisal. He is available to help resolve shareholders' concerns and attend meetings with major shareholders and financial analysts to understand issues and concerns.

Group Chief Executive

António Horta-Osório

António Horta-Osório manages the Group on a day-to-day basis and makes decisions on matters affecting the operation, performance and strategy of the Group's business. He delegates aspects of his own authority, as permitted under the Corporate Governance Framework, to members of the Group Executive Committee (GEC). He provides leadership and direction to senior management and coordinates all activities to implement the strategy and for managing the business in accordance with the Group's risk appetite and business plan set by the Board.

Deputy Chairman

Anita Frew

Anita Frew as Deputy Chairman ensures continuity of Chairmanship during any change of chairmanship. She supports the Chairman in representing the Board and acting as a spokesperson. She deputises for the Chairman and is available to the Board for consultation and advice. The Deputy Chairman represents the Group's interests to official enquiries and review bodies.

Non-Executive Directors

Alan Dickinson, Simon Henry, Nick Luff, Deborah McWhinney, Nick Prettejohn, Stuart Sinclair, Sara Weller

The Non-Executive Directors challenge constructively and help develop and set the Group's strategy. They actively participate in Board decision making and scrutinise management performance. The Non-Executive Directors satisfy themselves on the integrity of financial information and review the Group's risk exposures and controls. The Non-Executive Directors, through the Remuneration Committee, determine the remuneration of Executive Directors.

Executive Directors

Juan Colombás, George Culmer

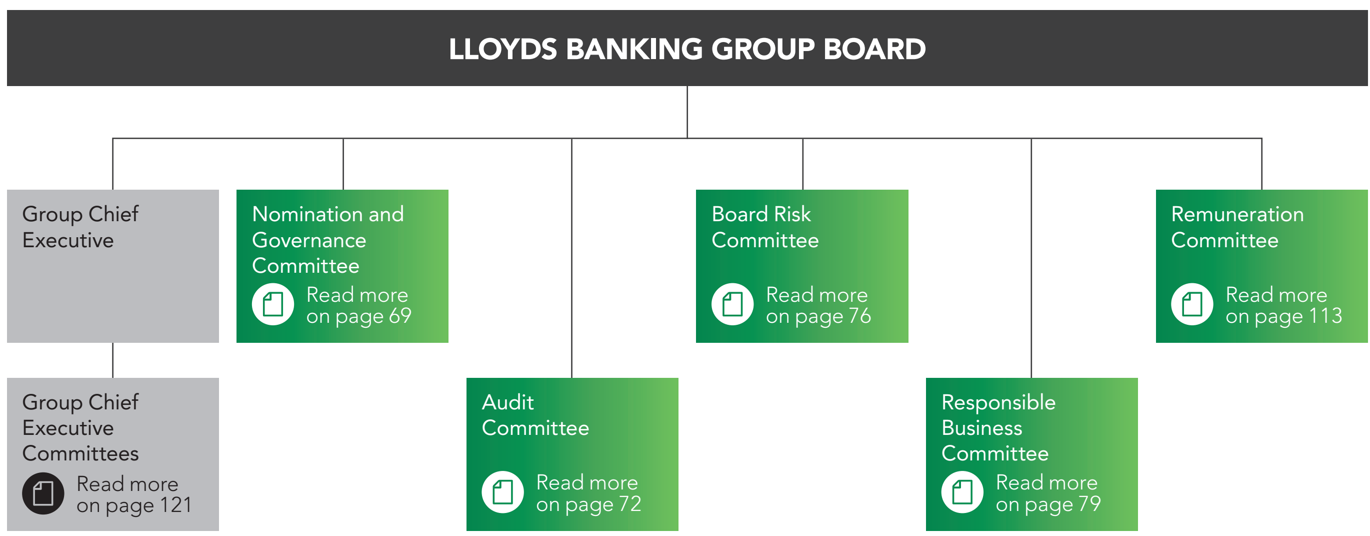
Under the leadership of the Group Chief Executive, the Executive Directors make and implement decisions in all matters affecting operations, performance and strategy. They provide specialist knowledge and experience to the Board. They are responsible for the successful leadership and management of the Risk and Finance divisions respectively. The Executive Directors design, develop and implement strategic plans and deal with day-to-day operations of the Group.

Company Secretary

Malcolm Wood

The Company Secretary advises the Board and ensures good information flows and comprehensive practical support are provided to Directors. He maintains the Group's Corporate Governance Framework and organises Directors' induction and training. The Company Secretary communicates with shareholders as appropriate and ensures due regard is paid to their interests. Both the appointment and removal of the Company Secretary is a matter for the Board as a whole.

BOARD AND GOVERNANCE STRUCTURE



A full schedule of all matters reserved to the Board and Terms of Reference for each of the Board Committees can be found at www.lloydsbankinggroup.com/our-group/corporate-governance

Board Committees

The Board is supported by its Committees which make recommendations on matters delegated to them under the Corporate Governance Framework, in particular in relation to internal control, risk, financial reporting, governance and remuneration matters.

This enables the Board to spend a greater proportion of its time on strategic, forward looking agenda items. Each Committee comprises Non-Executive Directors only and is chaired by an experienced Chairman. The Committee Chairmen report to the Board on the activities of the Committee at each Board meeting.

The Board recognises that governance must be dynamic and evolve to meet current and future demands. Therefore, in 2016 two further sub-committees of the Board Risk Committee were established to focus on Financial Markets and IT Resilience & Cyber, in addition to an existing Stress Testing & Recovery Planning sub-committee. The sub-committees were constituted to enable members of the Board Risk Committee to dedicate additional time and resource to better understand and to enable fuller review and challenge of the risks associated with the topic of the sub-committee. Current direct Board level oversight of these activities through regular updates and annual review continues unchanged.

Additionally, a Cyber Security Advisory Panel was established to bring an industry perspective and allow for discussion of the key cyber related activities and threats.

The Board in 2016

Non-Executive Directors see attendance at Board and Committee meetings as only one part of their role. In addition to the annual schedule of Board and Committee meetings, the Non-Executive Directors undertake a full programme of activities each year, as set out on page 64.

Non-Executive Directors regularly meet with senior management and spend time increasing their understanding of the business through site visits, formal briefing sessions or more informal events including breakfast meetings with senior staff, which the Chief People, Legal and Strategy Officer also attends. Board dinners are held prior to each scheduled Board meeting. This allows the Directors greater time to discuss their views, ensuring that there is sufficient time for the Board to discuss matters of a material nature at Board meetings. Some of these pre meetings are for Non-Executive Directors only, some also include the Group Chief Executive and others the full Board and GEC members. At least once a year, a meeting is held without the Chairman in attendance.

Prior to the AGM in Scotland the Board held a joint discussion with the Board of Scottish Widows Group Limited allowing in-depth focus on insurance matters.

Attendance at Board meetings in 2016

	Eligible to attend[1]	Attended
Directors who served during 2016		
António Horta-Osório	9	9
Lord Blackwell	9	9
Juan Colombás	9	9
George Culmer	9	9
Alan Dickinson	9	9
Anita Frew	9	9
Simon Henry[2]	9	8
Nick Luff	9	9
Deborah McWhinney	9	9
Nick Prettejohn[3]	9	8
Stuart Sinclair[4]	9	9
Anthony Watson	9	9
Sara Weller	9	9
Former directors who served during 2016		
Dyfrig John[5]	4	4

1 The attendance of Directors at Committee meetings is displayed within the individual Committee reports found on pages 69 to 80 and for the Remuneration Committee on page 113. Whilst all Non-Executive Directors are, where appropriate, invited to and regularly attend other Committee meetings, only their attendance at Committees of which they are members is recorded.
2 Mr Henry was unable to join the July Board meeting due to the second quarter 2016 results announcement for Royal Dutch Shell plc, of which he is Chief Financial Officer, being presented on the same day.
3 Mr Prettejohn was unable to join the June Board meeting due to a prior commitment.
4 Joined the Board on 4 January 2016.
5 Retired on 11 May 2016.

Corporate governance report continued

How Board meetings are run

The Chairman ensures Board meetings are structured to facilitate open discussion, debate and challenge. Through his opening remarks, the Chairman sets the focus of each meeting.

In the rare event of a Director being unable to attend a meeting, the Chairman discusses the matters proposed with the Director concerned, seeking their support and or feedback accordingly. The Chairman subsequently represents those views at the meeting.

Directors are sent papers for the Board meeting typically seven days in advance of the meeting in order that they may have the time to consider the proposals put forward and seek clarification or further information as required. The Board makes full use of technology such as video conferencing, teleconferencing, a Board portal and tablets in its meeting arrangements. This leads to greater flexibility, security and efficiency in Board paper distribution.

Ensuring the right focus to deliver the Group's strategy

The Board recognises the need to be adaptable and flexible to respond to changing circumstances and emerging business priorities, whilst ensuring the continuing monitoring and oversight of core issues.

The Group has a comprehensive and continuous agenda setting and escalation process in place for ensuring the Board has the right information at the right time and in the right format to enable the Directors to make the right decisions. The Chairman leads the process, assisted by the Group Chief Executive and Company Secretary. The process ensures that sufficient time is being set aside for strategic discussions and business critical items.

The process of escalating issues and agenda setting is reviewed at least annually as part of the Board Effectiveness Review with enhancements made to the process, where necessary, to ensure it remains effective.

The Non-Executive Directors also receive regular updates from the Group Chief Executive's office including a weekly email which gives context to current issues. In-depth and background materials are regularly provided via a reading room on the Board portal.

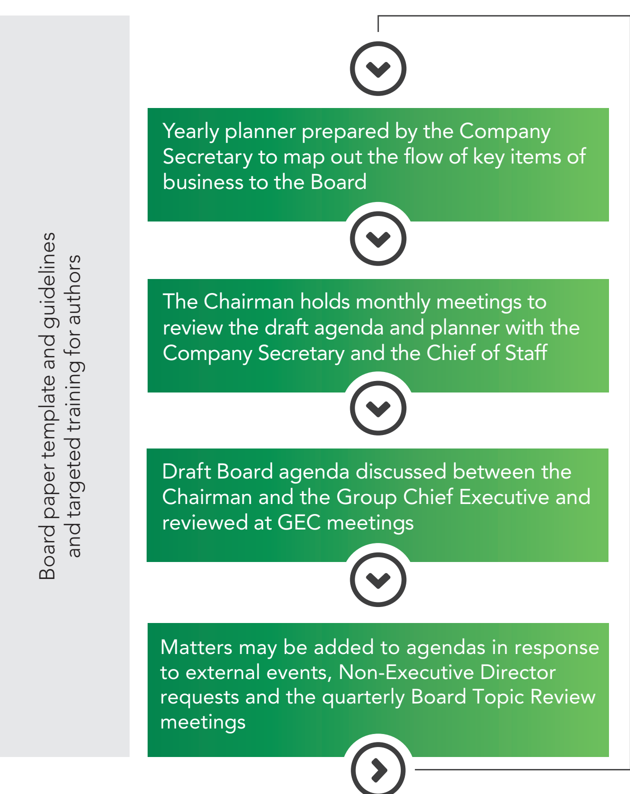
Senior Managers and Certification Regime

Last year, the Corporate Governance Framework was reviewed in preparation for the introduction in March 2016 of the Senior Managers and Certification Regime (SM&CR) and, as relevant to the Scottish Widows Group, the Senior Insurance Managers Regime.

The review, which was part of a wider range of initiatives undertaken to prepare the Group for the introduction of SM&CR, found that the framework was generally aligned with the requirements of the SM&CR but a number of changes were recommended.

These included amendments to the statements of responsibilities of the Directors and members of the GEC and minor amendments to the terms of reference of a number of Board and Group Chief Executive Committees.

AGENDA SETTING PROCESS



PROCESS FOR ESCALATING ISSUES

Board and Committee agendas and topics

Corporate Governance Framework imposes clear responsibility on GEC members to escalate matters	Time allocated at each GEC meeting to consider whether any matters require escalation	Quarterly Board Topic Review meetings led by the Chairman

Board oversight: MBNA acquisition

In December 2016 the Group announced that it had agreed to acquire MBNA, a UK consumer credit card business, from Bank of America. This is a significant strategic step which reinforces the Group's ability to deliver sustainable growth whilst helping Britain prosper and will enhance the Group's position and offering in the UK prime credit card market. The transaction is expected to complete by the end of the first half of 2017, subject to the receipt of competition and regulatory approval.

The Board considered the opportunity at a number of meetings during 2016 and spent considerable time at each meeting discussing and reviewing the acquisition and approving next steps. As part of its oversight role, the Board challenged and scrutinised the rationale for the acquisition and received detailed progress updates and papers. Key issues considered by the Board in reaching the decision to approve the acquisition included: strategic context; funding options; financial effects; due diligence findings; cost synergies; risks; and their impact on the Group.

BOARD FOCUS IN 2016

Financial
- Budget for 2016
- Group operating plan
- Draft results and presentation to analysts
- Approval of dividends
- Funding and Liquidity plan
- Capital plan

Strategy
- Review of progress in implementing the Group's 2015-17 strategy
- Approval of large transactions
- MBNA acquisition
- EU referendum outcome
- Review of future environment and business model

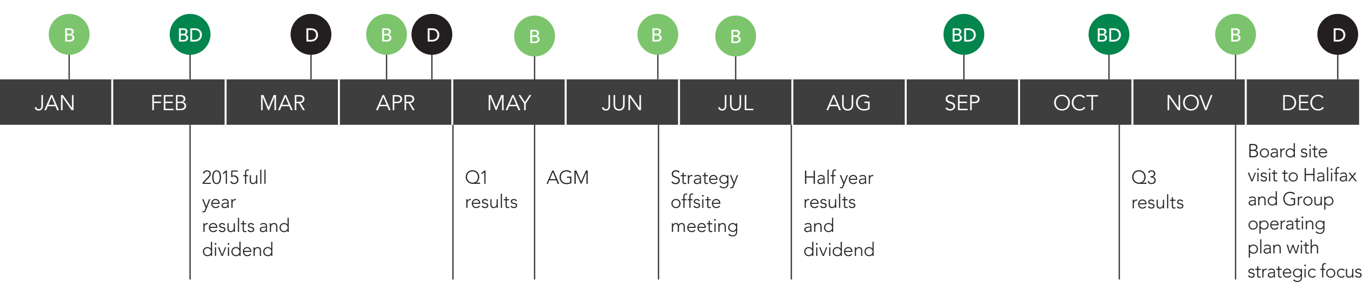
Culture and values
- Customer performance dashboard
- Conduct, culture and values
- Responsible Business report
- Helping Britain Prosper Plan

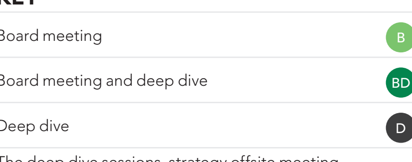
Governance and shareholders
- Board effectiveness and Chairman's performance reviews
- Board Diversity Policy
- Review of Corporate Governance Framework
- Investor Relations updates
- AGM briefing
- In the first half of 2016, preparation for proposed public offering of shares in the Company by HM Treasury

Regulatory
- Ring-fencing and resolution
- SM&CR updates
- Regulatory updates
- Whistleblowing updates

Risk management
- Approval of Group risk appetite
- Approval of Risk Management Framework
- Review of internal control systems
- Review and approval of PRA and EBA stress testing results
- CMA market review into retail banking services
- IT resilience and cyber security

BOARD MEETINGS AND ACTIVITY IN 2016





The deep dive sessions, strategy offsite meeting and site visit to Halifax are described on page 64

Corporate governance report continued

BOARD ACTIVITIES IN 2016 – SUPPORTING DELIVERY OF THE GROUP'S STRATEGIC PRIORITIES

Deep dives

The Board regularly takes the opportunity to hold 'deep dive' sessions with senior management outside of formal Board meetings.

The purpose of the sessions is to provide the Board with deeper insight into key areas of strategic focus. The sessions are structured to allow for plenty of opportunity for discussion and include presentations and videos.

In 2016 'deep dive' sessions were held on the following topics:

– Commercial Banking
– Customer perspective
– Data infrastructure and information security
– Consumer Finance
– Customer segmentation
– Retail product pricing

Board strategy offsite

The Board sets aside time each year outside of the annual Board calendar to hold a strategy offsite giving the Directors the opportunity to solely focus on strategic issues.

This year the Board and the GEC held a two day offsite in June to discuss the strategic challenges and opportunities the Group faces in the future, based on four scenarios for how banking could evolve over the next ten years. The offsite enabled the Board to take a view of the longer-term outlook for the Group. The Board debated the transformation required to be 'Bank of the Future' in order to underpin continued competitive success. This will provide the backdrop to the next phase of strategic development, on which the Group will report later in 2017.

The agenda included case studies from banking and other industries, and presentations from senior management and smaller break-out sessions on specific topics.

The offsite concluded with a group discussion leveraging the broad range of experience and perspectives from across the Board.

Creating the best customer experience

Becoming simpler and more efficient

Delivering sustainable growth

Board visit to Halifax

Over two days in November the Board visited the Group's Halifax offices. In addition to the Board and Committee meetings, a separate strategy meeting, attended by GEC members, was held reviewing the Group operating plan. During the visit, the Chairman and several Non-Executive Directors, spent half a day with some of the c.3,000 colleagues based in Halifax. The visit included a walk through the Mortgage Transformation lab to learn about the improvements being made to the customer mortgage journey.

The Chairman and Non-Executive Directors also spent time with the Banking Complaints Team, where they followed a complaint through to its outcome and joined a 'huddle' discussing how Financial Ombudsmen Service learnings could be used to ensure fair customer outcomes in the future.

Chairman's engagement programme

The Chairman undertakes an extensive engagement programme each year representing the Group at industry events, acting as a spokesperson for the Group and meeting with clients, regulators, investors, the media, the Foundations and their beneficiaries.

The programme includes visits to regional offices, branches, IT and operations centres, where the Chairman meets local management and colleagues through meetings, floor walks, team talks and Town Hall sessions.

The Town Hall sessions are an opportunity for colleagues to hear from the Chairman on the Group's performance and strategic direction, and importantly, to ask questions. These events are very popular and are always well attended.

Showing support for customers and the community

In September, Lord Blackwell spent two days in Aberdeen where he met with more than 100 business customers. During his visit, he delivered the keynote speech at a dinner for customers and local influencers, emphasising the Group's vital role in helping Britain prosper and the importance of building long-term customer relationships. At a breakfast for Mid Markets clients and local business leaders, he outlined his views on the economy and the importance of supporting local businesses.

Lord Blackwell also found time to host a Town Hall and Q&A session for colleagues at the Group's Albyn Place office. His final stop was an inspiring visit to Fly Cup Catering in Inverurie, a charity funded by the Bank of Scotland Foundation which provides catering training, employment experience and placements for adults with learning difficulties.

Speaking about the visit, he said: 'I came away enthused by the commitment and enthusiasm of everyone I met, and by the general sense of cautious optimism from our commercial clients and relationship managers. It is extremely helpful to me to hear these perspectives first hand and to meet more of our tremendous colleagues.'

EFFECTIVENESS

Board induction

The Chairman personally ensures that on appointment each Director receives a full, formal and tailored induction. The emphasis is on ensuring the induction brings the business and its issues alive for the new Director, taking account of the specific role they have been appointed to fulfil and the skills/experience of the Director to date.

Directors who take on or change roles during the year attend induction meetings in respect of those new roles.

An outline of the induction programme is set out opposite and Deborah McWhinney and Stuart Sinclair share their experiences on joining the Board on page 71.

Professional development and training

The Chairman leads the learning and development of Directors and the Board generally and regularly reviews and agrees with each Director their training and development needs.

Ample opportunities, support and resources for learning are provided through a comprehensive programme, which is in place throughout the year comprising both formal and informal training and information sessions.

The Company Secretary maintains a training and development log for each Director.

Time commitments

Non-Executive Directors are required to devote such time as is necessary for the effective discharge of their duties. The estimated minimum time commitment set out in the terms of appointment is 35-40 days per annum including attendance at Committee meetings. For Committee Chairmen and the Senior Independent Director, this increases to a minimum of 45 to 50 days. As described elsewhere , the time devoted on the Group's business by the Non-Executive Directors is in reality considerably more than the minimum requirements.

Executive Directors are restricted to taking no more than one non-executive director role in a FTSE 100 company and may not take on the chairmanship of such a company. The Chairman is committed to this being his primary role, limiting his other commitments to ensure he can spend as much time as the role requires. In February 2016, the Chairman retired as Chairman of Interserve plc. The Chairman's biography can be found on page 54.

Conflicts of interest

The Board has a comprehensive procedure for reviewing and, as permitted by the Companies Act 2016 and the Company's articles of association, approving actual and potential conflicts of interests.

Directors have a continuing duty to notify the Chairman and Company Secretary as soon as they become aware of actual or potential conflict situations. Changes to the commitments of all Directors are reported to the Nomination and Governance Committee and the Board and a register of potential conflicts and time commitments is regularly reviewed and authorised by the Board to ensure the authorisation status remains appropriate.

Stuart Sinclair is Senior Independent Director at both QBE Insurance (Europe) Limited, a general insurance and reinsurance company, and Swinton Group Limited, an insurance broker for home and motor insurance. The Board has recognised that potential conflicts may arise in relation to his position at QBE Insurance and in relation to Swinton Group. The Board has authorised the potential conflicts and requires Mr Sinclair to recuse himself from discussions, should the need arise.

Access to advice

The Group provides access, at its expense, to the services of independent professional advisers in order to assist Directors in their role. Board Committees are also provided with sufficient resources to undertake their duties. All Directors, including Non-Executive Directors, have access to the services of the Company Secretary in relation to the discharge of their duties.

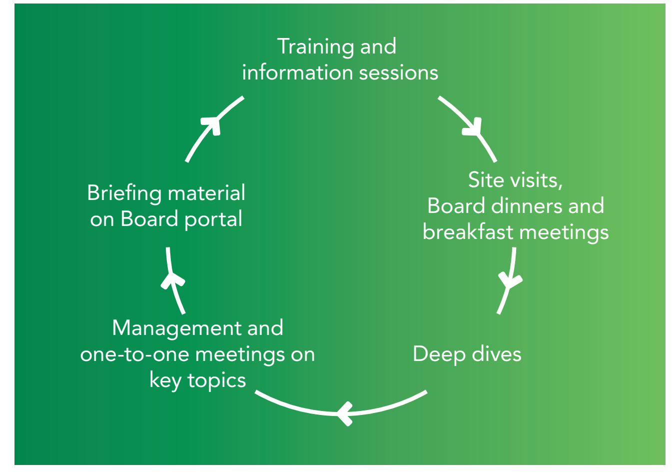
BOARD INDUCTION PROGRAMME

Core programme	– Strategic and corporate induction – Governance and Director responsibilities – Senior Managers and Certification Regime – Detailed risk induction programme – Detailed briefings on each of the Group's business divisions – Branch and site visits – Opportunity to meet with major shareholders as requested
One-to-one briefings	– Chairman – Company Secretary – Executive Directors – GEC members – Group Audit Director – Senior executives from across the Group
Bespoke programme	– The Chairman personally ensures a new Director receives a tailored induction. – Specific briefings are provided on the Committees on which the new Director will serve.

Briefing and reading materials

Briefing and reading materials are made available on the Board portal.

PROFESSIONAL DEVELOPMENT AND TRAINING PROGRAMME AT A GLANCE



Corporate governance report continued

Board effectiveness

The Chairman of the Board leads the annual review of the Board's effectiveness and that of its Committees and individual Directors with the support of the Nomination and Governance Committee, which he also chairs. The annual evaluation is facilitated externally at least once every three years.

2016 evaluation of the Board's performance

The 2016 evaluation was conducted internally between November 2016 and December 2016 by the Company Secretary, and was overseen by the Nomination and Governance Committee.

The 2016 review sought the Directors' views on a range of topics including: strategy; planning and performance; risk and control; Board composition and size; balance of skills and experience; diversity; culture and dynamics; the Board's calendar and agenda; the quality and timeliness of information; and support for Directors and Committees.

If Directors have concerns about the Company or a proposed action which cannot be resolved, it is recorded in the Board minutes. Also on resignation, Non-Executive Directors are encouraged to provide a written statement of any concerns to the Chairman, for circulation to the Board. No such concerns were raised in 2016 and up to the date of this report.

Anthony Watson, Senior Independent Director, is due to retire at the 2017 AGM. At the time of the 2017 AGM, he will have served on the Board for more than eight years and therefore, in compliance with the Code, his review was particularly rigorous.

Outcome of 2016 Board effectiveness review

The reviews concluded that the performance of the Board, its Committees, the Chairman and each of the Directors continues to be effective. All Directors demonstrated commitment to their roles.

Many Directors commented favourably on the performance of the Board as a whole, describing it as hardworking, collegiate, questioning and highly engaged. Developments during 2016, including the continued use of deep dives, the establishment of sub-committees of the Board Risk Committee and the Cyber Security Advisory Panel have generally been welcomed and Directors have commented on the high quality of debate within the Board. Highlights mentioned by several Directors were the strategy offsite in June and governance of the acquisition of the MBNA UK consumer credit card business, where the Board was highly engaged in oversight and challenge of the acquisition process. Directors also spoke highly of the work done by the Chairman and the Chairs of the Committees in structuring agendas and ensuring that business is covered at the meetings.

2016 EVALUATION PROCESS

Step	Description
Step 1	Detailed questionnaire completed by each Director
Step 2	Individual meetings held between each Director and the Company Secretary
Step 3	Evaluation of the findings by the Company Secretary and report prepared
Step 4	Draft conclusions discussed by the Company Secretary with the Chairman
Step 5	Discussion of the Company Secretary's report and draft conclusions and actions agreed

Chairman's evaluation

The Senior Independent Director carried out the evaluation of the Chairman's performance using a questionnaire and individual meetings with Directors other than the Chairman. The outcome of the evaluation of the Chairman's performance was discussed by the Directors in the absence of the Chairman.

Recommendations from the 2016 Board effectiveness review (internal)

The review identified a number of actions to maintain and improve the Board's effectiveness.

Volume of Board/Committee papers

The most common observation by Directors concerned the volume of information which they received. Directors would like to receive more concise reports with clearer signposting of the key issues.

Links to strategy

Several Directors said they would welcome more frequent linkage to strategy in the regular business of the Board.

Conduct of Board/Committees

Several Directors said that they would value more time in agendas for discussion, while recognising the pressures on meeting time.

2015 Board effectiveness review (external)

In accordance with the three year cycle, the 2015 evaluation was facilitated externally by JCA Group between October 2015 and January 2016. The review was commissioned by the Chairman, assisted by the Company Secretary and overseen by the Nomination and Governance Committee. A summary of the Board's progress against the actions arising from the 2015 effectiveness review are set out below.

Recommendations	Actions taken/progress
Strategy	
– Continue to focus on strategy, with particular attention to the longer term horizon and the impact of the changing technology and competitive landscape	– 2016 strategy offsite focused on reviewing future environment and business model – Regular Board deep dives and discussion topics related to digital disruption and strategic development held during the year
Succession planning	
– Maintain a proactive approach to succession planning for Executive and Non-Executive Directors and for senior management	– Non-Executive Director discussion on Executive succession carried out – Non-Executive Directors are informed about and able to input on Group Chief Executive succession planning – Chairman and Nomination and Governance Committee continued to review Non-Executive Director profile and succession
Board information	
– Continue the progress made in 2015 in ensuring that information provided to the Board and its Committees is clear, concise, relevant and focused – Review and continue to evolve metrics used to assess business performance to ensure that they provide an appropriate level of detail and insight for the Board	– Continued progress on reducing unnecessary material and presentations – Revised Board template and guidance in place – Regular reporting on business performance has continued to develop in response to Board feedback

INTERNAL CONTROL

Board responsibility

The Board is responsible for the Group's risk management and internal control systems, which are designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. The Directors and senior management are committed to maintaining a robust control framework as the foundation for the delivery of effective risk management. The Directors acknowledge their responsibilities in relation to the Group's risk management and internal control systems and for reviewing their effectiveness.

In establishing and reviewing the risk management and internal control systems, the Directors carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency or liquidity, the likelihood of a risk event occurring and the costs of control. The process for identification, evaluation and management of the principal risks faced by the Group is integrated into the Group's overall framework for risk governance. The Group is forward-looking in its risk identification processes to ensure emerging risks are identified. The risk identification, evaluation and management process also identifies whether the controls in place result in an acceptable level of risk. At Group level, a consolidated risk report and risk appetite dashboard are reviewed and regularly debated by the Group Risk Committee, Board Risk Committee and the Board to ensure that they are satisfied with the overall risk profile, risk accountabilities and mitigating actions. The report and dashboard provide a monthly view of the Group's overall risk profile, key risks and management actions, together with performance against risk appetite and an assessment of emerging risks which could affect the Group's performance over the life of the operating plan. Information regarding the main features of the internal control and risk management systems in relation to the financial reporting process is provided within the risk management report on pages 116 to 169. The Board concluded that the Group's risk management arrangements are adequate to provide assurance that the risk management systems put in place are suitable with regard to the Group's profile and strategy.

Control effectiveness review

An annual control effectiveness review (CER) is undertaken to evaluate the effectiveness of the Group's control framework with regard to its material risks, and to ensure management actions are in place to address key gaps or weaknesses in the control framework. Business areas and head office functions assess the controls in place to address all material risk exposures across all risk types. The CER considers all material controls, including financial, operational and compliance controls. Senior management complete an attestation to confirm the CER findings which are reviewed and independently challenged by the Risk Division and Group Audit and reported to the Board. Action plans are implemented to address any control deficiencies.

Reviews by the Board

The effectiveness of the risk management and internal control systems is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by the Risk Division and Group Audit. The Audit Committee receives reports from the Company's auditor, PricewaterhouseCoopers LLP (which include details of significant internal control matters that they have identified), and has a discussion with the auditor at least once a year without executives present, to ensure that there are no unresolved issues of concern.

The Group's risk management and internal control systems are regularly reviewed by the Board and are consistent with the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting issued by the Financial Reporting Council and compliant with the requirements of CRD IV. They have been in place for the year under review and up to the date of the approval of the annual report. The Group has determined a pathway to compliance with BCBS 239 risk data aggregation and risk reporting requirements and continues to actively manage enhancements.

Conclusion

Our Controls Frameworks are continuously improved and enhanced, addressing known issues and keeping pace with the dynamic environment. Progress continues to be made in IT, Cyber, and Financial Crime. The 2016 CER assessment provides reasonable assurance that the Group's controls are effective or that where control weaknesses are identified, they are subject to management oversight and action plans. The Audit Committee, in conjunction with the Board Risk Committee, concluded that the assessment process was effective and recommended them to the Board for approval.

REMUNERATION

The statement by the Chairman of the Remuneration Committee, the Directors' Remuneration policy and the Directors' Remuneration Implementation Report are set out on pages 84 to 114.

Spotlight on subsidiary governance

The Group conducts the majority of its business through a number of subsidiary entities. The Corporate Governance Framework sets out minimum governance standards and a subsidiary directors' handbook sets out detailed guidance on the role and responsibilities of a subsidiary director.

An annual certification process, at individual entity level, of compliance with the minimum governance standards set out in the Corporate Governance Framework enhances management of any legal, regulatory and reputational risks associated with the Group's subsidiary entities. The process provides GEC members with additional oversight of subsidiary entities within their respective business area, including an escalation process for any matters of non-compliance. In addition, the process provides continued focus on simplification of the Group's legal entity structure through consideration of the lifecycle of each entity.

Scottish Widows Group Limited

The Board of the Group's insurance subsidiary, Scottish Widows Group Limited, which also sits as the Board of its major subsidiaries, is chaired by a Non-Executive member of the Lloyds Banking Group Board and contains a balance of independent Non-Executive Directors, Group executives (serving as Non-Executives) and Insurance Division executives. This composition supports its legal and regulatory requirements for independent decision making within the overall framework of Group policies and controls.

Corporate governance report continued

SHAREHOLDER RELATIONSHIPS

The Board recognises and values greatly the need to deliver a programme of engagement that offers all shareholders the opportunity to receive Company communications and to share their views with the Board.

The Group has a diverse range of shareholders and investors with different communication and engagement needs which are addressed by specialist teams.

The Group's website enables access to documents and communications as soon as they are published, including a live webcast of the AGM. Recordings of webcasts and other analyst presentations are also available.

Relationships with institutional investors

Investor Relations has primary responsibility for managing and developing the Group's external relationships with existing and potential institutional equity investors and analysts. With support from senior management, they achieved this through a combination of more than 1,100 meetings and various presentations in 2016. The presentations were primarily aligned to results and included content on strategic progress and financial and operational performance.

In addition to this direct shareholder engagement, Investor Relations provides regular reports to the executive team and Board on key market issues and shareholder concerns.

Corporate governance meeting with institutional shareholders

In October 2016, the Chairman hosted a meeting with a number of large institutional shareholders focused on the Group's corporate governance arrangements. Following an overview from the Chairman on the Group's strategy and culture and Board governance, the shareholders heard from each of the Chairmen of the Audit, Board Risk, Remuneration and Responsible Business Committees and the Senior Independent Director. The meeting was also attended by the Company Secretary and the Group Investor Relations Director. The meeting was structured to allow for an open dialogue and discussion on the matters of importance to institutional shareholders. Those in attendance were especially interested in hearing about the Group's approach to becoming a more responsible business.

Governance and executive remuneration

Lord Blackwell (Chairman and Chairman of the Nomination and Governance Committee) and Anita Frew (Deputy Chairman and Chairman of the Remuneration Committee) participated in meetings and discussions with investors and other stakeholders, including the Group's regulators, regarding governance and the strategic direction of the Group. They also engaged with proxy advisors, regulators and shareholders on issues relating specifically to executive remuneration.

Relationships with retail shareholders

The Company Secretary has a team dedicated to engage with retail shareholders who, with support from the Company's registrar Equiniti Limited, deliver the Group's shareholder service strategy, including the AGM. Group Secretariat provides feedback to the Board and appropriate Committees to ensure the views of retail shareholders are received and considered. Important shareholder information, including details on the arrangements for the 2017 AGM, can be found on pages 286 and 287.

Annual General Meeting 2016 at a glance

The AGM is an opportunity for shareholders to hear directly from the Board on the Group's performance and strategic direction, and importantly, to ask questions.

- nearly 200 shareholders represented
- over 70 per cent of total voting rights voted
- over 97 per cent of votes cast 'in favour' of the Directors' Remuneration Report
- all resolutions voted on by way of a poll

2016 RELATIONSHIP PROGRAMME

JANUARY TO MARCH

Preliminary results

Analyst briefings

Mailing of Annual Report and Accounts, which includes an update from the Group Chief Executive

Notice of AGM and voting materials

APRIL TO JUNE

Q1 interim management statement

Annual General Meeting

JULY TO SEPTEMBER

Half year results

Analyst briefings

Group Chief Executive half-year update to shareholders

OCTOBER TO DECEMBER

Q3 interim management statement

Corporate governance meeting with institutional shareholders

A summary of the reports and communications to be issued in 2017 can be found on page 286.

Statement of compliance

UK Corporate Governance Code - The UK Corporate Governance Code 2014 (the 'Code') applied to the 2016 financial year. The Group confirms that it applied the main principles and complied with all provisions of the Code throughout the year, and that it has applied the UK Corporate Governance Code 2016 since its financial year end. The Code is publicly available at www.frc.org.uk

The British Bankers' Association Code for Financial Reporting Disclosure - The Group has adopted the British Bankers' Association's Code for Financial Reporting Disclosure and its 2016 financial statements have been prepared in compliance with its principles.

NOMINATION AND GOVERNANCE COMMITTEE REPORT

We are committed to the highest standards of corporate governance, designed to ensure rigour in the Board's discussions and decision making

	Committee meetings	
	Eligible to attend	Attended
Committee Chairman		
Lord Blackwell	5	5
Committee members who served during 2016		
Alan Dickinson	5	5
Anita Frew	5	5
Nick Luff[1]	5	4
Anthony Watson	5	5

1 Mr Luff was unable to attend the February Committee meeting due to a prior commitment.

Dear Shareholder

A key priority for the Committee, under my leadership, is to keep the composition of the Board and its Committees under review and to make appropriate recommendations to the Board. There were two changes to the Board in 2016. Stuart Sinclair joined the Board in January 2016 and Dyfrig John retired from the Board in May 2016. Stuart's appointment followed that of Deborah McWhinney, who joined the Board in December 2015.

As set out earlier in the report, a number of Board changes have been agreed since the year end. Anthony Watson, our Senior Independent Director, will retire at the 2017 AGM after serving more than eight years on the Board, and Nick Luff, an independent Non-Executive Director and Chairman of the Audit Committee, has notified the Board that in light of his other commitments he does not intend to seek re-election at the 2017 AGM. On the Committee's recommendation, the Board has appointed Anita Frew to succeed Anthony as Senior Independent Director, which she will combine with the role of Deputy Chairman. Anita's significant board, financial and investment management experience, including as a Senior Independent Director, make her ideally suited to take on this role. On the Committee's recommendation, the Board has appointed Simon Henry to succeed Nick as Chairman of the Audit Committee. Simon has been a member of the Audit Committee since June 2014 and his background and experience enable him to fulfil the role of Audit Committee Chairman and for SEC purposes the role of Audit Committee financial expert.

The Committee will continue to keep under review the structure, size and composition of the Board and its Committees and to make appropriate recommendations to the Board.

Another important role for the Committee is ensuring the adequacy of succession planning, including contingency arrangements, both for Board appointments and key senior management roles. An in-depth review was conducted during the year of the Group's talent management approach and succession pipeline and this will continue to be a focus during 2017.

Lord Blackwell
Chairman, Nomination and Governance Committee

Committee purpose and responsibilities

The purpose of the Committee is to keep the Board's governance, composition, skills, experience, knowledge, independence and succession arrangements under review and to make appropriate recommendations to the Board to ensure the Company's arrangements are consistent with the highest corporate governance standards.

The Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. The Committee's terms of reference can be found at www.lloydsbankinggroup.com/our-group/corporate-governance

Committee composition, skills and experience

To ensure a broad representation of experienced and independent Directors, membership of the Committee comprises the Chairman, the Deputy Chairman, who is also the Chairman of the Remuneration Committee, the Senior Independent Director, the Chairman of the Audit Committee and the Chairman of the Risk Committee. The Group Chief Executive attends meetings as appropriate.

Annual effectiveness review

During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

How Committee meetings are run

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 62. Its structure facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

Matters considered by the Committee

During the year the Committee considered a number of issues relating to the Group's governance arrangements, both internal and external. It assisted the Chairman in keeping the composition of the Board and its Committees under review and to lead the appointment process for nominations to the Board.

These issues are summarised on the next page.

Corporate governance report continued

How the Nomination and Governance Committee spent its time in 2016

KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Board and Committee size and composition	During the year the Committee, led by the Chairman, continued to keep under review the structure, size and composition of the Board and its Committees and to make appropriate recommendations to the Board. The Board should be of sufficient size to reflect a broad range of views and perspectives whilst allowing all Directors to participate effectively in meetings. The Board currently comprises three Executive Directors, nine independent Non-Executive Directors and the Chairman who was independent on appointment. Details of Board changes are set out on page 52.
Succession planning	The Committee, led by the Chairman, continued to keep the adequacy of succession arrangements under review to ensure the desired mix of skills and experience of Board members now and in the future. Full details of the Group's approach to succession planning can be found on the next page.
Diversity policy	The Committee reviewed the Board Diversity Policy in light of new and emerging best practice and recommended to the Board a specific target to maintain at least three female Board members and to take opportunities to increase the number of female Board members over time. The Board Diversity Policy is set out below.
Effectiveness	The Committee oversaw the annual evaluations of the performance of the Board and its Committees. In January 2016, the Committee reviewed the findings of the 2015 Board Effectiveness Review and recommended actions to the Board to address the areas identified for improvement. Progress against the plan was reviewed during the year. In preparation for the 2016 Board Effectiveness Review, the Committee made recommendations to the Board on the process and timing of the review, which was carried out internally by the Company Secretary. Full details of the 2016 Board Effectiveness Review together with details of the progress against the 2015 review actions are set out on page 66.
Corporate governance	In 2016, the Committee: – oversaw the annual review of the Corporate Governance Framework, including the amendments necessary to accommodate the SM&CR and recommended it to the Board for approval – received regular corporate governance updates from the Company Secretary – recommended to the Board a revised share dealing policy for Directors and GEC in light of the new Market Abuse Regulation – reviewed reports from the Chairman on communications from shareholders – received updates on the SM&CR – approved the appointment of Trustees to the Bank's Foundations – received updates on ring-fencing governance
Independence and time commitments	In assessing independence, the Committee did not rely solely on the Code criteria but considered whether, in fact, the Non-Executive Director was demonstrably independent and free of relationships and other circumstances that could affect their judgement. It did this with reference to the individual performance and conduct in reaching decisions. It also took account of any relationships that had been disclosed and authorised by the Board. Based on its assessment for 2016, the Committee is satisfied that, throughout the year, all Non-Executive Directors remained independent as to both character and judgement. The Committee reviewed the role, including capabilities and time commitment, of the Chairman, Deputy Chairman, Senior Independent Director, Non-Executive Directors, the Group Chief Executive and Executive Directors and found them to be appropriate.

Board Diversity Policy

The Board places great emphasis on ensuring that its membership reflects diversity in its broadest sense. A combination of demographics, skills, experience and personal attributes on the Board is important in providing a range of perspectives, insights and challenge needed to support good decision making.

New appointments are made on merit, taking account of the specific skills and experience needed to ensure a rounded Board and the diversity benefits each candidate can bring to the overall Board composition. On gender diversity the Board has a specific target to maintain at least three female Board members and, recognising the emerging target for FTSE companies to move towards 33 per cent female representation, to take opportunities to increase the number of female Board members over time where that is consistent with other skills and diversity requirements.

The Board also places high emphasis on ensuring the development of diversity in the senior management roles within the Group and supports and oversees the Group's objective of achieving 40 per cent of senior roles held by female executives by 2020, along with other metrics which promote the engagement of other underrepresented groups within the business. This is underpinned by a range of policies within the Group to help provide mentoring and development opportunities for female executives and to ensure unbiased career progression opportunities. Progress on this objective is monitored by the Board and built into its assessment of executive performance.

You can read more on the Group's diversity programmes, including details of the Group's commitment to raise the percentage of women employed in senior management roles to 40 per cent by 2020 on page 18 of the strategic report.

A copy of the Board Diversity Policy is available on our website at www.lloydsbankinggroup.com/responsible-business and information on Board diversity can be found on page 54.

Female representation on the Board is currently 23 per cent (based on three female directors and 10 male directors).

Our approach to succession planning

Good succession planning contributes to the delivery of the Group's strategy by ensuring the desired mix of skills and experience of Board members now and in the future. The Board is also committed to recognising and nurturing talent within executive and management levels across the Group to ensure the Group creates opportunities to develop current and future leaders. The role of succession planning in promoting diversity is recognised and the Group has a range of policies which promote the engagement of underrepresented groups within the business in order to build a diverse talent pipeline.

Board size and composition

Under the leadership of the Chairman, the Committee continued to keep under review the structure, size and composition of the Board and its Committees. At the core of the process is an ongoing assessment led by the Chairman of the collective Board's technical and governance skill set. From this the Chairman creates a board skills matrix which the Committee uses to track the Board's strengths and identify gaps in the desired collective skills profile of Board members, giving due weight to diversity in its broadest sense. Recommendations are made to the Board as appropriate.

Senior management succession

During the year, the Committee, led by the Chairman, also reviewed the succession plans for the Group Chief Executive and other key senior management roles.

The Committee's review was shaped by an in-depth review and broader discussion by the Non-Executive Directors of the Group's talent management approach and succession pipeline for key senior executive roles. This annual talent review allows the Board to identify talent and ensure the Group has the right succession plans and development programmes in place. The review noted the work done to strengthen the approach to talent and development during the year, including the extension of the annual talent review programme and improved tracking and review of succession plans. There was recognition of the further work to be done to continue to increase the diversity of the succession pipeline. The robustness of the succession plans for the Group Chief Executive and other key senior management roles in terms of contingency arrangements and over the medium to longer term were also reviewed.

BOARD INDUCTION

Deborah McWhinney and Stuart Sinclair share their insights

Deborah McWhinney and Stuart Sinclair who joined the Board in December 2015 and January 2016 respectively, share their insights on their induction and first year on the Board

How did the induction programme help you prepare for your role on the Board?

Deborah

I found the programme very well structured and comprehensive. There was a good mix of formal presentations and more informal sessions. It really brought the business and its issues alive for me and, having spent my career in the United States, the tailored and in-depth overview of the UK regulatory landscape was especially instructive.

Colleagues were always very open and willing to spend time with me to ensure my questions were fully answered. The level of openness within the senior management team is reflective of the Group's wider culture.

Stuart

I have been through quite a few inductions over the years and what was especially effective about the Group's induction was the mixture of highly structured overviews on key topics such as capital, liquidity and conduct, together with self-selected 'top-ups' and site visits. Attending functions, conferences, product forums, customer focus groups and branches provided valuable context too.

At all times colleagues were welcoming and never failed to find answers to my questions. As a newly appointed Non-Executive Director, I felt that a 'go anywhere, ask anything' culture was apparent.

How will you reflect on your first year on the Board?

Deborah

I have extensive experience in managing IT operations and digital innovations. I was therefore delighted to be asked to join the new sub-committee of the Board Risk Committee, solely focusing on IT resilience and cyber security, bringing an independence of judgement and challenge to Board discussions.

What also struck me during my first year is the very genuine commitment to diversity in its broadest sense. There is a real understanding that diversity is more than gender, it's a 'frame of mind' that helps bring diversity of thought to Board debate and conversations. I support the Group's diversity programmes through mentoring women in senior roles and by speaking at diversity events.

Stuart

I have really enjoyed my first year on the Board because the Group to me was a mixture of relatively familiar topics such as retail network analysis, product testing, capital models and conduct requirements and newer topics such as ring-fencing.

Board and Committee meetings are open, fact-based and collegiate in the best sense: on any given topic there will typically be both experts and generalists. The Board culture works to draw all Directors into the subject, allowing for appropriate consideration and challenge from many angles, which enables an appropriate decision to be reached.

Corporate governance report continued

AUDIT COMMITTEE REPORT

It is the Audit Committee's job to review the integrity of the financial statements and the effectiveness of the internal and external auditor. The Audit Committee has delivered on its responsibilities

	Committee meetings	
	Eligible to attend	Attended
Committee Chairman		
Nick Luff	8	8
Committee members who served during 2016		
Alan Dickinson	8	8
Anita Frew	8	8
Simon Henry	8	4[1]
Deborah McWhinney	8	8
Nick Prettejohn	8	7[2]
Anthony Watson	8	8

1 Mr Henry was unable to attend Audit Committee meetings in January, July, October and December due to prior executive commitments. Mr Henry will succeed Mr Luff as Audit Committee Chairman following Mr Luff's retirement at the AGM in May 2017. Prior to taking on the Chairmanship of the Audit Committee, Mr Henry is retiring as Chief Financial Officer of Royal Dutch Shell plc in March 2017.
2 Mr Prettejohn was unable to attend the June Audit Committee meeting due to a prior commitment.

Dear Shareholder

Throughout 2016, the Audit Committee has continued to focus on its key objectives, overseeing financial reporting, internal controls, whistleblowing, and internal and external audit.

Overseeing financial reporting requires an assessment of key accounting judgements and related disclosures. The cost of redress relating to Payment Protection Insurance (PPI) has been substantial, and accounting provisions for this cost remain the most significant judgement made in drawing up the Group's financial statements.

Estimates of the cost have changed as complaint trends and regulatory factors have evolved. The Committee has reviewed these estimates, and challenged the assumptions behind them, as well as ensuring that appropriate disclosures have been made to explain the uncertainties that remain.

The Committee also considered other areas of significant judgement that were relevant to the financial statements. These included other conduct provisions, loan impairments, tax matters, actuarial assumptions for insurance and pension accounting, and the appropriate classification of gilts held by the Group for liquidity purposes. Further details are set out in this report.

The transformation of the internal audit function has also been a focus for the Committee. This has included reviewing the scope and direction of internal audit's work, overseeing changes to the leadership of the function, supporting independence of audit, and encouraging improved reporting of audit findings. The Committee has also monitored the effectiveness of the external audit as the new lead audit partner was introduced.

Nick Luff
Chairman, Audit Committee

Committee purpose and responsibilities

The purpose of the Committee is to monitor and review the Group's financial and narrative reporting arrangements, the effectiveness of the internal controls over financial reporting and the risk management framework, whistleblowing arrangements and each of the internal and external audit processes.

The Audit Committee reports to the Board on how it discharges its responsibilities and makes recommendations to the Board, all of which have been accepted during the year. A full list of responsibilities is detailed in the Committee's terms of reference, which can be found at www.lloydsbankinggroup.com/our-group/corporate-governance

Committee composition, skills and experience

The Committee acts independently of the executive to ensure that the interests of the shareholders are properly protected in relation to financial reporting and internal control.

All members of the Committee are independent Non-Executive Directors with competence in the financial sector with the Committee as a whole having competence relevant to the financial sector. Nick Luff is a Chartered Accountant and has significant financial experience in the UK listed environment enabling him to fulfil the role of Audit Committee Chairman, for the purposes of the UK Corporate Governance Code (the 'Code') as a member having recent and relevant financial experience, and for SEC purposes, the role of Audit Committee financial expert. In addition, Simon Henry is a Chartered Global Management Accountant and has extensive knowledge of financial markets, treasury and risk management, and also qualifies as a member having recent and relevant financial experience under the Code and an Audit Committee financial expert under SEC rules.

How Committee meetings are run

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 62. Its structure facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

During the course of the year, the Committee held separate sessions with the internal and external audit teams, without members of the executive management present.

Based on the outcome of the annual board effectiveness review in 2015 additional training for Committee members has been introduced. Targeted training on risk weighted assets, derivative accounting, IFRS9 and insurance accounting has been provided. This year's annual effectiveness review confirmed the Committee met its key objectives and carried out its responsibilities effectively.

Whilst the Committee's membership comprises the Non-Executive Directors noted above, all Non-Executive Directors may attend meetings as agreed with the Chairman of the Committee. The Interim Group Audit Director, the external auditor, the Group Chief Executive, the Chief Financial Officer and the Chief Risk Officer also attend meetings of the Committee as appropriate.

During the year the Committee considered a number of issues relating to the Group's financial reporting, these issues are summarised below, including discussion of the conclusions the Committee reached, and the key factors considered by the Committee in reaching its conclusions.

In addition, the Committee considered a number of other significant issues not related directly to financial reporting, including internal controls, internal audit and external audit. These issues are also discussed in detail in the next section, including insight into the key factors considered by the Committee in reaching its conclusions.

Matters considered by the Committee
How the Audit Committee spent its time in 2016

Financial reporting

During the year, the Committee considered the following significant financial issues in relation to the Group's financial statements and disclosures, with input from management, Group Audit and the external auditor:

KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Payment Protection Insurance (PPI) In determining the adequacy of the provision for redress payments and administration costs in connection with the mis-selling of PPI the Group makes a number of assumptions based on management judgement. Such assumptions include the number of future complaints that will be received and the extent to which they will be upheld; average redress payments; and related administrative costs. During the year the Group provided a further £1,000 million to cover further operating costs and redress, including the impact of a proposed June 2019 deadline. To 31 December 2016, the Group has provided a total of £17,025 million in respect of PPI mis-selling redress and administration costs.	– The Committee continued to challenge the assumptions made by management to determine the provision for PPI redress and administration costs. The Committee oversaw continued use of sensitivities reflecting the uncertainty that remains around the ultimate cost of PPI redress. – The Committee also reviewed management's assessment of the potential impact of a consultation paper by the Financial Conduct Authority which set a proposed deadline of June 2019 for consumers to make their PPI complaints and on the potential impact of the Plevin case. – Group Audit undertook periodic agreed upon procedures over the process used by management to calculate the PPI provision. Procedures undertaken were designed to identify the use of reasonable, consistent and supportable assumptions and inputs. No items were raised by exception for consideration by the Committee. – The Committee concluded that the provision for PPI redress and the Group's external disclosures were appropriate. – The disclosures relating to PPI are set out in note 38: 'Other provisions' on page 230 of the financial statements.
Other conduct provisions The Group has also made provisions totalling £1,085 million in respect of other conduct matters, including £280 million for packaged back accounts and £261 million for secured and unsecured arrears handling activities.	– For packaged bank accounts, the Committee has continued to monitor the utilisation of the provision and management's assessment of both the remaining exposure and the additional provisions required. This has included reviewing the expected level of complaints and the average redress payments. – The Committee has understood the basis for determining the provision in respect of the Group's secured and unsecured arrears handling activities. The provision includes the cost of both identifying and rectifying the customers affected. – Group Audit undertook periodic agreed upon procedures over the process that has been used by management to calculate the extent of conduct related provisions. Procedures undertaken were designed to identify the use of reasonable, consistent and supportable assumptions and inputs. No items were raised by exception for consideration by the Committee. – The Committee was satisfied that the provisions for other conduct matters were appropriate. The disclosures relating to other conduct provisions are set out in note 38: 'Other provisions' on page 230 of the financial statements.
Allowance for impairment losses on loans and receivables Determining the appropriateness of impairment losses requires the Group to make assumptions based on management judgement.	– The Committee challenged the level of provisions made and the assumptions used to calculate the impairment provisions held by the Group. – Group Audit has provided assurance to the Audit Committee that the impairment governance processes are effective. – The Committee was satisfied that the impairment provisions were appropriate. The disclosures relating to impairment provisions are set out in note 52: 'Financial risk management' on page 261 of the financial statements.

Corporate governance report continued

KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Recoverability of the deferred tax asset A deferred tax asset can be recognised only to the extent that it is recoverable. The recoverability of the deferred tax asset in respect of carry forward losses requires consideration of the future levels of taxable profit in the Group.	– The Committee considered the recognition of deferred tax assets, in particular the forecast taxable profits based on the Group's operating plan, the split of these forecasts by legal entity and the Group's long-term financial and strategic plans. – The Committee agreed with management's judgement that the deferred tax assets were appropriately supported by forecast taxable profits, taking into account the Group's long-term financial and strategic plans. The disclosures relating to deferred tax are set out in note 37: 'Deferred tax' on page 228 of the financial statements.
Uncertain tax positions The Group has open tax matters which require it to make judgements about the most likely outcome for the purposes of calculating its tax position.	– The Committee took account of the respective views of both management and the relevant tax authorities when considering the uncertain tax positions of the Group. The Committee also understood the external advice obtained by management to support the views taken. – The Committee was satisfied that the provisions and disclosures made in respect of uncertain tax positions were appropriate. The relevant disclosures are set out in note 48: 'Contingent liabilities and commitments' on page 242 of the financial statements.
Retirement benefit obligations The Group must make both financial and demographic assumptions of a judgemental nature to determine the value of the defined benefit obligation.	– The Committee considered the financial and demographic assumptions used to determine the defined benefit liabilities, in particular mortality assumptions and the discount rate, which have been updated to reflect recent experience. – The Committee was also satisfied that the Group's quantitative and qualitative disclosures made in respect of retirement benefit obligations are appropriate. The relevant disclosures are set out in note 36: 'Retirement benefit obligations' on page 222 of the financial statements.
Value-In-Force (VIF) asset and insurance liabilities Determining the value of the VIF asset and insurance liabilities is judgemental and requires economic and non-economic actuarial assumptions.	– The Committee challenged the economic and non-economic actuarial assumptions made by management which underpin the calculation of the VIF asset and the insurance liabilities. The Committee also reviewed the movements in the key assumptions since 31 December 2015. – The Committee was satisfied that the value of the VIF asset and insurance liabilities were appropriate. The disclosures are set out in note 24: 'Value of in-force business' on page 213 and note 32: 'Liabilities arising from insurance contracts and participating investment contracts' on page 217 of the financial statements.
Reclassification of gilts held within the liquidity portfolio Determining the appropriate accounting treatment for gilts held within the liquidity portfolio.	– During the year, the Group reclassified approximately £20 billion of gilts within the liquidity portfolio as 'available-for-sale'; the gilts were previously classified as 'held-to-maturity'. – The Committee considered and was satisfied with management's assessment of the circumstances which support the reclassification of the gilts, the appropriateness of the accounting treatment and related disclosure. – The disclosure is set out in note 49: 'Financial instruments' on page 245 of the financial statements.
One-off transactions Determining the appropriate accounting for certain one-off transactions requires management to assess the facts and circumstances specific to each transaction.	– The sale of Visa Europe is one example of one-off transactions considered by the Audit Committee during the year. – The Committee was satisfied that the accounting treatment of the sale was appropriate.
Viability statement The Directors are required to confirm whether they have a reasonable expectation that the Company and the Group will be able to continue to operate and meet their liabilities as they fall due for a specified period. The viability statement must also disclose the basis for Directors' conclusions and explain why the period chosen is appropriate.	– The Committee assisted the Board in performing its assessment of the viability of the Company and the Group with input from management. The viability assessment, which was based on the Group's operating, capital and funding plans, included consideration of the principal and emerging risks which could impact the performance of the Group, and the liquidity and capital projections over the period. – The Committee was satisfied that the viability statement could be provided and advised the Board that three years was a suitable period of review. – The viability statement is disclosed on page 82 of the Directors' report.

Other significant issues

The following matters were also considered by the Committee:

Risk management and internal control systems

Full details of the internal control and risk management systems in relation to the financial reporting process are given within the risk management section on pages 116 to 169. Specific matters that the Committee considered during the year included:

– the effectiveness of systems for internal control, financial reporting and risk management;
– the extent of the work undertaken by the Finance teams across the Group and consideration of the resources to ensure that the control environment continued to operate effectively; and
– the major findings of internal investigations into control weaknesses, fraud or misconduct and management's response along with any control deficiencies identified through the assessment of the effectiveness of the internal controls over financial reporting under the US Sarbanes-Oxley Act.

The Committee was satisfied that internal controls over financial reporting were appropriately designed and operating effectively.

Group Audit

In monitoring the activity, role and effectiveness of the internal audit function and their audit programme the Committee:

– monitored the effectiveness of Group Audit and their audit programme through quarterly reports on the activities undertaken and a report from the Quality Assurance function within Group Audit;
– approved the annual audit plan and budget and reviewed progress against the plan through the year;
– oversaw the process for the appointment of an Interim Group Audit Director; and
– considered the major findings of significant internal audits, and management's response.

Speak Up (the Group's whistleblowing service)

The Committee received and considered reports from management on the Group's whistleblowing arrangements including summaries of cases and ongoing reviews of the Whistleblowing Governance Structure. On consideration of the reports submitted, the Committee was satisfied with the actions which had been taken, the report first having been considered and approved by the Board's Whistleblowing Champion, Anita Frew.

Auditor independence and remuneration

Both the Board and the external auditor have safeguards in place to protect the independence and objectivity of the external auditor. In 2016 the Audit Committee approved an amended policy to regulate the use of the auditor for non-audit services to ensure compliance with the revised Ethical Standards for Auditors from the Financial Reporting Council (FRC).

In order to ensure the objectivity and independence of the external auditor, the policy sets a financial threshold above which all non-audit services provided by the external auditor must be approved in advance by the Committee, with additional provision made for the approval of non-material services which are below the threshold by certain members of senior management. The policy further formalises within the Group the restriction on the provision of non-audit services by the external auditor which the FRC consider to be prohibited.

The total amount of fees paid to the auditor for both audit and non audit related services in 2016 is disclosed in note 11 to the financial statements on page 201.

External auditor

The Committee oversees the relationship with the external auditor. During the year, the Committee considered the auditors' terms of engagement (including remuneration), their independence and objectivity and approved the audit plan (including methodology and risk identification processes).

In accordance with regulations there was a change of lead audit partner.

The Committee also considered the effectiveness and performance of the auditor and the audit process.

These assessments considered data and information from a number of sources including:

– the results of an internal effectiveness survey; and
– the FRC's Audit Quality Inspection Report (AQIR) on PwC published in May 2016.

The Committee concluded that it was satisfied with the auditor's performance and recommended to the Board a proposal for the reappointment of the auditor, to be approved at the Company's AGM.

Statutory Audit Services compliance

The Company and the Group confirm compliance with the provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014 for the year to 31 December 2016.

PwC have been auditor to the company and the Group since 1995, having previously been auditor to certain of the Group's constituent companies. PwC were re-appointed as auditor with effect from 1 January 2016 following a tender process conducted during 2014. There will be a mandatory rotation for the 2021 audit, if not earlier.

Corporate governance report continued

BOARD RISK COMMITTEE REPORT

The Committee has continued to take a dynamic approach to the consideration of existing and emerging risks

	Committee meetings	
	Eligible to attend	Attended
Committee Chairman		
Alan Dickinson	8	8
Committee members who served during 2016		
Lord Blackwell	8	8
Anita Frew	8	8
Simon Henry	8	7[1]
Nick Luff	8	7[2]
Deborah McWhinney	8	8
Nick Prettejohn	8	8
Stuart Sinclair	8	8
Anthony Watson	8	8
Sara Weller	8	8
Former Committee members who served during 2016		
Dyfrig John[3]	4	4

1 Mr Henry was unable to attend the May Risk Committee meeting due to prior executive commitments.
2 Mr Luff was unable to attend the July Risk Committee meeting due to prior executive commitments.
3 Mr John retired on 11 May 2016.

Dear Shareholder

I am pleased to report on how the Board Risk Committee has discharged its responsibilities throughout 2016.

The Committee has continued to take a dynamic approach to the consideration of existing and emerging risks, through a balanced agenda which included standing areas of risk management, together with specific focus on emerging risks focusing significant additional resource where considered necessary. An example of this has been the establishment of dedicated sub-committees to further enhance focus on particular areas, such as IT resilience and cyber security, enabling members of the Committee to direct more time to better understand, and challenge, the associated risks and actions being taken by management.

The Committee has continued to build upon the progress reported last year around furthering the understanding of complex risks and seeking to enhance risk management. I am pleased to report that good progress continued to be made throughout 2016 in reducing risks across the Group's material lending portfolios within both the Mortgage and Commercial businesses. The Committee will continue to review progress and developments during 2017.

The Group continues to operate in an environment subject to considerable change and, during 2016, another key area of activity for the Committee has been the proactive review, oversight and management of risks arising from the outcome of the EU referendum and wider geo-political risks. The Committee will continue to monitor developments and any impact on the Group's risk profile.

The Committee has concluded, through its detailed work, that the Group continues to have strong discipline in the management of both emerging and existing risks, and the Committee's work continues to help support the Group in achieving its core aim of operating as a safe, low risk bank.

Alan Dickinson
Chairman, Board Risk Committee

Committee purpose and responsibilities

The purpose of the Board Risk Committee is to review the risk culture of the Group, setting the tone from the top in respect of risk management. The Committee is also responsible for ensuring the risk culture is fully embedded and supports at all times the Group's agreed risk appetite, covering the extent and categories of risk which the Board considers as acceptable for the Company.

In seeking to achieve this, the Committee assumes responsibility for monitoring the Group's Risk Management Framework, which embraces risk principles, policies, methodologies, systems, processes, procedures and people. It also includes the review of new, or material amendments to risk principles and polices, and overseeing any action resulting from material breaches of such policy.

More details on the Group's wider approach to risk management can be found in the risk management section on pages 116 to 169. Full details of the Committee's responsibilities are set out in its terms of reference, which can be found at www.lloydsbankinggroup.com/our-group/corporate-governance

Committee composition, skills and experience

Alan Dickinson, Chairman of the Committee, is a highly regarded retail and commercial banker, having spent 37 years with the Royal Bank of Scotland, most notably as Chief Executive of RBS UK, overseeing the group's Retail and Commercial operations in the UK. The Committee is composed of independent Non-Executive Directors, who provide core banking and risk knowledge, together with breadth of experience which brings knowledge from other sectors, and a clear awareness of the importance of putting the customer at the centre of all that the Group does.

Since January 2016, all Non-Executive Directors have been members of the Board Risk Committee. The Chief Risk Officer has full access to the Committee and attends all meetings. The Interim Group Audit Director and members of the Executive also attend meetings as appropriate.

During the year the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

How Committee meetings are run

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 62, with a structure which facilitates open discussion and debate. Steps are taken to ensure adequate time for members to consider proposals which are put forward.

As the most senior risk forum in the Group, the Committee interacts with other related risk forums, including the Executive Group Risk Committee. Such interaction assists with the agenda planning process, where in addition to annual agenda planning, matters considered by the Group Risk Committee are reviewed to ensure escalation of all relevant matters to the Board Risk Committee.

Matters considered by the Committee

Over the course of the year the Committee considered a wide range of risks facing the Group, both standing and emerging, across all key areas of risk management, in addition to risk culture and risk appetite, as noted above.

As part of this review, certain risks were identified which required further detailed consideration. Set out below is a summary of these risks, with an outline of the material factors considered by the Committee, and the conclusions which were ultimately reached.

In addition, during 2016, two further sub-committees of the Board Risk Committee were established to focus on Financial Markets and IT Resilience & Cyber, in addition to an existing Stress Testing & Recovery Planning sub-committee. The sub-committees were constituted to enable members of the Board Risk Committee to dedicate additional time and resource to better understand and to enable fuller review and challenge of the risks associated with the topic of the sub-committee.

KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
EU referendum The Committee regularly reviewed a range of lead economic and Key Performance Indicators across the portfolios, to help identify any early signs of deterioration in the economy and the Group's credit risk profile.	As a result of the referendum outcome and to manage the impact of uncertainty caused by the referendum process and ensuing economic concerns, detailed EU exit portfolio assessments were undertaken to understand potential impacts on the Bank's credit risk profile and to assess the potential need for any changes to Group risk appetite. Additional regular monitoring of internal and external early warning and key performance indicators was instigated and continues to be closely monitored by the Committee to track any adverse movement in the risk profile of the Retail and Commercial portfolios, and to ensure that risk appetite remains appropriate. Conclusion: Regular monitoring continues to assist the Committee in its assessment of the portfolios, with management continuing to take action to mitigate potential risks associated with the EU exit decision. Key credit risks continue to be well managed through strong, effective risk management and risk appetite, including early identification and management of potential concern customers.
Cyber risk and IT resilience A resilient IT environment is critical to providing reliable services to customers and enabling sustainable growth. The dynamic threat posed by cyber risk and the potential for external attacks on the integrity of electronic data or the availability of systems are key risks for the Group and central area of focus for the Committee.	Given the dynamic nature and significance of IT and cyber risks the Committee has established a sub-committee to enable more in depth consideration of IT resilience and cyber risks. During the year the sub-committee gave consideration to a wide range of issues including insider risk, cyber reverse stress testing, IT Resilience and Cyber Programme updates, cyber insurance and cloud technology. Alongside this an advisory panel comprising external industry experts has been established to provide the sub-committee with an external view of current and evolving industry wide cyber security threats, challenges and developments. Conclusion: Much has been achieved in respect of IT resilience and cyber security initiatives and the focus given by the Committee during 2016 has raised awareness across the Group. However, IT resilience and cyber security risk will remain a key area of focus for the Committee in 2017.
Conduct risk The Committee continues to focus closely on the Group's approach to conduct risk.	Throughout 2016, the Committee considered reports on the proactive identification and resolution of conduct issues which have had an impact on customers. The pace and quality of required remediation received particular attention together with actions taken to address root cause analysis and the prevention of similar issues. Consideration was also given to the conduct risks within the collections process for customers in arrears as well as customers in financial difficulties. In addition the Committee considered developments in the Group's conduct culture as well as reports on complaints, conduct risk appetite metrics and product governance. Conclusion: Whilst good progress has been made as a result of the Group's conduct strategy initiatives, continued improvement in the Group's conduct risk profile will remain a priority for the Group in 2017 and will continue to be a subject of focus for the Committee.
UK Secured and buy-to-let Regular reviews were undertaken of the risks associated with the UK Secured portfolio, including specifically the buy-to-let segment.	In reviewing the UK Secured portfolio, consideration was given to the quality of new lending, the credit performance of the portfolio, the risk adjusted returns, and the adequacy of impairment and capital provisions under both expected and stressed conditions. The Committee specifically considered appetite for higher loan to value lending following the government's announcement to discontinue the Help to Buy 2 scheme. Additionally, for the buy-to-let segment, the Committee reviewed management's plans to implement changes in response to the revised tax regime and additional regulatory requirements for underwriting. Conclusion: The Group's mortgage portfolio remains well balanced, with overall debt to value ratios having improved and concentration risks reduced. Management continues to take appropriate action to address the risks arising from these portfolios and the Committee will continue to review developments during the course of 2017.

Corporate governance report continued

KEY ISSUES	COMMITTEE REVIEW AND CONCLUSION
Data risk Data risk has been identified as a key focus within the Group to take into account the growing importance of data as a means of competitive advantage and to underpin key risk decision making and risk management.	The Committee continued to focus attention on key data initiatives within the Group. The Committee considered a number of reports on data risk throughout 2016 covering, amongst other topics, user access management, risk data aggregation and reporting and data privacy, all of which have impacts across the Group. Additionally, regular reporting on data risk, as a distinct risk type, has been introduced in 2016 in recognition of the growing importance of data as an asset to the Group as well as the forthcoming EU General Data Protection Regulation (GDPR). Conclusion: Improvement to risk data systems, governance and controls over the last two years have strengthened risk reporting, whilst there remains opportunity to develop further. Data risk will remain a key area of focus for the Committee in 2017 in line with the growing importance of data as an asset to the Group and maturity of the Group Chief Data Office.
Residual value risk A review of the impact of used car prices on the residual value risk of motor finance businesses was undertaken.	Given the increased uncertainty around used car prices in the current market environment, consideration was given to the residual value risk associated with the Group's growing motor finance businesses and the impact of a range of possible scenarios for the future path of used car prices and deteriorating macro environment. Conclusion: The combination of pricing that reflects the future value of vehicles, and prudent provisioning, appropriately reflects potential risk. The Committee introduced a new risk appetite limit to reflect planned business growth and manage the concentration of residual value risk. The Committee will continue to monitor this throughout 2017.
Stress testing The review of stress testing exercises and their results continued to be a key area of focus during the year.	The Committee reviewed a diverse set of stress testing scenarios in 2016, including internally defined moderate and severe economic downturns, reverse stress test events including a large scale cyber-attack and external scenarios set by the Bank of England and the European Banking Authority. The assessment included a review of the resilience of the Group, including specific areas of focus such as credit risk as well as impacts on the Group's capital and liquidity positions. An assessment of the impact on dividends and mitigating actions proposed by management in each scenario was also undertaken. Conclusion: The Group's capital and liquidity positions remained above required minimums and the relevant risk appetite metric, with outcomes reflecting the ongoing de-risking by the Group. The implementation and assessment of robust and well managed stress testing arrangements will remain a key area of focus for the Committee in the coming year.
Model risk The approach to model risk management, including the Group's model governance framework, material models and regulatory requirements were reviewed.	Assessment was made of the overall governance framework for models including scope, the model landscape, the role of the Group Model Governance Committee and modelling standards. Additionally, the Committee considered the Group's material models at Divisional level, including their purpose, design and how regular performance monitoring and validation ensure they remain fit-for-purpose and identify areas for improvement in an evolving regulatory environment. The Committee also observed a structured reporting framework which facilitates good senior management awareness and escalation, when required. Conclusion: The Group's management of model risk is robust with a strong control framework, consisting of specialist teams, regular performance monitoring, annual validation and appropriate escalation of issues. Model risk will continue to be an area of focus for the Committee via regular reporting, including risk appetite measures.
Commercial Banking portfolios The Committee considered a range of regular and ad-hoc papers covering key risks associated with the Commercial Banking portfolios.	The Committee continued to provide oversight of the risks in the Commercial Banking portfolios via a regular update on the credit quality in key sectors such as Commercial Real Estate, Acquisition Finance and SME as well as oversight of large single name exposures. Additional topics covered in 2016 included country risk, the potential impact of the EU referendum, a review of the exposure to European Banks and deep dives in to the oil and gas sector. There was also increased focus on the Financial Markets business and the associated traded market risk through a newly created sub-committee. Conclusion: Regular and cyclical assessments of key portfolios has assisted the Committee in its oversight of risk management within Commercial Banking and any impact arising from both existing and emerging risks. Management continues to take satisfactory action to mitigate and address risks and the Committee will continue to review core aspects of the Commercial Banking business during 2017.

RESPONSIBLE BUSINESS COMMITTEE REPORT

Being a responsible business is fundamental to our strategy. We are proud that our colleagues support so many people, businesses and communities across the UK to achieve a better future through the work of our Helping Britain Prosper Plan

	Committee meetings	
	Eligible to attend	Attended
Committee Chairman		
Sara Weller	5	5
Committee members who served during 2016		
Lord Blackwell	5	5
Anita Frew	5	4[1]

1 Ms Frew was unable to attend the Committee meeting in April 2016 due to a prior business commitment.

Dear Shareholder

I am pleased to present the second Responsible Business Committee report, following its establishment in July 2015.

Responsible Business practices are fundamental building blocks of our strategy, and the Committee has made good progress in continuing to support the embedding of responsible business activities during 2016.

The Committee focuses its work on the three areas of People, Businesses and Communities. At each meeting we explore in depth the progress made towards achieving the Group's purpose of helping Britain prosper, through becoming the best bank for customers.

Key areas reviewed have been: work to deepen our customer-centric culture; programmes to tackle disadvantage, including through our Foundations, our role in supporting UK businesses build for the future; and the development of the programme of skills-based volunteering undertaken by colleagues across the Group.

The Committee is supported in its work by two business-wide committees which report to the Group Chief Executive: the Group Customer First Committee and the Responsible Business Management Committee. Information on the work of these committees can be found on page 122.

I welcomed the opportunity during the year to get involved in responsible business activities in different parts of the country, including taking part in a panel for the School for Social Entrepreneurs (more detail on page 80). And I very much enjoyed meeting the profoundly deaf founder of the Yumma Café, a catering business aimed specifically at supporting deaf people. This was a great example of how the personal experience which drives many social entrepreneurs is making a significant difference. I would like to thank all those who attended our meetings this year for their support.

I would like to thank all the Board Directors and executives who attended and contributed to the Committee during the year. Most of all, I would like to recognise the tremendous contribution of our colleagues who have given their support to people, businesses and communities across the country, to help Britain prosper.

Sara Weller
Chairman, Responsible Business Committee

Committee composition and effectiveness

The membership of the Committee comprises Sara Weller, independent Non-Executive Director (Chairman of the Committee) the Group Chairman and the Deputy Chairman. All Non-Executive Directors are invited to attend the Committee's meetings. The Group Chief Executive attended two meetings in 2016. During the year, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

The operation of the Committee

Committee meetings are managed in accordance with the principles outlined on page 62 for the management of Board agendas and meetings. These principles are intended to facilitate open debate and constructive challenge. The Committee Chairman reviews the draft agenda regularly to ensure that adequate time is devoted to issues of interest to Committee members and that its key responsibilities are addressed. The Committee Chairman reports regularly to the Board on the Committee's work and presents the Helping Britain Prosper Plan to the Board for approval prior to publication.

Corporate governance report continued

How the Committee spent its time in 2016

The Committee has reviewed and discussed the following topics:

- the development of the Group's responsible business strategy, with input from the Group Chief Executive
- the Group's approach to measuring stakeholder and customer trust against its peers in financial services and acknowledged leaders in generating trust
- the continuing development of the Group's culture programme, in conjunction with the Board
- the results of colleague surveys as they relate to the Group's responsible business activities
- the steps taken to identify vulnerable customers and to ensure the Group's products and customer service approach take account of their varying needs
- the initiatives in place to tackle financial disadvantage amongst customers and to promote financial and digital inclusion
- the work of the School for Social Entrepreneurs and the Schools Activity Programme
- a report on the Group's charitable Foundations, and their planned future activities, from the Chief Executive of the Lloyds Bank Foundation for England and Wales
- the Group's responsible and sustainable finance approach, including the creation of the Green Loan Initiative and the work being done to develop innovative solutions to meet the increasing demand of customers for responsible lending products

Responsible Business Committee and external stakeholders

The members of the Committee have an ongoing dialogue with key stakeholders with an interest in the Committee's activities. Committee members look forward to engaging with key stakeholders, including the independent Stakeholder Panel, in 2017.

Sara Weller joined colleagues, representatives from the SSE Dartington school and a member of South Gloucestershire Council on a panel to select the next cohort of Social Entrepreneurs.

HELPING BRITAIN PROSPER PLAN: THE COMMITTEE'S ROLE

The Committee is responsible for overseeing the design and development of the Helping Britain Prosper Plan, the measurement of performance against the Plan and the internal and external communication of the Plan.

APRIL 2016

Review of campaign for the 2016 Plan and its impact on colleague and stakeholder engagement in order to identify opportunities to raise the profile of the Plan and the activities which underpin it

JULY

Report on progress against the metrics in the 2015/16 Plan with updates from divisional sponsors and review of outline approach to the 2016/17 Plan

OCTOBER

Detailed review of metrics and design of the 2016/17 Plan and outline of 2017 campaign

DECEMBER

Detailed consideration of an agreement on the metrics to include in the 2016/17 Plan to be presented to the Board

JANUARY 2017

Final review of draft 2016/17 Plan before recommending to the Board for approval

Responsible business in action: School for Social Entrepreneurs

The Lloyds Bank and Bank of Scotland Social Entrepreneurs programme is delivered through a partnership with the School for Social Entrepreneurs and the Big Lottery. The programme aims to support 2,000 social entrepreneurs by 2020.

In July 2016, Sara Weller was asked to join a panel to select the next cohort of 21 Social Entrepreneurs to secure a place on the programme. This was an opportunity to understand how each of the social entrepreneurs is supported through a 12 month package comprising a series of interactive learning sessions, a senior colleague from within Lloyds Bank to support them as they develop their social business, and a small grant.

The panel membership comprised local colleagues, representatives from the SSE Dartington school and a member of South Gloucestershire Council. Each candidate 'pitches' their social business idea for three minutes before being interviewed by the panel.

The programme attracts a diverse array of applicants, ranging from an artisan bakery providing employment opportunities for young adults with learning difficulties to an artists' space dedicated to tackling problems of isolation through arts and creativity.

Directors' report

Corporate governance statement

The corporate governance report found on pages 52 to 80 together with this report of which it forms part, fulfils the requirements of the Corporate Governance Statement for the purpose of the Financial Conduct Authority's Disclosure Guidance and Transparency Rules (DTR).

Profit and dividends

The consolidated income statement shows a statutory profit before tax for the year ended 31 December 2016 of £4,238 million (2015: £1,644 million).

The Directors have recommended a final dividend, which is subject to approval by the shareholders at the AGM, of 1.7 pence per share (2015: 1.5 pence per share) totalling £1,212 million (2015: £1,070 million). The Directors have also recommended a special dividend of 0.5 pence per share (2015: 0.5 pence per share) totalling £356 million (2015: £357 million). The final and special dividend will be paid on 16 May 2017.

The final dividend in respect of 2015 of 1.5 pence per ordinary share was paid to shareholders on 17 May 2016, the special dividend in respect of 2015 of 0.5 pence per ordinary share was paid to shareholders on 17 May 2016 and an interim dividend for 2016 of 0.85 pence per ordinary share was paid on 28 September 2016; these dividends totalled £2,034 million. Further information on dividends is shown in note 45 on page 238 and is incorporated by reference.

Appointment and retirement of Directors

The appointment and retirement of Directors is governed by the Company's articles of association, the UK Corporate Governance Code and the Companies Act 2006. The Company's articles of association may only be amended by a special resolution of the shareholders in a general meeting.

No Directors have been appointed to the Board since the 2016 AGM. In the interests of good governance and in accordance with the provisions of the UK Corporate Governance Code, all Directors will however retire, and those wishing to serve again, will submit themselves for re-election at the forthcoming AGM. Anthony Watson, Senior Independent Director, will retire at the 2017 AGM after serving more than eight years on the Board and Nick Luff, an independent Non-Executive Director, has notified the Board that he does not intend to seek re-election at the 2017 AGM.

Biographies of current Directors are set out on pages 54 to 57. Details of the Directors seeking re-election at the AGM are set out in the Notice of Meeting.

Board composition changes

Changes to the composition of the Board since 1 January 2016 up to the date of this report are shown in the table below:

	Joined the Board	Retired from the Board
Stuart Sinclair	4 January 2016	
Dyfrig John		11 May 2016

Directors' and Officers' liability insurance

Throughout 2016 the Group had appropriate insurance cover in place to protect Directors, including the former Director who retired during the year, from liabilities that may arise against them personally in connection with the performance of their role. As well as insurance cover, the Group agrees to indemnify the Directors to the maximum extent permitted by law. Further information on the Group's indemnity arrangements is provided below. No Director or former Director sought to recover costs or expenses under their indemnity in 2016.

Directors' indemnities

The Directors of the Company, including the former Director who retired during the year, have entered into individual deeds of indemnity with the Company which constituted 'qualifying third party indemnity provisions' for the purposes of the Companies Act 2006. The deeds indemnify the Directors to the maximum extent permitted by law and remain in force for the duration of a Director's period of office. The deeds were in force during the whole of the financial year or from the date of appointment in respect of the Director appointed in 2016. In addition, the Group had appropriate Directors' and Officers' liability insurance cover in place throughout 2016.

Deeds for existing Directors are available for inspection at the Company's registered office.

The Company has also granted deeds of indemnity by deed poll and by way of entering into individual deeds, which constitute 'qualifying third party indemnity provisions' to the Directors of the Group's subsidiary companies, including to former Directors who retired during the year and since the year end. Such deeds were in force during the financial year ended 31 December 2016 and remain in force as at the date of this report.

Qualifying pension scheme indemnities have also been granted to the Trustees of the Group's Pension Schemes, which were in force for the whole of the financial year and remain in force as at the date of this report.

Power of Directors in relation to shares

The Board manages the business of the Company under the powers set out in the articles of association, these powers include the Directors' ability to issue or buy back shares. The Directors were granted authorities to issue and allot shares and to buy back shares at the 2016 AGM. Shareholders will be asked to renew these authorities at the 2017 AGM. The authority in respect of purchase of the Company's ordinary shares is limited to 7,145,465,640 ordinary shares, equivalent to 10 per cent of the issued ordinary share capital of the Company.

The Company did not repurchase any of its shares during the year (2015: none).

Information incorporated by reference

The following additional information forms part of the Directors' report, and is incorporated by reference.

Content		Pages
Group results	Summary of Group results	33 to 36
Ordinary dividends	Dividends on ordinary shares	238
Directors' biographies	Board of Directors	54 to 57
Directors in 2016	Board of Directors	54 to 57
Directors' emoluments	Directors' remuneration report	84 to 114
Internal control and financial risk management	Financial reporting risk Risk management and Financial instruments	168 to 169 116 to 169 and 245 to 257
Information included in the strategic report	Future developments Greenhouse gas emissions (additional information) Inclusion and diversity Engaging colleagues	6 to 31 25 23 to 24 21
Disclosures required under Listing Rule 9.8.4R	Significant contracts Dividend waivers	241 to 242 238
Principal risks and uncertainties	Funding and liquidity Capital position	30 and 154 to 158 159 to 166
Share capital and control	Share capital and restrictions on the transfer of shares or voting rights – note to the accounts Special rights with regard to the control of the Company – note to the accounts	234 234

Directors' report continued

Substantial shareholders

Information provided to the Company by substantial shareholders pursuant to the DTR is published via a Regulatory Information Service.

As at 31 December 2016, the Company had been notified by its substantial shareholders under Rule 5 of the DTR of the following interests in the Company's shares:

	Interest in shares	% of issued share capital with rights to vote in all circumstances at general meetings[1]
The Solicitor for the Affairs of Her Majesty's Treasury	4,943,698,490[2]	6.93%
BlackRock Inc.	3,668,756,765[3]	5.14%
Norges Bank	2,133,494,625[4]	2.99%

1 Percentage provided was correct at the date of notification.
2 A direct holding. The Solicitor for the Affairs of Her Majesty's Treasury notified the Company on 6 January 2017 that their holding had decreased, to 4,243,603,868 shares, representing 5.95 per cent of the issued share capital, and on 27 January 2017 that their holding had decreased, to 3,567,130,415 shares, representing 4.998 per cent of the issued share capital.
3 The most recent notification provided by BlackRock Inc. under Rule 5 of the DTR identifies (i) an indirect holding of 3,599,451,380 shares in the Company representing 5.04 per cent of the voting rights in the Company, and (ii) a holding of 69,305,385 in other financial instruments in respect of the Company representing 0.09 per cent of the voting rights of the Company. BlackRock Inc.'s holding most recently notified to the Company under Rule 5 of the DTR varies from the holding disclosed in BlackRock Inc.'s Schedule 13-G filing with the US Securities and Exchange Commission dated 24 January 2017, which identifies beneficial ownership of 4,566,352,317 shares in the Company representing 6.4 per cent of the issued share capital in the Company. This variance is attributable to different notification and disclosure requirements between these regulatory regimes.
4 A direct holding.

No further notifications have been received under Rule 5 of the DTR as at the date of this report.

Change of control

The Company is not party to any significant contracts that are subject to change of control provisions in the event of a takeover bid. There are no agreements between the Company and its Directors or employees providing compensation for loss of office or employment that occurs because of a takeover bid.

The Company is party to a deed of covenant with each of the four Lloyds Foundations (the Foundations) which hold limited voting shares in the Company (the limited voting shares are further described in note 40 on page 234). Under the terms of the deeds of covenant, the Company makes an annual payment to each of the Foundations. In the event of a successful offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting share would convert to an ordinary share under the terms of the Company's articles of association. The payment obligation under the deeds of covenant would come to an end one year following the conversion of the limited voting shares.

Branches

The Group provides a wide range of banking and financial services through branches and offices in the UK and overseas.

Research and development activities

During the ordinary course of business the Group develops new products and services within the business units.

Post balance sheet events

There have been no other material post balance sheet events.

Going concern

The going concern of the Company and the Group is dependent on successfully funding their respective balance sheets and maintaining adequate levels of capital. In order to satisfy themselves that the Company and the Group have adequate resources to continue to operate for the foreseeable future, the Directors have considered a number of key dependencies which are set out in the risk management section under principal risks and uncertainties: funding and liquidity on page 30 and pages 154 to 158 and capital position on pages 159 to 166 and additionally have considered projections for the Group's capital and funding position. Accordingly, the Directors conclude that it is appropriate to continue to adopt the going concern basis in preparing the accounts over the next 12 months, from the date of approval of the financial statements.

Viability statement

The Directors have an obligation under the UK Corporate Governance Code to state whether they believe the Company and the Group will be able to continue in operation and meet their liabilities as they fall due over a specified period determined by the Directors, taking account of the current position and the principal risks of the Company and the Group.

In making this assessment, the Directors have considered a wide range of information, including the principal and emerging risks which could impact the performance of the Group, and the Group's five year operating plan which comprises detailed customer, financial, capital and funding projections together with an assessment of relevant risk factors. In particular in 2016, the assessment included consideration of the effects of the continuing low interest rate environment, the impact of a potential slow-down in economic growth as a result of the uncertainty surrounding the UK's exit from the EU, the possible effect upon the Group's financial position of the implementation of IFRS 9 "*Financial Instruments*" and the implications of ring-fencing, which over the next two years will lead to internal restructuring and the establishment of the ring-fenced sub-group and a non-ring-fenced sub-group.

Group, divisional and business unit operating plans covering a period of five years are produced and subject to rigorous stress testing on an annual basis. The planning process takes account of the Group's business objectives, the risks taken to seek to meet those objectives and the controls in place to mitigate those risks to remain within the Group's overall risk appetite.

The Group's planning process comprises the following key stages:

– Each year, divisional teams develop their operating plans which are based on Group and divisional targets. These targets are driven by the Group's strategy, risk appetite and objectives in the context of the operating environment and external market commitments, which are revised annually by the Board.
– The financial projections and the underlying assumptions in respect of expected market and business changes, and future expected legal, accounting and regulatory changes are subject to rigorous review and challenge from both divisional and Group executives. The Board obtains independent assurance from Risk Division over the alignment of the plan with Group strategy and Board risk appetite. This assessment also identifies the key risks to delivery of the Group's operating plan.
– The Group operates a robust stress testing framework to assess compliance of the operating plan with the Group risk appetite. The plan, which incorporates detailed capital and funding plans, is subject to both regulatory and internal stress testing scenarios, in addition to reverse stress testing. Further information on stress testing and reverse stress testing is provided on page 119. The internal stress testing scenarios are designed to be severe but plausible; and take full account of the availability and likely effectiveness of the mitigating actions that could be taken to avoid or reduce the impact or occurrence of the underlying risks. In considering the likely effectiveness of such actions, the conclusions of the Board's regular monitoring and review of risk and internal control systems, as discussed on page 67, is taken into account.
– The final five year operating plan, Risk Division assessment and the results of the stress testing are presented to the Board for approval. Once approved, the operating plan drives detailed divisional and Group targets for the following year.

The Directors have specifically assessed the prospects of the Company and the Group over the first three years of the current plan. The uncertain economic and political environment caused by the UK's plans to leave the EU and the pace of regulatory change mean that the assumptions supporting the fourth and fifth years of the operating plan are likely to be less reliable. As a result, the Board considers that a three year period continues to present a reasonable degree of confidence over expected events and macroeconomic assumptions, whilst still providing an appropriate longer-term outlook, although the remaining period of the operating plan contains no information which would cause different conclusions

to be reached over the longer-term viability of the Company and Group.

Information relevant to the assessment can be found in the following sections of the annual report and accounts:

- The Group's principal activities, business and operating models and strategic direction are described in the strategic report on pages 1 to 31;
- Emerging risks are disclosed on page 118;
- The principal risks, including the Group's objectives, policies and processes for managing credit, capital, liquidity and funding, are provided in the risk management section on pages 124 to 169; and
- The Group's approach to stress testing and reverse stress testing, including both regulatory and internal stresses, is described on page 119.

Based upon this assessment, the Directors have a reasonable expectation that the Company and the Group will be able to continue in operation and meet its liabilities as they fall due over the next three years to 31 December 2019.

Greenhouse gas emissions

The Group has voluntarily reported greenhouse gas emissions and environmental performance since 2009, and since 2013 this has been reported in line with the requirements of the Companies Act 2006. Our total emissions, in tonnes of CO_2 equivalent, are reported in the strategic report on page 25.

Deloitte LLP has provided limited level ISAE 3000 (Revised) assurance over selected non-financial indicators as noted by ✓. Their full, independent assurance statement is available online at www.lloydsbankinggroup.com/rbdownloads

Methodology

The Group follows the principles of the Greenhouse Gas (GHG) Protocol Corporate Accounting and Reporting Standard to calculate our Scope 1, 2 and 3 emissions from our worldwide operations.

The reporting period is 1 October 2015 to 30 September 2016, which is different to that of our Directors' report (January 2016 – December 2016). This is in line with Regulations in that the majority of the emissions reporting year falls within the period of the Directors' report. Emissions are reported based on an operational boundary. The scope of reporting is in line with the GHG Protocol and covers Scope 1, Scope 2 and Scope 3 emissions. Reported Scope 1 emissions cover emissions generated from gas and oil used in buildings, emissions from UK company-owned vehicles used for business travel and emissions from the use of air conditioning and chiller/refrigerant plant. Reported Scope 2 emissions cover emissions generated from the use of electricity, calculated using the location based methodology. Reported Scope 3 emissions relate to business travel undertaken by colleagues and emissions associated with the extraction and distribution of each of our energy sources – electricity, gas and oil. A detailed definition of these emissions can be found in our 2016 Reporting Criteria online at www.lloydsbankinggroup.com/rbdownloads

Intensity ratio

An intensity ratio of GHG gases (CO_2e) per £m of underlying income has been selected.

	Oct 2015 – Sept 2016	Oct 2014 – Sept 2015
GHG emissions per unit of underlying income	**19.7**	22.4

Omissions

Emissions associated with joint ventures and investments are not included in this disclosure as they fall outside the scope of our operational boundary. The Group does not have any emissions associated with heat, steam or cooling and is not aware of any other material sources of omissions from our reporting.

Independent auditor 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 Company's auditor is 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 Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of the Companies Act 2006.

Resolutions concerning the re-appointment of PricewaterhouseCoopers LLP as auditor and authorising the Audit Committee to set its remuneration will be proposed at the AGM.

Statement of directors' responsibilities

The Directors are responsible for preparing the annual report, the Directors' remuneration 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 Company and of the profit or loss of the Company and Group 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 Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and the Group and enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Company 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 our website at www.lloydsbankinggroup.com. The Directors are responsible for the maintenance and integrity of the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the current Directors who are in office as at the date of this report, and whose names and functions are listed on pages 54 to 57 of this annual report, confirm that, to the best of his or her knowledge:

- the Group financial statements, which have been prepared in accordance with IFRSs as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and Group; and
- the management report contained in the strategic report and the Directors' report includes a fair review of the development and performance of the business and the position of the Company and Group, together with a description of the principal risks and uncertainties that they face.

The Directors consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's position and performance, business model and strategy.
The Directors have also separately reviewed and approved the strategic report.

On behalf of the Board

Malcolm Wood
Company Secretary
21 February 2017
Lloyds Banking Group plc
Registered in Scotland
Company number SC95000

Directors' remuneration report

STATEMENT BY THE CHAIRMAN OF THE REMUNERATION COMMITTEE

The Committee's focus goes beyond executive pay to ensure that the interests of all colleagues and shareholders are considered fairly and consistently

KEY MESSAGES

- Remuneration review concluded in 2016, resulting in revised Reward Principles and variable remuneration design aligned to the Group's strategic priorities.
- Strong financial performance overall and further progress against strategic priorities, supporting bonus outcome of £392.9 million. This included a 19 per cent downward collective adjustment and equates to 4.8 per cent of pre bonus underlying profit.
- Executive Director 2016 bonus awards approximately 77 per cent of maximum.
- Executive Director single figure remuneration outcomes approximately 35 per cent lower than 2015, with 2014 Long-Term Incentive Plan awards vesting at 55 per cent of maximum.
- Consistent 2 per cent base salary budget applied to all colleagues, including Executive Directors.
- To build a long-term ownership culture, all colleagues will, for the first time, receive an award of shares under the new Group Ownership Share Plan.

Dear Shareholder

On behalf of the Board and as Chair of the Group's Remuneration Committee, I have pleasure in presenting the Directors' remuneration report for the year ended 31 December 2016. I am very grateful for the continued support and engagement we have had with shareholders and their representative bodies, especially during consultations on the outcomes of the remuneration review which I outlined in last year's statement and which was a key priority for 2016.

Outcomes of the remuneration review

The Committee conducted a full review of the Group's remuneration arrangements in 2016. The main focus of this review was to ensure the remuneration arrangements support our purpose of helping Britain prosper and align to the Group's aim of becoming the best bank for customers whilst delivering superior and sustainable returns for shareholders. With this in mind, the Committee simplified and updated the Reward Principles that apply across the Group to ensure they support the strategic priorities, as set out below:

Strategic priorities	Reward principle
Creating the best customer experience	Customer alignment
Becoming simpler and more efficient	Simple, affordable and motivating
Delivering sustainable growth	Shareholder alignment
Building the best team	Competitive, performance-driven and fair

Further detail is set out in the 'Summary of the remuneration review'.

There are no significant changes to the remuneration policy for Executive Directors that is being put to a binding vote at the 2017 AGM, and the maximum opportunity for both the short-term and long-term elements of variable remuneration will remain the same.

Fair reward for colleagues

The Committee's focus goes beyond executive pay. I have engaged with the Group's recognised unions, and I am keen to ensure that the interests of all colleagues are considered in the Committee's deliberations. We are mindful of the relationship between pay for executives and more junior colleagues, and to that end have sought to ensure consistency of pay outcomes with a salary budget of 2 per cent applied across the whole Group. In order to ensure that the Committee's approach to remuneration aligns to Group strategy, I have engaged the Responsible Business Committee in discussions on pay. This dialogue will continue during 2017.

In 2016, the Group has completed the moves to ensure that all customer-facing colleagues in Retail are now incentivised by reference to Balanced Scorecard metrics, rather than individual or branch level sales or product targets. This change ensures that colleagues are rewarded for action and behaviour that puts customers first. All variable remuneration decisions take into consideration the Group's Value, Codes of Responsibility, and the Conduct Pillars (Integrity, Compliance and Competence).

Sharing in the Group's performance

As part of considering the structure of remuneration, the Committee concluded that it was important all colleagues should understand that they share in the overall performance of the Group alongside other stakeholders. The short-term variable remuneration element that supports this will be known as the 'Group Performance Share plan'.

The plan outcome will be determined 'top-down' as a percentage of the Group's underlying profit, modified based on the Group's Balanced Scorecard performance and any collective adjustment for risk and conduct matters. The clear and transparent link between risk-adjusted profit and the Group Performance Share plan outcome ensures direct alignment between the interests of colleagues (including Executive Directors) and shareholders.

Building a long-term ownership culture

The Group promotes the broadest possible share ownership by colleagues to build a culture of acting as stewards of the long-term interests of the Group.

Over 80 per cent of colleagues hold an interest in the Group through participation in one of our existing share plans. To achieve 100 per cent share ownership, for the first time in 2017, all colleagues in the Group will receive an award of shares valued at £200, which they will be required to hold for at least three years. We will look to repeat awards in future years, dependent on delivering against the Group's strategic aims.

Executive-level share ownership is high, with all Executive Director shareholdings well above their minimum requirement under the shareholding policy. The Group Chief Executive's current shareholding significantly exceeds the level required, as detailed in the annual report on remuneration.

To align with the culture of broader share ownership, the long-term element of variable remuneration will be known as the 'Group Ownership Share plan'. This plan incentivises and rewards Executive Directors and senior colleagues against Group financial and strategic objectives designed to deliver superior and sustainable long-term returns for shareholders. Executives will build a direct ownership interest in the Group if those strategic objectives are met over the three-year performance period. The Committee decided that the performance measures for the 2017 awards should align to the revised Reward Principles, and with that, the Group's strategic priorities.

Remuneration outcomes for 2016

The Group has delivered strong financial performance in 2016 following further strategic progress. Underlying profit was £7.9 billion and statutory profit has more than doubled to £4.2 billion. The Group's balance sheet remains strong and capital generation of approximately 190 basis points has enabled the Group to increase the ordinary dividend, pay a special dividend and fully cover the expected capital impact of the MBNA acquisition.

The gross bonus that results from underlying profit modifiers and Balanced Scorecard performance is £484.1 million. In reaching the final decision on the 2016 bonus outcome, the Committee considered the conduct-related provisions, including an additional provision for PPI in 2016. This led to a downward adjustment of 19 per cent resulting in a final bonus outcome for 2016 of £392.9 million. This is an increase of 11 per cent compared to 2015.

The Group's bonus outcome is amongst the lowest of large UK banks and at 4.8 per cent of pre bonus underlying profit, significantly lower than the Group's funding limit of 10 per cent of pre bonus underlying profit.

A formulaic approach has been used to set the Executive Directors' bonus awards, consistent with other colleagues across the Group. The Committee determined that bonus awards of between 77 per cent and 78 per cent of maximum should be made to Executive Directors. Each of these awards, as well as the proposed Group Ownership Share awards detailed in the report, reflect the Group's strong underlying performance against both financial and Balanced Scorecard metrics.

The long-term incentive plan (LTIP) awards made in 2014 are proposed to vest at 55 per cent, reflecting performance in the period to 31 December 2016.

Overall, the total remuneration for the Executive Directors is down by around 35 per cent compared to 2015. Further details on the reward outcomes for Executive Directors are outlined in the annual report on remuneration.

The Group's approach to deferral of total variable remuneration ensures that both the short-term and long-term elements are subject to deferral in a way that results in a slower release of variable remuneration than the minimum regulatory requirements. In line with the new PRA remuneration requirements for PRA Senior Managers, the Group Ownership Share element is deferred over seven years with pro rata vesting between the third and seventh year.

Across all colleagues, less than 3.5 per cent of annual bonus plan awards are above £25,000 and relate to high performing colleagues at senior levels. The first £2,000 of any bonus award continues to be paid in cash in March 2017, with the balance deferred in shares which are released periodically over subsequent months and years.

2017 Executive Director salaries

It was the Committee's intent that Executive Director salary increases remain aligned with the 2 per cent budget for all colleagues. With that principle in mind, the Committee proposes to increase the base salaries of the Chief Financial Officer and the Chief Risk Officer by 2 per cent.

As disclosed in the 2015 Directors' remuneration report, for the first time since 2011, a salary increase was applied in 2016 for the Group Chief Executive to begin to adjust his base salary to the previously disclosed Reference Salary of £1.22 million, which was set relative to the market when he joined in 2011, and for the adjustment to be staged over two years. As a result the second stage of the adjustment to £1.22 million is to be implemented with effect from January 2017, with 2 per cent of the increase delivered in cash and the remainder in shares.

2017 Annual General Meeting

Approval for the Directors' remuneration policy will be sought at the AGM on 11 May 2017; if approved, it will take effect from that date. I hope you will support the resolutions relating to remuneration.

Anita Frew
Chairman, Remuneration Committee

Directors' remuneration report continued

SUMMARY OF THE REMUNERATION REVIEW

Enhancing the link between remuneration and strategy

As part of the review of the Group's variable remuneration arrangements in 2016, the existing reward principles were simplified and updated to ensure they support the Group's strategic priorities. The table below shows the link between strategic priorities, the reward principles and performance measures for the Group Ownership Share and Group Performance Share plans. Further detail can be found in the strategic report.

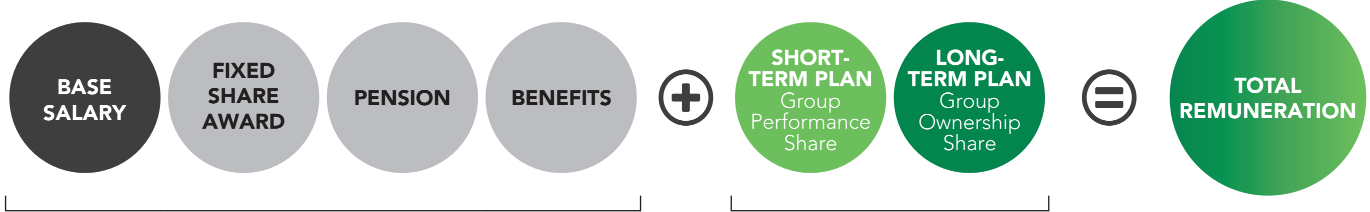
Strategic priorities	Reward principle	Long-term measures (Group Ownership Share plan)	Short-term measures (Group Performance Share plan), examples include:
Creating the best customer experience	**Customer alignment** – Rewards action and behaviour which puts customers first – Builds a responsible business plan that helps Britain prosper – Supports the Culture Plan	– Net promoter score – FCA total reportable complaints per 1,000 accounts and Financial Ombudsman Service (FOS) uphold rate – Digital active customer base	– Helping Britain Prosper Plan – Best Bank for Customers index – Digital active customer base
Becoming simpler and more efficient	**Simple, affordable and motivating** – Flexible and simple – Transparent and understood (by colleagues and other stakeholders) – Motivating awards which colleagues value	– Cost:income ratio – Economic profit	– Cost:income ratio
Delivering sustainable growth	**Shareholder alignment** – Supports delivery of long-term, superior and sustainable returns – Promotes sound and effective risk management – Complies with regulations	– Absolute Total Shareholder Return	– Underlying profit before tax – Common equity tier 1 (CET1) ratio – PRA stress test
Building the best team	**Competitive, performance-driven and fair** – Drives successful change towards Bank of the Future – Encourages working together as one team – Delivers fair outcomes, based on performance, not personal characteristics	– Employee engagement index	– Performance excellence index – Employee engagement index – Inclusion & Diversity

The Group's remuneration arrangements support its purpose of helping Britain prosper and align to the Group's aim of becoming the best bank for customers, whilst delivering long-term, superior and sustainable returns for shareholders.

The Group believes in offering fair reward. It fosters a performance-driven and meritocratic culture where colleagues share in the collective success of the Group and are rewarded for performance aligned to the long-term sustainable success of the business and the commitment to changing the culture of the Group.

The new variable remuneration arrangements have been designed to reinforce the simplified reward principles and maintain a separate short-term and long-term model. Remuneration remains weighted towards the long-term and the design closely aligns to the Group's strategic priorities. There have not been any changes to the maximum potential under either plan.

The graphic below summarises the elements of the Executive Directors' total remuneration package for 2017.



Simplifying the approach to short-term variable remuneration: Group Performance Share

The Group Performance Share plan provides Executive Directors and colleagues with a reward for delivery against the Group's short-term financial and strategic priorities. The annual performance share outcome is based on a percentage of the Group's underlying profit, adjusted by a strategic multiplier based on the Group's Balanced Scorecard (BSC) metrics and risk matters. This approach replaces the more complex methodology used in recent years where the Group's total bonus outcome was driven by the aggregate divisional and functional bonus outcomes and provides a clear line of sight for Executive Directors, colleagues and shareholders.

In order to ensure that the opportunity under the Group Performance Share plan is not increased when compared to the previous annual bonus plan, the Committee has included threshold and maximum payout levels. The maximum for 2017 is 20 per cent above the underlying profit target and a 'Top' rating against Balanced Scorecard objectives. This is consistent with prior years. The threshold is set at 20 per cent below the Group's underlying profit target.

Long-term variable remuneration: Group Ownership Share

From 2017, the long-term incentive plan will be known as the Group Ownership Share plan to reinforce its link to the Group's strategic priorities and provide greater shareholder alignment. The Group Ownership Share plan ensures Executive Directors and senior colleagues build an ownership interest in the Group and are motivated by delivering long-term superior and sustainable returns for shareholders. Vesting is subject to future three-year performance with a clear link between measures and key strategic priorities.

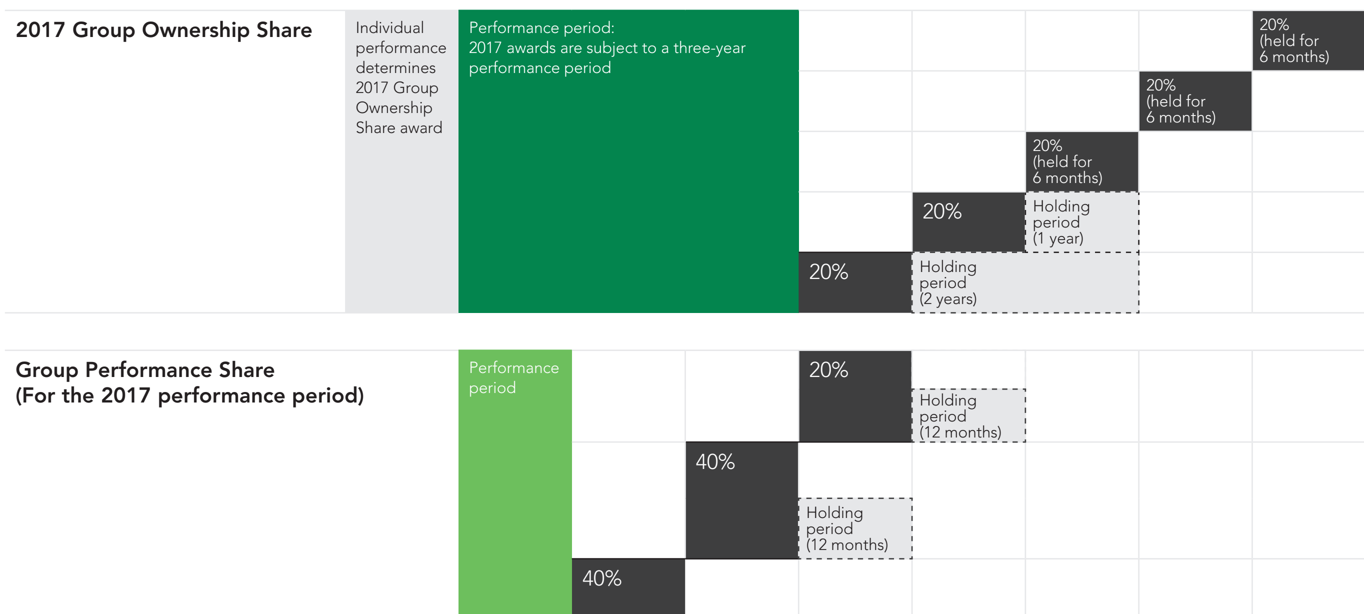
2017 deferral of variable remuneration

Under new PRA remuneration requirements, 60 per cent of variable remuneration awarded to PRA Senior Managers must be deferred for seven years with pro rata vesting between the third and seventh year. The Group's approach ensures that both short-term and long-term variable remuneration is subject to deferral and is more onerous than the minimum PRA requirements, as over 60 per cent of variable remuneration awarded to Executive Directors is deferred under the Group Ownership Share plan and vests over a period of seven years from the date of grant.

Due to this more onerous approach under the Group Ownership Share plan, awards for Executive Directors under the Group Performance Share plan are deferred for two years as follows:

– 40 per cent will be released in the first year following award;
– 40 per cent will be released in the second year; and
– the remaining 20 per cent will be released in the third year.

The graphic below illustrates how the Group's deferral approach for Executive Directors (who are PRA Senior Managers for regulatory purposes) continues to be weighted to the long term, underpinning the strategic priority and reward principle of delivering sustainable growth. Any shares released are subject to a further holding period in line with regulatory requirements and market practice. In line with shareholder expectations, no Group Ownership Share awards are unconditionally released until at least five years after grant.



Directors' remuneration report continued

REMUNERATION AT A GLANCE

How Lloyds Banking Group performed

Key performance measures

The table below illustrates outcomes against the Group's key performance measures relevant to remuneration.

The annual bonus outcome is driven by a combination of Group underlying profit and Balanced Scorecard performance. The long-term incentive plan measures Group performance over a three-year period, using a range of financial and strategic measures.

Measure	2016	2015
Underlying profit before tax	**£7,867m**	£8,112m[1]
Group Balanced Scorecard	**Strong plus**	Strong
Economic profit	**£3,377m**	£2,233m
Total Shareholder Return (TSR) *Per annum for the three years ended 31 December*	**(5%)**	16.6%
Cost:income ratio	**48.7%[2]**	49.3%
Net promoter score	**62.7**	59.3
Digital active customer base	**12.5m**	11.5m
Employee engagement index	**71**	71

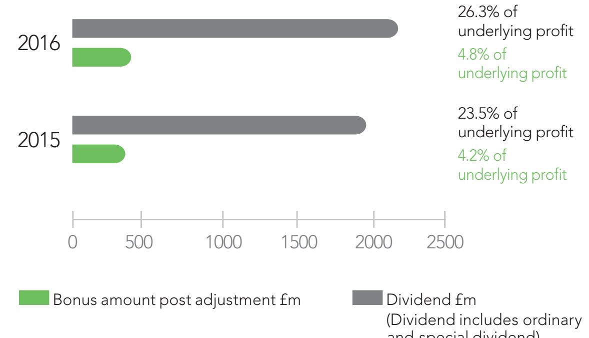
1 The underlying profit result used for remuneration purposes was £7,994 million (excluding TSB).
2 The adjusted cost:income ratio result used for remuneration purposes was 50.5 per cent.

Annual bonus plan outcome

The Group has delivered strong financial performance in 2016 following further strategic progress. In reaching the decision on the 2016 bonus outcome, the Committee considered the conduct-related provisions, including an additional provision for PPI in 2016. This led to a downward adjustment of 19 per cent.

The total bonus award as a percentage of pre-bonus underlying profit before tax increased from 4.2 per cent in 2015 to 4.8 per cent in 2016. This compares favourably to shareholder return from dividend payments over the same period which increased to 26.3 per cent of underlying profit and remains significantly lower than the Group's funding limit of 10 per cent of pre bonus underlying profit.

For Executive Directors, awards of between 77 per cent and 78 per cent of maximum opportunity were determined reflecting Group and individual performance.



Long-term incentive plan outcome

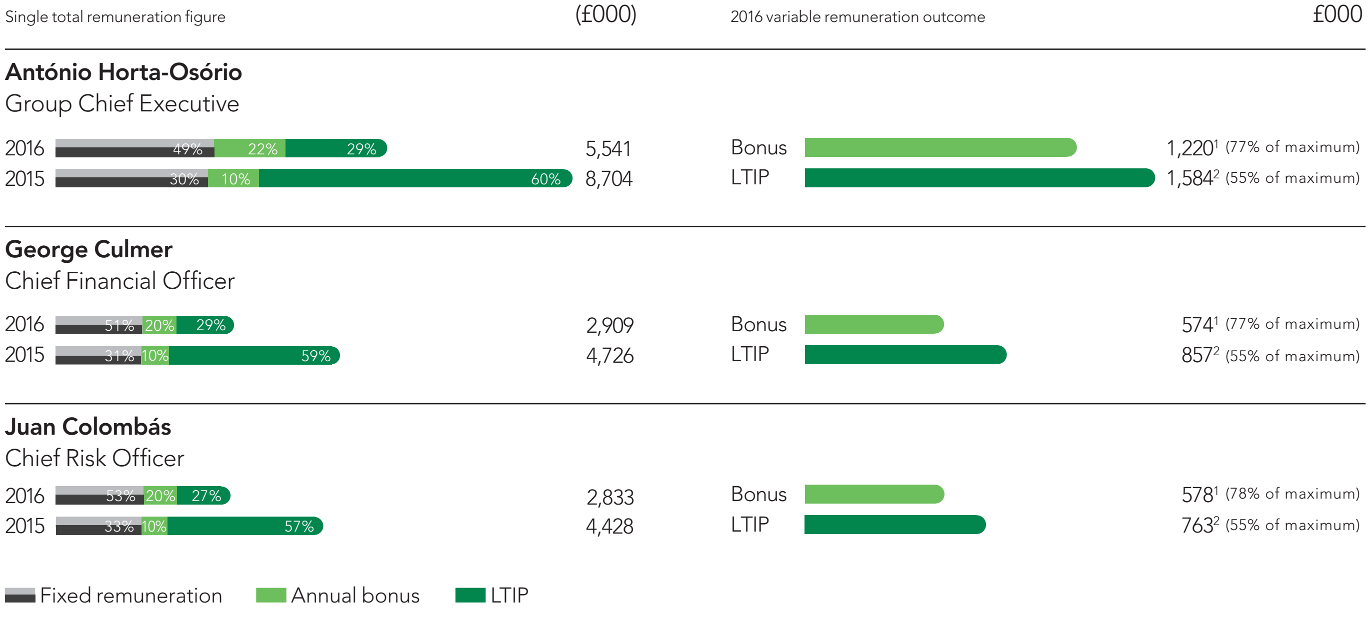
The Group has delivered a good financial performance over the performance period of the 2014 Long-Term Incentive Plan (LTIP) awards, continuing to transform the business for the benefit of its shareholders. Performance was measured over three financial years ended 31 December 2016. The performance conditions attached to these awards and actual performance are set out in the table below. At the end of the performance period, it has been assessed that awards will vest at 55 per cent of maximum. Executive Directors are required to retain any shares vesting for a further two years post vesting.

Weighting	Measure	Performance achievement versus targets: Threshold	Maximum	Actual	Vesting as % maximum (for that element)
30%	Economic profit	£2,154m	£3,231m	Actual: £3,377m	30%
30%	Absolute TSR	8% p.a	16% p.a.	Actual: (5%)	0%
10%	Cost:income ratio[1]	48.9%	46.5%	Actual: 50.5%	0%
10%	Customer satisfaction[2]	0.54	0.50	Actual: 0.46	10%
10%	Net promotor score	3rd place	1st place	Actual: 1st place	10%
5%	SME lending	14%	18%	Actual: 13.4%	0%
5%	Share of first-time buyer market	20%	25%	Actual: 25.5%	5%
LTIP (% maximum) vesting					55%

1 Adjusted total costs.
2 FCA reportable complaints per 1,000 for the period up to and including H1 2016 and formally closed FCA complaints per 1,000 accounts for the period from H2 2016. Both exclude PPI complaints, any complaints received via Claims Management Companies (CMC) and any complaints relating to TSB activity. With the introduction of the FCA guidance contained in PS15/19 applicable from 1 July 2016, the complaint classification and reporting for the original metric ceased on 30 June 2016. Accordingly, the Remuneration Committee has rebased the original 2014 metrics in line with the new FCA reporting regime. The Remuneration Committee considers the rebased targets equally stretching.

Executive Director remuneration outcomes

The charts below summarise the Executive Directors' remuneration for the years ended 31 December 2015 and 2016.



1 2016 bonus, awarded in March 2017.

2 2014 LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 15 February 2017. The average share price between 1 October 2016 and 31 December 2016 (58.30 pence) has been used to calculate the value. The shares were awarded in 2014 based on a share price of 78.878 pence.

Directors' fixed remuneration for 2017

Base salary

2017 base salaries will be as follows:

Group Chief Executive: £1,220,000 (1 January 2017)

Chief Financial Officer: £764,070 (1 April 2017)

Chief Risk Officer: £753,458 (1 January 2017)

Fixed share award

The levels of award set for 2017 remain unchanged and are as follows:

Group Chief Executive: £900,000

Chief Financial Officer: £504,000

Chief Risk Officer: £497,000

Directors' remuneration report continued

DIRECTORS' REMUNERATION POLICY

Approval for this remuneration policy will be sought at the AGM on 11 May 2017 and, if approved, will take effect from that date.

It is intended that approval of the remuneration policy will be sought at three-year intervals, unless amendments to the policy are required, in which case further shareholder approval will be sought. Information on how the Policy will be implemented in 2017 is included in the annual report on remuneration.

The Group's policy continues to help ensure that the remuneration proposition is both cost effective and enables the Group to attract and retain executives of the highest calibre. The objective is to align individual reward with the Group's performance, the interests of its shareholders and a prudent approach to risk management. In this way, the requirements of the major stakeholders are balanced: customers, shareholders, employees, and regulators.

The policy is based on principles which are applicable to all employees within the Group and, in particular, the principle that the reward package should support the delivery of the Group's purpose of helping Britain prosper and the strategic aim of becoming the best bank for customers whilst delivering long-term superior and sustainable returns to shareholders. It fosters a performance-driven and meritocratic culture, encourages effective risk disciplines and is in line with relevant regulations and codes of best practice. There is no significant difference between the policy for Executive Directors and that for other senior employees. If a significant difference for any individual were proposed, this would be subject to approval by the Remuneration Committee (within regulatory requirements). The table below summarises how the policy applies across the Group.

		Executive Directors	Group Executive Committee	Other Material Risk Takers	Other employees
Fixed	Base salary	✔	✔	✔	✔
	Fixed share award[1]	✔	✔	✔	✔
	Pension and benefits	✔	✔	✔	✔
Variable	Short-term incentive	✔	✔	✔	✔
	Long-term incentive	✔	✔	✔[1]	✔[1]

1 Eligibility based on seniority, grade and role.

Consideration of shareholders' and employees' views

The Group is committed to regular dialogue with stakeholders. In formulating the policy, the Remuneration Committee has consulted extensively with a number of shareholders and key stakeholders, such as the Group's main regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The following topics were discussed:

- Alignment of variable remuneration to Group strategic priorities
- Structure of variable remuneration
- Latest regulatory requirements
- Latest shareholder guidelines

Formal consultation on the remuneration of Executive Directors is not undertaken with employees and no formal remuneration comparison measurements were used. However, surveys are undertaken semi-annually on employee engagement and discussion on the Group's remuneration approach takes place with union representatives during the annual pay review cycle and on relevant employee reward matters, on which the Remuneration Committee receives and considers relevant feedback. In addition, the Remuneration Committee has reviewed equal pay analysis undertaken by an independent third party and will continue to monitor this on an ongoing basis.

Colleague opinion is also sought through regular engagement surveys. This includes questions relating to remuneration, the results of which in 2016 positioned colleague satisfaction with the Group's reward arrangements, including the link to performance, above the high performing norm of UK companies.

Remuneration policy table for Executive Directors

Base salary	
Purpose and link to strategy	To support the recruitment and retention of Executive Directors of the calibre required to develop and deliver the Group's strategic priorities. Base salary reflects the role of the individual, taking account of market competitiveness, responsibilities and experience, and pay in the Group as a whole.
Operation	Base salaries are typically reviewed annually with any increases normally taking effect from 1 January. When determining and reviewing base salary levels, the Committee takes into account base salary increases for employees throughout the Group and ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Pay for comparable roles in comparable publicly listed financial services groups of a similar size. Salary may be paid in sterling or other currency and at an exchange rate determined by the Committee.
Maximum potential	The Committee will make no increase which it believes is inconsistent with the two parameters above. Increases will normally be in line with the increase awarded to the overall employee population. However, a greater salary increase may be appropriate in certain circumstances, such as a new appointment made on a salary below a market competitive level, where phased increases are planned, or where there has been an increase in the responsibilities of an individual. Where increases are awarded in excess of the wider employee population, the Committee will provide an explanation in the relevant annual report on remuneration.
Performance measures	N/A
Changes	Previously, the Group Chief Executive (GCE) had a reference salary of £1.22 million which was used to calculate certain elements of long-term remuneration and the pension allowance. Due to the GCE's base salary being increased to his reference salary (effective from 1 January 2017), the concept of reference salary is being removed. Elements of long-term remuneration and the pension allowance which were previously calculated with regard to reference salary will be calculated with regard to the GCE's base salary.

Fixed share award	
Purpose and link to strategy	To ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for Executive Directors with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements.
Operation	The fixed share award will initially be delivered entirely in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The Committee can, however, decide to deliver some or all of it in the form of cash.
Maximum potential	The maximum award is 100 per cent of base salary.
Performance measures	N/A
Changes	No change to policy

Pension	
Purpose and link to strategy	To provide cost effective and market competitive retirement benefits, supporting Executive Directors in building long-term retirement savings.
Operation	Executive Directors are entitled to participate in the Group's defined contribution scheme with company contributions set as a percentage of salary. An individual may elect to receive some or all of their pension allowance as cash in lieu of pension contribution.
Maximum potential	The maximum allowance for the GCE is 50 per cent of base salary less any flexible benefits allowance. The maximum allowance for other Executive Directors is 25 per cent of base salary.
Performance measures	N/A
Changes	No change to policy for existing Executive Directors. All future appointments as Executive Directors will attract a maximum allowance of 25 per cent of base salary.

Benefits	
Purpose and link to strategy	To provide flexible benefits as part of a competitive remuneration package.
Operation	Benefits may include those currently provided and disclosed in the annual report on remuneration. Core benefits include a company car or car allowance, private medical insurance, life insurance and other benefits that may be selected through the Group's flexible benefits plan. Additional benefits may be provided to individuals in certain circumstances such as relocation. This may include benefits such as accommodation, relocation, and travel. The Committee retains the right to provide additional benefits depending on individual circumstances. When determining and reviewing the level of benefits provided, the Committee ensures that decisions are made within the following two parameters: – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective job-sizing methodologies. – Benefits for comparable roles in comparable publicly listed financial services groups of a similar size.
Maximum potential	The Committee will make only increases in the benefits currently provided which it believes are consistent with the two parameters above. Executive Directors receive a flexible benefits allowance, in line with all other employees. The flexible benefits allowance does not currently exceed 4 per cent of base salary.
Performance measures	N/A
Changes	No change to policy

All-employee plans	
Purpose and link to strategy	Executive Directors are eligible to participate in HMRC-approved share plans which promote share ownership by giving employees an opportunity to invest in Group shares.
Operation	Executive Directors may participate in these plans in line with HMRC guidelines currently prevailing (where relevant), on the same basis as other eligible employees.
Maximum potential	Participation levels may be increased up to HMRC limits as amended from time to time. The monthly savings limits for Save As You Earn (SAYE) is currently £500. The maximum value of shares that may be purchased under the Share Incentive Plan (SIP) in any year is currently £1,800 with a two-for-one match. Currently a three-for-two match is operated up to a maximum employee investment of £30 per month. The maximum value of free shares that may be awarded in any year is £3,600.
Performance measures	N/A
Changes	No change to policy

Directors' remuneration report continued

Group Performance Share plan

Purpose and link to strategy	To incentivise and reward the achievement of the Group's annual financial and strategic targets whilst supporting the delivery of long-term superior and sustainable returns.
Operation	Measures and targets are set annually and awards are determined by the Committee after the year end based on performance against the targets set. The Group Performance Share may be delivered partly in cash, shares, notes or other debt instruments including contingent convertible bonds. Where all or part of any award is deferred, the Committee may adjust these deferred awards in the event of any variation of share capital, demerger, special dividend or distribution or amend the terms of the plan in accordance with the plan rules. Where an award or a deferred award is in shares or other share-linked instrument, the number of shares to be awarded may be calculated using a fair value or based on discount to market value, as appropriate. The Committee applies its judgement to determine the payout level commensurate with business and/or individual performance. The Committee may reduce the level of award (including to zero), apply additional conditions to the vesting, or delay the vesting of deferred awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.
Maximum potential	The maximum Group Performance Share opportunities are 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors.
Performance measures	Measures and targets are set annually by the Committee in line with the Group's strategic business plan and further details are set out in the annual report on remuneration for the relevant year. Measures consist of both financial and non-financial measures and the weighting of these measures will be determined annually by the Committee. The weightings of the performance measures for the 2017 financial year are set out on page 99. All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance (as determined by the Committee) is not met for financial measures or the individual is rated 'Developing performer' or below. The expected value of the Group Performance Share is 30 per cent of maximum opportunity. The Committee is committed to providing transparency in its decision making in respect of Group Performance Share awards and will disclose historic measures and target information together with information relating to how the Group has performed against those targets in the annual report on remuneration for the relevant year except to the extent that this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.
Changes	Due to regulatory changes, Executive Directors can no longer receive dividend equivalents on deferred shares. The number of shares to be awarded may be calculated using a fair or discounted value. If regulatory requirements change, dividend equivalents may be paid. There are no changes to maximum opportunity.

Group Ownership Share plan

Purpose and link to strategy	To incentivise and reward Executive Directors and senior management to deliver against strategic objectives designed to support the long-term success of the Group and encourage working as a team. It ensures executives build an ownership interest in the Group and are motivated by delivering long-term superior and sustainable returns for shareholders.
Operation	Awards are granted under the rules of the 2016 Long-Term Incentive Plan approved at the AGM on 12 May 2016. Awards are made in the form of conditional shares or nil cost options. Award levels are set at the time of grant, in compliance with regulatory requirements, and may be subject to a discount in determining total variable remuneration under the rules set by the European Banking Authority. The number of shares to be awarded may be calculated using a fair value or based on a discount to market value, as appropriate. Vesting will be subject to the achievement of performance conditions measured over a period of three years, or such longer period, as determined by the Committee. The Committee retains full discretion to amend the payout levels should the award not reflect business and/or individual performance. The Committee may reduce (including to zero) the level of the award, apply additional conditions to the vesting, or delay the vesting of awards to a specified date or until conditions set by the Committee are satisfied, where it considers it appropriate as a result of an event occurring before vesting. Awards may be subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation.
Maximum potential	The maximum annual award for Executive Directors will normally be 300 per cent of salary. Under the plan rules, awards can be made up to 400 per cent of salary in exceptional circumstances.

Performance measures	Measures and targets are set by the Committee annually and are set out in the annual report on remuneration each year. At least 60 per cent of awards are weighted towards typical market (e.g. Total Shareholder Return) and/or financial measures (e.g. economic profit), with the balance on strategic measures. 25 per cent will vest for threshold performance, 50 per cent for on-target performance and 100 per cent for maximum performance. The measures are chosen to support the best bank for customers strategy and to align management and shareholder interests. Targets are set by the Committee to be stretching within the context of the strategic business plan. Measures are selected to balance profitability, achievement of strategic goals and to ensure the incentive does not encourage inappropriate risk-taking. Following the end of the relevant performance period, the Committee will disclose in the annual report on remuneration for the relevant year historic measure and target information, together with how the Group has performed against those targets, unless this information is deemed to be commercially sensitive, in which case it will be disclosed once it is deemed not to be sensitive.
Changes	Due to regulatory changes, Executive Directors can no longer receive dividend equivalents on deferred shares. The number of shares to be awarded may be calculated using a fair or discounted value. If regulatory requirements change, dividend equivalents may be paid. There are no changes to maximum opportunity.

Deferral of variable remuneration and holding periods

Operation	The Group Performance Share and Group Ownership Share plans are both considered variable remuneration for the purpose of regulatory payment and deferral requirements. The payment of variable remuneration and deferral levels are determined at the time of award and in compliance with regulatory requirements (which currently require that at least 60 per cent of total variable remuneration is deferred for seven years with pro rata vesting between the third and seventh year, and at least 50 per cent of total variable remuneration is paid in shares or other equity linked instruments subject to a holding period in line with current regulatory requirements). A proportion of the aggregate variable remuneration may vest immediately on award. The remaining proportion of the variable remuneration is then deferred in line with regulatory requirements.
Changes	The deferral period has been extended to comply with new regulatory requirements.

Further information on which performance measures were chosen and how performance targets are set are disclosed in the relevant sections throughout the report.

Discretion in relation to Group Performance Share and Group Ownership Share plans

The Committee retains discretion with regards to these plans. This relates to:

- the timing, size and type of awards and holding periods, subject to policy maxima;
- adjustments required in certain circumstances (e.g. rights issues, corporate restructuring events and special dividends);
- where qualitative performance measures are used and performance against those measures is not commensurate with the Group's overall financial performance over the performance period;
- adjustment of targets and measures if events occur which cause it to determine that the conditions are no longer appropriate. The Committee also retains the right to change performance targets and measures and the weighting of measures, including following feedback from regulators, shareholders and/or other stakeholders; and
- amending the plan rules in accordance with their terms.

The exercise of the Committee's discretion will be disclosed in accordance with regulatory requirements.

Legacy awards and restrictions on payments

The Committee reserves the right to make any remuneration payments/awards and any payments/awards for loss of office, notwithstanding that they are not in line with the policy set out above where the terms of the payment/award were agreed (i) before the Directors' remuneration policy approved by shareholders on 15 May 2014 (the '2014 policy') came into effect; (ii) pursuant to the 2014 policy; or (iii) at a time when the relevant individual was not a Director of the Group and, in the opinion of the Committee, the payment/award was not in consideration for the individual becoming a Director of the Group. Such payments/awards will have been set out in the annual report on remuneration for the relevant year. They include awards and payments made under previous approved remuneration policy and payments in relation to deferred bonus awards and long-term incentive awards granted in 2012 and 2013.

Illustration of application of remuneration policy

The charts below illustrate possible remuneration outcomes under the following three scenarios:

1. The maximum that may be paid, assuming full Group Performance Share payout and full vesting under the Group Ownership Share plan.
2. The expected value of remuneration for performance midway between threshold and maximum, assuming 30 per cent of maximum Group Performance Share opportunity and 50 per cent vesting under the Group Ownership Share plan.
3. The minimum that may be paid, where only the fixed element is paid (salary, benefits, pension and the fixed share award).

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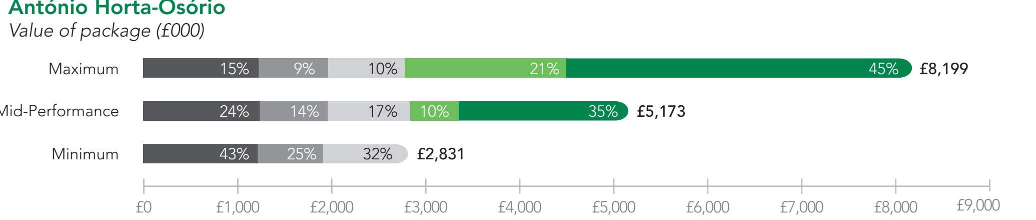
No share price growth has been assumed. The amounts are based on salaries as at 1 January 2017 (GCE and CRO) and 1 April 2017 (CFO) and implementation of the policy in 2017 as set out in the annual report on remuneration.

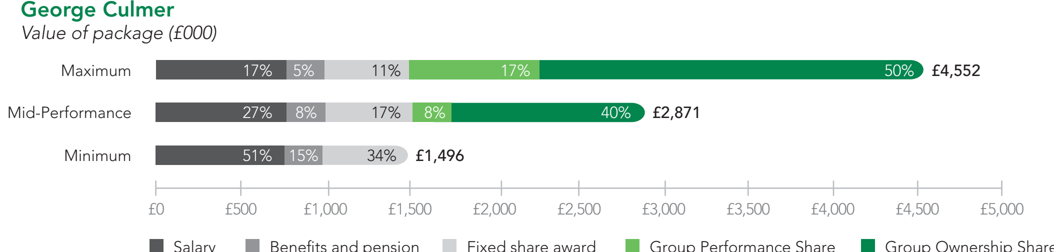
António Horta-Osório

Value of package (£000)



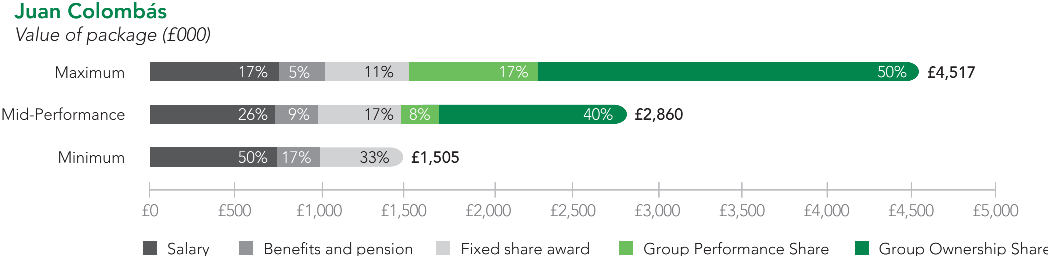
George Culmer

Value of package (£000)



Juan Colombás

Value of package (£000)



Approach to recruitment and appointment to the Board

In determining appropriate remuneration arrangements on hiring a new Executive Director, the Committee will take into account all relevant factors. This may include the experience and calibre of the individual, local market practice, the existing remuneration arrangements for other executives and the business circumstances. The Committee will seek to ensure that arrangements are in the best interests of both the Group and its shareholders and will seek not to pay more than is necessary.

The Committee may make awards on hiring an external candidate to 'buy-out' remuneration arrangements forfeited on leaving a previous employer. In doing so the Committee will take account of relevant factors including any performance conditions attached to these awards, the form in which they were granted (e.g. cash or shares), the currency of the awards, and the timeframe of awards. Any such award made will be made in accordance with the PRA's Rulebook and made on a comparable basis to those forfeited and subject to malus and clawback at the request of the previous employer as required by the PRA rules.

The package will normally be aligned with the remuneration policy as described in the policy report. However, the Committee retains the discretion to make appropriate remuneration decisions outside the standard policy to facilitate the recruitment of an individual of the calibre required and in exceptional cases.

This may, for example, include the following circumstances:

- An interim recruit, appointed to fill an Executive Director role on a short-term basis.
- Exceptional circumstances requiring the Chairman to take on an executive function on a short-term basis.
- An Executive Director recruited at a time in the year when it would be inappropriate to provide a Group Performance Share or Group Ownership Share award for that year, for example, where there may be insufficient time to assess performance. In this situation the Committee may feel it appropriate to transfer the quantum in respect of the months employed during the year to the subsequent year so that reward is provided on a fair basis.
- An Executive Director recruited from a business or location where benefits are provided that do not fall into the definition of 'variable remuneration forfeited' but where the Committee considers it reasonable to buy-out these benefits.
- Transitional arrangements for overseas hires, which might include relocation expenses and accommodation.

The maximum level of variable remuneration (excluding buy-out awards) that may be awarded to new Executive Directors is equal to 200 per cent of fixed remuneration, including any discount permitted by the European Banking Authority for Group Ownership Share awards. In making any such remuneration decisions, the Committee will apply any appropriate performance measures in line with those applied to other Executive Directors.

A full explanation will be provided of any buy-out award or discretionary payment.

Service agreements

The service contracts of all current Executive Directors are terminable on 12 months' notice from the Group and six months' notice from the individual. The Chairman also has a letter of appointment. His engagement may be terminated on six months' notice by either the Group or him.

	Notice to be given by the Group	Date of service agreement
Lord Blackwell	6 months	31 March 2014
António Horta-Osório	12 months	3 November 2010
George Culmer	12 months	1 March 2012
Juan Colombás	12 months	30 November 2010

Under his contract (dated 3 November 2010), António Horta-Osório (GCE) is entitled to an amount equivalent to base salary and pension allowance as a payment in lieu of notice if notice to terminate is given by the Group. If notice to terminate is given by the GCE, he is entitled to an amount equivalent to base salary if the Group chooses to make a payment in lieu of notice. Such payments in lieu will be made in monthly instalments subject to mitigation. He is also entitled to six months' notice from the Group in the event of his long-term incapacity. As part of a buy-out of a pension forfeited on joining from Santander, the GCE is also entitled to the provision of a conditional unfunded pension commitment, subject to performance conditions as described further in the annual report on remuneration. In the event of long-term incapacity, if the GCE does not perform his duties for a period of at least 26 weeks (in aggregate over a 12 month period), the Group shall be entitled to terminate his employment by giving six months' notice. In all other respects, the terms of the GCE's contract in relation to payments for loss of office match those set out below for new directors.

Under terms agreed when joining the Group, Juan Colombás is entitled to a conditional lump sum benefit, payable either (i) on reaching normal retirement age unless he voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death, as described further in the annual report on remuneration.

The service contracts and letters of appointment are available for inspection at the Company's registered office.

Notice periods

Newly-appointed Executive Directors will be employed on contracts that include the following provisions:

- The individual will be required to give six months' notice if they wish to leave and the Group will give 12 months' notice other than for material misconduct or neglect or other circumstances where the individual may be summarily dismissed by written notice. In exceptional circumstances, new joiners will be offered a longer notice period (typically reducing to 12 months within two years of joining).
- In the event of long-term incapacity, if the Executive Director does not perform their duties for a period of at least 26 weeks (in aggregate over a 12 month period), the Group shall be entitled to terminate the executive's employment by giving three months' notice.
- At any time after notice to terminate is given by either the Group or the Executive Director, the Group may require the Executive Director to take leave for some or all of the notice period.
- At any time, at its absolute discretion, the Group may elect to terminate the individual's employment by paying to the Executive Director, in lieu of the notice period, an amount equivalent to base salary, subject to mitigation as described more fully in the termination payments section of this report, below.

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Termination payments

It is the Group's policy that where compensation on termination is due, it should be paid on a phased basis, mitigated in the event that alternative employment is secured. Where it is appropriate to make a bonus payment (now known as Group Performance Share) to the individual, this should relate to the period of actual service, rather than the full notice period. Any Group Performance Share payment will be determined on the basis of performance as for all continuing employees and will remain subject to performance adjustment (malus and clawback) and deferral. Generally, on termination of employment, Group Performance Share awards, long-term incentive awards (now known as Group Ownership Share) and other rights to payments will lapse except where termination falls within one of the reasons set out below. In the event of redundancy, the individual may receive a payment in line with statutory entitlements at that time. If an Executive Director is dismissed for gross misconduct, the Executive Director will receive normal contractual entitlements until the date of termination and all deferred Group Performance Share and Group Ownership Share awards will lapse.

	Base salary	Fixed share award	Pension, benefits and other fixed remuneration
Resignation	In the case of resignation to take up new employment, paid until date of termination (including any period of leave required by the Group). In the case of resignation for other reasons, base salary will be paid in monthly instalments for the notice period (or any balance of it), offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Redundancy or termination by mutual agreement	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination unless, in the case of mutual agreement, the Committee determines that exceptional circumstances apply in which case shares may be released on termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).
Retirement/ill health, injury, permanent disability/death	Paid until date of retirement/death. For ill health, injury or permanent disability which results in the loss of employment, paid for the applicable notice period (including any period of leave required by the Group).	Awards will normally continue and be released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination except for (i) death where shares are released on the date of termination; or (ii) in the case of permanent disability the Committee determines that exceptional circumstances apply in which case shares may be released on the date of termination.	Paid until date of death/ retirement (subject to individual benefit scheme rules). For ill health, injury, permanent disability, paid for the notice period including any period of leave required by the Group (subject to individual benefit scheme rules).
Change of control or merger	N/A	Awards will be payable on the date of the Change of Control and the number of shares subject to the award will be reduced to reflect the shorter accrual period. The Committee may decide that vested awards will be exchanged for (and future awards made over) shares in the acquiring company or other relevant company.	N/A
Other reason where the Committee determines that the executive should be treated as a good leaver	Paid until date of termination (including any period of leave required by the Group). In respect of the balance of any notice period, base salary will be paid in monthly instalments, offset by earnings from new employment during this period.	Awards continue and are released at the normal time and the number of shares subject to the award in the current year will be reduced to reflect the date of termination.	Paid until date of termination including any period of leave required by the Group (subject to individual benefit scheme rules).

	Annual bonus (now known as Group Performance Share)[1]	Long-term incentive (now known as Group Ownership Share)[2]	Chairman and Non-Executive Director fees[3]
Resignation	Unvested deferred Group Performance Share awards are forfeited and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier) unless the Committee determines otherwise in exceptional circumstances.	Awards lapse on date of leaving (or on notice of leaving) unless the Committee determines otherwise in exceptional circumstances that they will vest on the original vesting date (or exceptionally on the date of leaving). Where award is to vest it will be subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Redundancy or termination by mutual agreement	For cases of redundancy, unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback. For termination by mutual agreement, the same approach as for resignation would apply.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Retirement/ill health, injury, permanent disability	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Such awards would be subject to deferral, malus and clawback.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.
Death	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination. Deferred Group Performance Share awards vest on death in cash, unless the Committee determines otherwise.	Awards vest on death subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will apply.	Paid until date of leaving Board.
Change of control or merger[2]	In-year Group Performance Share accrued up until date of change of control or merger (current year). Where there is a Corporate Event, deferred Group Performance Share awards vest to the extent and timing determined by the Committee in its absolute discretion.	Awards vest on date of event. Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period unless determined otherwise). Malus and clawback will normally apply. Instead of vesting, awards may be exchanged for equivalent awards over the shares of the acquiring company or another company.	Paid until date of leaving Board.
Other reason where the Committee determines that the executive should be treated as a good leaver	Unvested deferred Group Performance Share awards are retained and in-year Group Performance Share awards are accrued until the date of termination (or the commencement of garden leave if earlier). Deferred Group Performance Share awards vest in line with normal timeframes and are subject to malus and clawback. The Committee may allow awards to vest early if it considers it appropriate.	Awards vest on the original vesting date (or exceptionally on the date of leaving). Vesting is subject to the performance conditions and time pro-rating (for months worked in performance period). Malus and clawback will apply.	Paid until date of leaving Board.

1 If any Group Performance Share is to be paid to the Executive Director for the current year, this will be determined on the basis of performance for the period of actual service, rather than the full notice period (and so excluding any period of leave required by the Group).
2 Reference to change of control or merger includes a compromise or arrangement under section 899 of the Companies Act 2006 or equivalent. Fixed share awards may also be released/exchanged in the event of a resolution for the voluntary winding up of the Company; a demerger, delisting, distribution (other than an ordinary dividend) or other transaction, which, in the opinion of the Committee, might affect the current or future value of any award; or a reverse takeover, merger by way of a dual listed company or other significant corporate event, as determined by the Committee. In the event of a demerger, special dividend or other transaction which would in the Committee's opinion affect the value of awards, the Committee may allow a long-term incentive award to vest to the extent relevant performance conditions are met to that date and if the Committee so determined, on a time pro-rated basis (unless determined otherwise) to reflect the number of months of the performance period worked.
3 The Chairman is entitled to six months' notice.

Directors' remuneration report continued

On termination, the Executive Director will be entitled to payment for any accrued but untaken holiday calculated by reference to base salary and fixed share award.

The cost of legal, tax or other advice incurred by an Executive Director in connection with the termination of their employment and/or the cost of support in seeking alternative employment may be met up to a maximum of £100,000. Additional payments may be made where required to settle legal disputes, or as consideration for new or amended post-employment restrictions.

Where an Executive Director is in receipt of expatriate or relocation expenses at the time of termination (as at the date of the AGM no current Executive Directors are in receipt of such expenses), the cost of actual expenses incurred may continue to be reimbursed for up to 12 months after termination or, at the Group's discretion, a one-off payment may be made to cover the costs of premature cancellation. The cost of repatriation may also be covered.

Remuneration policy table for Chairman and Non-Executive Directors

The table below sets out the remuneration policy for Non-Executive Directors (NEDs).

Chairman and Non-Executive Director fees

Purpose and link to strategy	To provide an appropriate reward to attract and retain a high-calibre individual with the relevant skills, knowledge and experience.
Operation	The Committee is responsible for evaluating and making recommendations to the Board with regards to the Chairman's fees. The Chairman does not participate in these discussions. The GCE and the Chairman are responsible for evaluating and making recommendations to the Board in relation to the fees of the NEDs. When determining and reviewing fee and benefit levels, the Committee ensures that decisions are made within the following parameters: – The individual's skills and experience. – An objective assessment of the individual's responsibilities and the size and scope of their role, using objective sizing methodologies. – Fees and benefits for comparable roles in comparable publicly listed financial services groups of a similar size. The Chairman receives an all-inclusive fee, which is reviewed periodically plus benefits including life insurance, car allowance, medical insurance and transportation. The Committee retains the right to provide additional benefits depending on individual circumstances. NEDs are paid a basic fee plus additional fees for the chairmanship/membership of committees and for membership of Group companies/boards/non-board level committees. Additional fees are also paid to the senior independent director and to the deputy chairman to reflect additional responsibilities. Any increases normally take effect from 1 January of a given year. The Chairman and the NEDs are not entitled to receive any payment for loss of office (other than in the case of the Chairman's fees for the six month notice period) and are not entitled to participate in the Group's bonus, share plan or pension arrangements. NEDs are reimbursed for expenses incurred in the course of their duties, such as travel and accommodation expenses, on a grossed-up basis (where applicable).
Maximum potential	The Committee will make no increase in fees or benefits currently provided which it believes is inconsistent with the parameters above.
Performance metrics	N/A
Changes	No change to policy.

Letters of appointment

The Non-Executive Directors all have letters of appointment and are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Non-Executive Directors may have their appointment terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

Date of letter of appointment

Alan Dickinson	26 June 2014	Deborah McWhinney	26 November 2015
Anita Frew	17 November 2010	Nick Prettejohn	1 April 2014
Simon Henry	1 May 2014	Stuart Sinclair	26 November 2015
Dyfrig John	28 October 2013	Anthony Watson	23 February 2009
Nick Luff	25 February 2013	Sara Weller	31 January 2012

All Directors are subject to annual re-election by shareholders.

The service contracts and letters of appointments are available for inspection at the Company's registered office.

ANNUAL REPORT ON REMUNERATION

Implementation of the policy in 2017

It is proposed to operate the policy in the following way in 2017:

Base salary

The Group has applied a 2 per cent overall salary budget increase for the general population differentiated by performance and market position (with increases of around 4 per cent for strongly performing colleagues). Salary increases of 2 per cent are proposed for the Chief Financial Officer (CFO) and the Chief Risk Officer (CRO).

As announced last year, for the first time since 2011 a salary increase was applied in 2016 for the Group Chief Executive to begin to adjust his base salary to the previously disclosed reference salary of £1,220,000 which was set relative to the market when he joined in 2011. After discussing the proposed increase with shareholders, the Remuneration Committee decided to stage the adjustment over two years, with an initial increase to £1,125,000 effective from 1 January 2016 and the second stage increase to £1,220,000 due to be implemented with effect from 1 January 2017. The form of the increase will follow that for 2016, with 2 per cent delivered in cash (in line with other colleagues) and the remainder in shares, held until the government has sold its shareholding in the Group.

Salaries will therefore be as follows, effective dates shown below:

GCE: £1,220,000 (1 January 2017)

CFO: £764,070 (1 April 2017)

CRO: £753,458 (1 January 2017)

Due to the GCE's base salary being increased in line with his reference salary (effective from 1 January 2017), the concept of a separate reference salary will be removed. Reference salary will therefore no longer be used when calculating certain elements of long-term remuneration and the pension allowance. Instead, these elements will be calculated with reference to the GCE's base salary.

Fixed share award

The levels of the 2017 award are unchanged from 2016 and are as follows:

GCE: £900,000

CFO: £504,000

CRO: £497,000

Shares will be released in equal tranches over a five year period.

Pension

Executive Directors are entitled to a pension allowance which they may choose to take as cash in lieu of pension contributions.
The level of allowances has not been increased for 2017.

GCE: 50 per cent of base salary less flexible benefits allowance

CFO: 25 per cent of base salary

CRO: 25 per cent of base salary

Benefits

For 2017, the benefits provided to Executive Directors include a car allowance, transportation, private medical insurance, life assurance and other benefits selected through the flexible benefits allowance which is currently capped at 4 per cent of base salary (unchanged from 2016).

All-employee plans

Executive Directors are eligible to participate in the Group's Sharesave and Sharematch plans on the same basis as other employees.

Group Performance Share plan

Opportunity	The maximum Group Performance Share opportunity is 140 per cent of base salary for the GCE and 100 per cent of base salary for other Executive Directors (unchanged from 2016). All assessments of performance are ultimately subject to the Committee's judgement, but no award will be made if threshold performance for the financial measure is not met and/or the individual is rated 'Developing performer' or below. The threshold is set at 20 per cent below the Group's underlying profit target.
Deferral	For the 2017 performance year, the Group Performance Share opportunity will be awarded in a combination of cash (up to 50 per cent) and shares. 40 per cent will be released in the first year following award, 40 per cent will be released in the second year and the remaining 20 per cent will be released in the third year. Any shares released are subject to a further holding period in line with regulatory requirements and market practice.
Performance measures and targets	For 2017, the Group Performance Share will be based on a percentage of the Group's underlying profit, adjusted by a strategic multiplier of up to 130 per cent based on the Group's Balanced Scorecard (BSC) metrics and risk matters. In 2017, at least 75 per cent of performance is weighted towards a financial measure. Individual awards are adjusted to reflect a balanced scorecard approach with clearly identified performance metrics used to assess Group performance in key areas. Stretching objectives for each division and function are approved around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: Customer, People, Control environment, Building the business and Finance. Each measure in the Group and divisional/functional BSC is assigned targets aligned to a five-point rating scale. BSC ratings are based on a scale ranging from 'Under' (at the lowest level), through 'Developing', 'Good', 'Strong' and up to 'Top', which is the highest rating. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'.

Directors' remuneration report continued

	The Committee considers the targets that apply to these measures to be commercially sensitive but will provide information on the level of payout relative to the performance achieved in next year's annual report on remuneration. The Committee applies its judgement to determine the payout level commensurate with Group, business and/or individual performance. Performance adjustment is determined by the Remuneration Committee and/or Board Risk Committee and may result in a reduction of up to 100 per cent of the bonus opportunity for the relevant period. It can be applied on a collective or individual basis. When considering collective adjustment, the Senior Independent Performance Adjustment and Conduct Committee (SIPACC) submits a report to the Remuneration Committee and Board Risk Committee regarding any adjustments required to BSCs or the overall bonus outcome to reflect in-year or prior year risk matters. The application of malus will generally be considered when: – there is reasonable evidence of employee misbehaviour or material error or that they participated in conduct which resulted in losses for the Group or failed to meet appropriate standards of fitness and propriety; – there is material failure of risk management at a Group, business area, division and/or business unit level; – the Committee determines that the financial results for a given year do not support the level of variable remuneration awarded; and/or – any other circumstances where the Committee consider adjustments should be made. Judgement on individual performance adjustment is informed by taking into account the severity of the issue, the individual's proximity to the issue and the individual's behaviour in relation to the issue. Individual adjustment may be applied through adjustments to BSC assessments and/or through reducing the bonus outcome. Awards are subject to clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation. The application of clawback will generally be considered when: – there is reasonable evidence of employee misbehaviour or material error; or – there is material failure of risk management at a Group, business area, division and/or business unit level.

Group Ownership Share plan

Opportunity	The maximum Group Ownership Share award for Executive Directors is 300 per cent of salary (unchanged from 2016). Awards in 2017 are being made as follows: GCE: 300 per cent of reference salary CFO: 275 per cent of base salary CRO: 275 per cent of base salary
Performance measures and targets	2017 awards will be subject to a three-year performance period with vesting between the third and seventh anniversary of award, on a pro-rata basis. Any shares released are subject to a further holding period in line with regulatory requirements and market practice. During 2016 and early 2017, the Committee consulted widely with shareholders on appropriate performance measures, particularly the link between performance measures and the Group's strategic priorities. The awards made in 2017 will vest based on the Group's performance against the following key financial and strategic measures: – Absolute Total Shareholder Return (30 per cent) – Cost:income ratio (10 per cent) – Economic profit (25 per cent) – Strategic measures (35 per cent)) The following table provides a breakdown of these measures and the targets applicable. The Committee believes that these measures appropriately capture risk management and long-term sustainable growth, aligning management and shareholder interests. Each of the measures aligns to the reward principles and, through that, the Group's strategic priorities. Awards are subject to malus and clawback for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation. The Committee may consider the application of malus and clawback as outlined in the Group Performance Share plan section above.

Strategic priorities	Measure	Basis of payout range	Metric	Weighting
Creating the best customer experience	FCA total reportable complaints per 1,000 accounts[1] and	Set relative to 2019 targets	See note 1 below	10%
	Financial Ombudsman Service (FOS) uphold rate (excl PPI)	Average rates over 2019	Threshold: =<29% Maximum: =<25%	
	Net promoter score	Major Group average ranking over 2019	Threshold: 3rd Maximum: 1st	10%
	Digital active customer base	Set relative to 2019 targets	Threshold: 14.3m Maximum: 14.9m	7.5%
Becoming simpler and more efficient	Economic profit[2]	Set relative to 2019 targets	Threshold: £3,074m Maximum: £3,769m	25%
	Cost:income ratio	Set relative to 2019 targets	Threshold: 47.2% Maximum: 45.7%	10%
Delivering sustainable growth	Absolute Total Shareholder Return (TSR)	Growth in share price including dividends over three-year period	Threshold: 8% Maximum: 16%	30%
Building the best team	Employee engagement index	Set relative to 2019 targets	Threshold: 67% Maximum: 73%	7.5%

1 The FCA changed the approach to complaint classification and reporting from 30 June 2016. Updated complaint data is not yet available on the new basis, but will be available by the end of the first quarter at which point, or shortly thereafter, the metric will be disclosed.
2 A measure of profit taking into account Expected Losses, tax and a charge for equity utilisation.

Chairman and Non-Executive Director fees in 2017

The annual fee for the Chairman was increased by 2 per cent to £728,280, in line with the overall salary budget for the general colleague population.

The annual Non-Executive Director fees were reviewed and as result of this review some of the fees were increased, as follows, to reflect market practice in financial services groups of a similar size. These changes took effect from 1 January 2017.

	2017	2016
Basic Non-Executive Director fee	**£76,500**	£75,000
Deputy Chairman	**£100,000**	£100,000
Senior Independent Director	**£60,000**	£60,000
Audit Committee Chairmanship	**£70,000**	£60,000
Remuneration Committee Chairmanship	**£70,000**	£60,000
Board Risk Committee Chairmanship	**£70,000**	£60,000
Responsible Business Committee Chairmanship	**£40,000**	£40,000[4]
Audit Committee membership	**£32,000**	£30,000
Remuneration Committee membership	**£32,000**	£30,000
Board Risk Committee membership	**£32,000**	£30,000
Responsible Business Committee members	**£15,000[1]**	£10,000[1]
Nomination and Governance Committee membership	**£15,000[2]**	£5,000[3]

1 New members only.
2 Including payments to Chairmen of other Committees who are members.
3 Where individual was not Chairman of another Committee.
4 During 2016, the fee for Chairmanship of the Responsible Business Committee increased from £30,000 to £40,000.

Non-Executive Directors may receive more than one of the above fees.

Remuneration outcome for 2016

Executive directors (audited)

The following table summarises the total remuneration delivered during 2016 in relation to service as an Executive Director.

	António Horta-Osório[1]		George Culmer		Juan Colombás		Totals	
£000	2016	2015	2016	2015	2016	2015	2016	2015
Base salary	**1,125**	1,061	**745**	731	**739**	724	**2,609**	2,516
Fixed share award	**900**	900	**504**	504	**497**	497	**1,901**	1,901
Benefits	**143**	140	**42**	41	**70**	73	**255**	254
Other remuneration[2]	**1**	2	**1**	2	**1**	2	**3**	6
Annual bonus	**1,220**	850	**574**	462	**578**	455	**2,372**	1,767
Long-term incentive[3]	**1,584**	5,183	**857**	2,804	**763**	2,496	**3,204**	10,483
Pension allowance[4]	**568**	568	**186**	182	**185**	181	**939**	931
Total remuneration	**5,541**	8,704	**2,909**	4,726	**2,833**	4,428	**11,283**	17,858
Less: performance adjustment[5]	**–**	(234)	**–**	(65)	**–**	(3)	**–**	(302)
Total remuneration less performance adjustment	**5,541**	8,470	**2,909**	4,661	**2,833**	4,425	**11,283**	17,556

1 2016 base salary increase: 6 per cent (2 per cent in cash and the remainder in shares, held until the government has sold its shareholding in the Group).
2 Other remuneration payments comprise income from all employee share plans, which arises through employer matching or discounting of employee purchases.
3 The LTIP vesting and dividend equivalents awarded in shares were confirmed by the Remuneration Committee at its meeting on 15 February 2017. The average share price between 1 October 2016 and 31 December 2016 (58.30 pence) has been used to indicate the value. The shares were awarded in 2014 based on a share price of 78.878 pence. LTIP and dividend equivalent figures for 2015 have been adjusted for the share price on the date of vesting (72.75 pence).
4 Following changes to the amount of tax relief available on pension contributions in each year, Executive Directors may elect to receive some or all of their allowances as cash. The breakdown of payments made in cash and contributions into the pension scheme are shown below.
5 In June 2015, the Group reached a settlement with the Financial Conduct Authority (FCA) with regard to aspects of its Payment Protection Insurance (PPI) complaint handling process during the period March 2012 to May 2013. As a result, the Committee decided to make performance adjustments in respect of bonuses awarded in 2012 and 2013 to the Group Executive Committee and some other senior executives given their ultimate oversight of the PPI operations. The number of shares adjusted was 409,039 for the Group Chief Executive (GCE), 109,464 for the Chief Financial Officer (CFO) and 376,055 for the Chief Risk Officer (CRO) (pro-rated in the above table to reflect his appointment to Executive Director on 29 November 2013). The share price used for the valuation was the market price for a share in the Group at the award dates, 49.29 pence and 78.878 pence, respectively.

Pension and benefits (audited)

Pension/Benefit £	António Horta-Osório	George Culmer	Juan Colombás
Employer contribution to pension scheme	**9,542**	**4,492**	**12,068**
Cash allowance in lieu of pension contribution	**558,018**	**181,862**	**172,711**
Car or car allowance	**12,000**	**12,183**	**12,000**
Flexible benefits payments	**42,440**	**29,376**	**28,968**
Private medical insurance	**30,950**	**760**	**14,068**
Tax preparation	**24,000**	**–**	**11,940**
Transportation	**33,760**	**–**	**2,900**

Directors' remuneration report continued

Defined benefit pension arrangements (audited)

The GCE has a conditional unfunded pension commitment, subject to share price performance. This was a partial buy-out of a pension forfeited on joining from Santander Group. It is an Employer-Financed Retirement Benefits Scheme (EFRBS). The EFRBS provides benefits on a defined benefit basis at a normal retirement age of 65. The EFRBS applies for a maximum of six years following the commencement of employment and the maximum allowance over that period is 26.5 per cent of the higher of the GCE's base salary or reference salary in the 12 months before retirement or leaving, subject to performance conditions. No additional benefit is due in the event of early retirement. The rate of pension accrual in each year depends on share price conditions being met. Accrual at 31 December 2016 is a pension of 6 per cent of the reference salary or £73,200. No new pension entitlement was accrued in 2016.

There are no other Executive Directors with defined benefit pension entitlements.

Under terms agreed when joining the Group, the CRO is entitled to a conditional lump sum benefit of £718,996 either (i) on reaching normal retirement age unless the CRO voluntarily resigns or is dismissed for cause, or (ii) on leaving due to long-term sickness or death.

2014 LTIP vesting (audited)

	Number of shares awarded	Vesting %[1]	Number of shares vesting	Indicative share price at vesting	Indicative value of award at vesting	Indicative dividend equivalent	Indicative total value
António Horta-Osório	4,640,077	55%	2,552,042	58.30 pence	£1,487,840	£95,940	£1,583,780
George Culmer	2,510,205	55%	1,380,612	58.30 pence	£804,897	£51,902	£856,799
Juan Colombás	2,234,780	55%	1,229,129	58.30 pence	£716,582	£46,207	£762,789

1 For details of the performance outcome please refer to section 'Long-term awards made in March 2014 vesting for the period ended on 31 December 2016'.

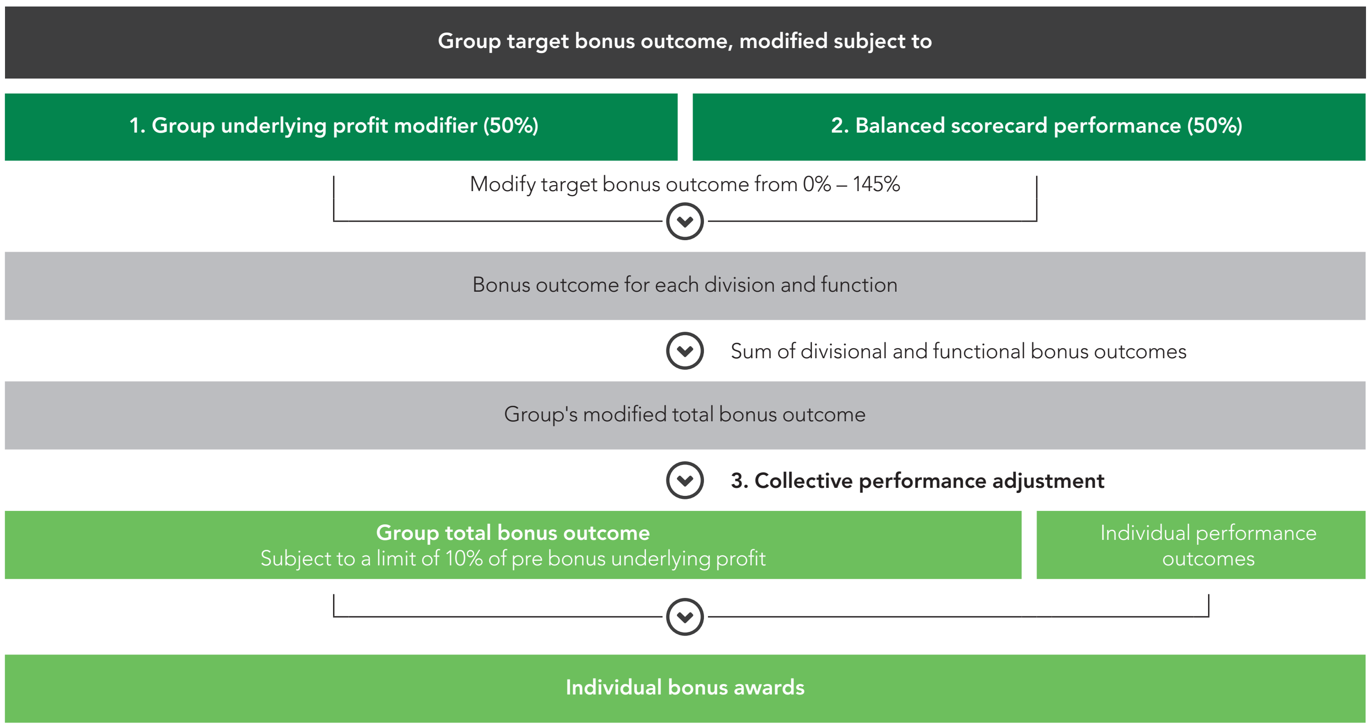
Annual bonus (audited)

The individual bonus awards for Executive Directors are determined in the same way as for colleagues across the Group, with outcomes based on the individual on-target award adjusted for the Group annual bonus outcome and for individual performance outcomes.

The Group total bonus outcome is the sum of the divisional and functional bonus outcomes. Performance outcomes are determined by adjusting the Group's target bonus outcome according to Group underlying profit and Balanced Scorecard performance. These are each used as a modifier to increase or decrease the target bonus outcome in the range of 0 per cent – 145 per cent, subject to an overall funding limit of 10 per cent of pre bonus underlying profit. A collective performance adjustment is then applied.

The individual on-target award is then adjusted for the Group annual bonus outcome and for individual performance outcomes. Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

The approach to determining annual bonus awards is summarised below:

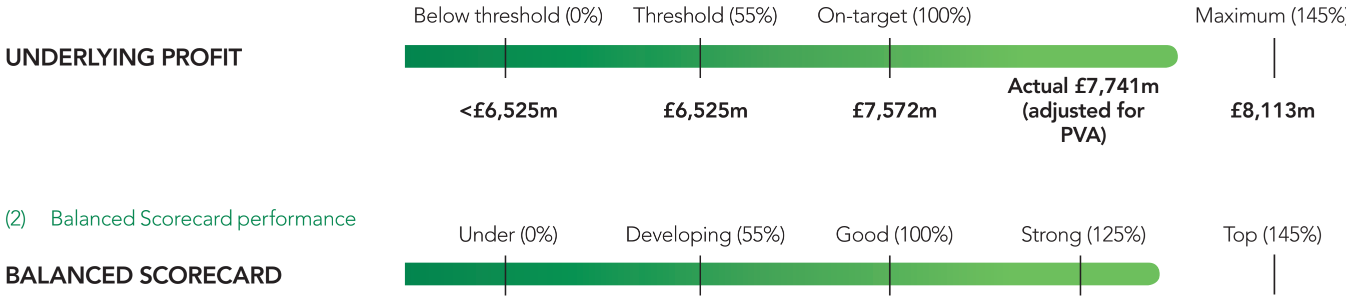


Annual bonus outcome for 2016 (audited)

The target bonus outcome for 2016 (£397.1 million) was adjusted for:

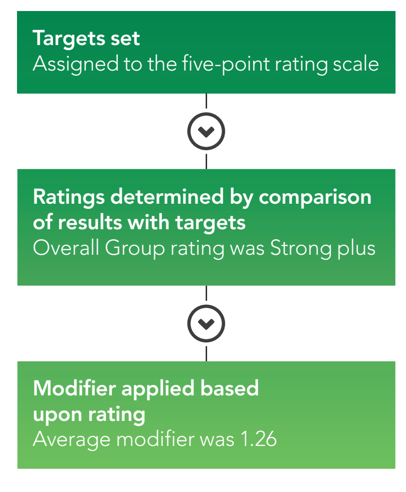
(1) Group underlying profit performance

A target of £7,572 million was approved by the Board. In line with regulatory requirements, the underlying profit of £7,867 million has been adjusted by the incremental movement in Prudential Valuation Adjustment (PVA) from year-end 2015 to year-end 2016. The adjustment of £126 million reduces the underlying profit figure to £7,741 million, resulting in a modifier of 1.22.



A balanced scorecard approach with clearly identified performance descriptors is used to assess Group performance in key areas. Stretching objectives for each division and function were approved by the Committee around the start of the performance year. The objectives are aligned to the Group's strategy and split across five categories: customer, people, control environment, building the business and finance.

Approach to the Balanced Scorecard (BSC)



Each measure in the Group and divisional/functional BSC is assigned targets aligned to a five-point rating scale.

BSC ratings are based on a scale ranging from 'Under' (at the lowest level), through 'Developing', 'Good', 'Strong' and up to 'Top', which is the highest rating. Each of these ratings may be further differentiated by the addition of 'minus' or 'plus'. The Committee reviewed performance in depth to determine ratings for the Group and each division and function, including consideration of risk matters arising in 2016. Risk adjustments were approved by the Board Risk Committee.

The ratings for each division and function are communicated to all colleagues within the business area to ensure bonus outcomes are transparent and understood. The ratings are considered commercially sensitive; however, as an indication of performance, the overall rating for the Group (as determined by the Committee) was Strong plus and the average of the divisional/functional modifiers applied was 1.26.

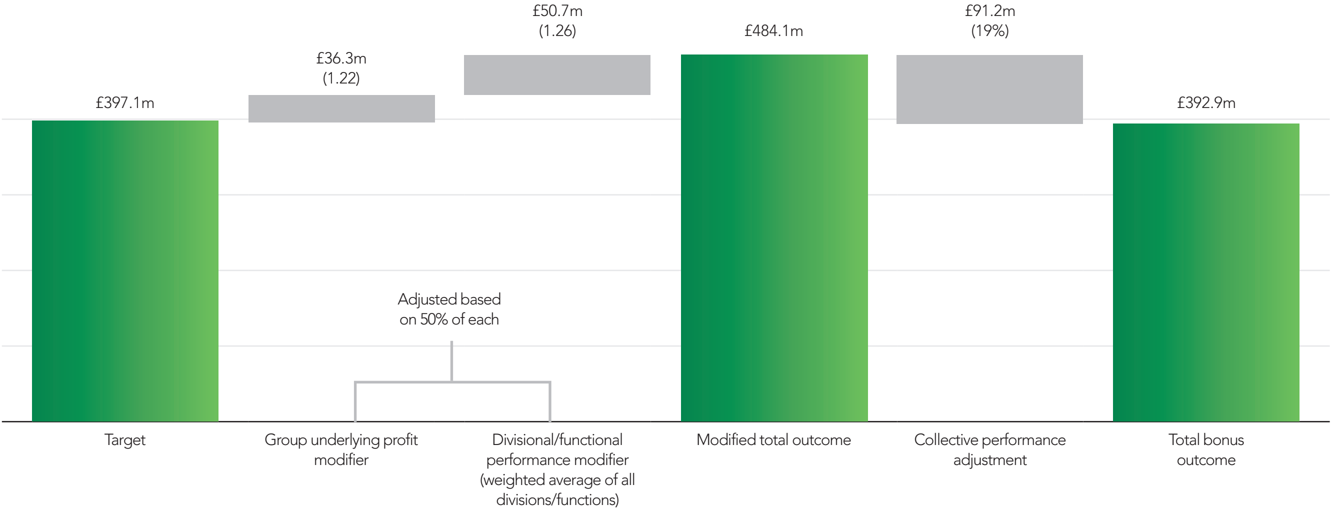
Key performance factors considered by the Committee in arriving at the performance assessment for the Group included:

Strong financial performance	Underlying profit was £7.9 billion and statutory profit has more than doubled to £4.2 billion. Despite an additional PPI provision and the challenging macroeconomic environment, the Group remains strongly capital generative with a pro forma CET1 ratio of 13.8 per cent after increased dividend.
Growth in the key customer segments	The Group continued to make good progress in growing market share in areas where it is under represented, growing lending to SME clients and in consumer finance.
Lower risk bank	Continued efforts to de-risk the bank, combined with sustained improvements in core prudential risks (capital, credit, funding) and a customer centric culture are delivering a lower risk bank. From a credit perspective, asset quality remained strong with no deterioration in the underlying portfolio. Prudent risk appetite and robust risk management framework reflected in lower impaired loans and an improved impaired loan ratio.
Effective cost leadership	Cost management remains a strategic priority and the acceleration of cost initiatives in response to the lower interest rate environment has enabled the Group to reduce operating costs by 3 per cent. The market leading cost:income ratio also improved to 48.7 per cent.
Increased dividends	Increased ordinary dividend of 2.55 pence per share in 2016 (2015: 2.25 pence), in line with the Group's progressive and sustainable dividend policy. Additional special dividend of 0.5 pence.
PRA stress test threshold exceeded	The resilience of the Group's capital position was demonstrated again in 2016 when it comfortably exceeded the threshold for the latest PRA stress test and performed well compared to peers.
Customer focus in the business	Development and launch of the Customer Journey framework and strategy which will be the basis to manage the Group and its control environment in a customer centric way. Further reductions in the level of customer complaints. Net promotor score continued to improve and is now nearly 50 per cent higher than at the end of 2011.
Culture and reputation	Accelerated progress towards the desired culture, developing new Management Information, further embedding the Group Customer First Committee and the work to establish the Customer Journey strategy. The Group's reputation with external stakeholders.

Directors' remuneration report continued

(3) Collective performance adjustment
Consideration was given to items not factored into the Group underlying profit or divisional or functional Balanced Scorecards. These included the provisions for legacy conduct-related matters relevant to the year. As a result of these items, the Committee approved an overall collective adjustment of £91.2 million or approximately 19 per cent, resulting in a final bonus outcome of £392.9 million as shown in the table below.
The bonus outcome of £392.9 million is significantly below the overall funding limit of 10 per cent of pre bonus underlying profit.

Total bonus outcome



Individual outcomes for Executive Directors (audited)

The individual bonus awards for Executive Directors are determined in the same way as for colleagues across the Group, with outcomes based on annual bonus outcome, weighted by:

1. Individual performance
2. On-target award

Awards are approved by the Committee, which has discretion to adjust outcomes for any reason.

António Horta-Osório

The Group Chief Executive's (GCE) individual performance assessment for 2016, as confirmed by the Committee, reflected the Group's performance as outlined on page 103 and a number of other considerations including:

Strong financial performance	Improvement in market-leading cost:income ratio delivered, with statutory profit more than doubled and key balance sheet metrics strengthened.
Low risk business model maintained	Continued improvement in credit quality of lending portfolio, strong performance in 2016 PRA stress test.
Increased dividends	Increase in ordinary dividend to 2.55 pence per share (2015: 2.25 pence) in line with the Group's progressive and sustainable dividend policy, with additional special dividend of 0.5 pence per share.
Strong employee engagement	Employee engagement survey results strengthened despite uncertain economic outlook and announcement of further role reductions – scores significantly higher than UK benchmark and close to UK high-performing benchmark.
Creating the best customer experience	Key Customer Journeys across retail and commercial banking and insurance significantly enhanced, leading to improved customer feedback and trust scores as well as complaints reducing from their low levels relative to the sector.
Continued growth in digital channels	With 12.5 million online and 8 million mobile banking customers, the Group operates the UK's largest digital bank, and now meets over 60 per cent of customers' banking needs digitally.
Supporting the UK economy and helping Britain prosper	Remaining the largest lender to first-time buyers and maintaining the recent record of above-market growth in lending to SMEs. Commitments to support communities and charities also exceeded.
Leading the Group's strategic development	Lead Board and executive team in highly impactful exercise to review the impact of digital technology and market change on the 'Bank of the Future', enabling the Group to develop critically important plans for the evolution of its business model and technology base.
UKFI reduction in government shareholding	Continued successful delivery of the Group's strategy enabling a significant reduction in the government shareholding to less than 5 per cent. UKFI no longer the Group's largest shareholder, with £18.5 billion now having been returned to the UK taxpayer at a profit.

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the GCE, an improvement from Strong in 2015.

Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Group BSC, as follows:

Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	42%	91%	140%

Following the Committee's assessment of performance against the underlying profit target and Group BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the improvement to the individual rating of Strong plus, the Committee determined a 2016 bonus award for the GCE of £1,219,537 (108 per cent of salary and 77 per cent of maximum).

George Culmer

The Chief Financial Officer's (CFO) personal performance assessment for 2016, as confirmed by the Committee, reflected a number of considerations including:

Strong financial performance	Strong financial performance delivered in challenging low interest rate and volatile market environment – key liquidity, funding and capital metrics either strengthened or maintained.
Cost leadership	Continued improvement in the Group's market-leading cost:income ratio to 48.7 per cent (2015: 49.3 per cent) – efficiency programme successfully accelerated in response to customers' changing preferences.
Strong capital generation	Group's pro forma CET1 capital ratio of 13.8 per cent comfortably above regulatory requirements after increased ordinary dividend of 2.55 pence per share and an additional special dividend of 0.5 pence per share.
Resilient business model	'Stressed' CET1 capital and leverage ratios of 10.3 per cent and 4.3 per cent from 2016 regulatory (PRA) stress test comfortably above regulatory requirements and strongest across major UK banking peers.
Successful outcome of ECN court case	Successful outcome of ECN ('enhanced capital notes') court case – enabling the Group to improve the efficiency of its balance sheet and reduce funding costs.
Well managed external stakeholder relations	Well-managed relationships with key external stakeholders, e.g. debt and equity investors, regulators, and credit rating agencies.

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the CFO. Expected outcomes are based on individual performance before taking into account a modifier based on underlying profit and the Finance division's BSC, as follows:

Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee's assessment of performance against the underlying profit target and the Finance division's BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the individual rating of Strong plus, the Committee determined a 2016 bonus award for the CFO of £574,326 (77 per cent of maximum).

Juan Colombás

The Chief Risk Officer's (CRO) personal performance assessment for 2016, as confirmed by the Committee, reflected a number of considerations including:

Strong risk management framework	The Group remains comfortably within risk appetite set by the Board, with strengthened processes and controls, aligning to the Group's objective of being a low risk bank.
Strengthened management of operational risk	Management of operational risk strengthened through the development of a robust control framework for key risk categories.
Credit quality	Prudent lending criteria reflected in credit quality across all lending portfolios and reduced gross impairment charges.
Low risk culture and effective controls	Low risk culture and effective controls reflected in very low level of financial losses following EU Referendum result and other periods of market volatility.
Effective optimisation of balance sheet	Effective optimisation of balance sheet leading to further reductions in risk-weighted assets (RWAs) – in turn supporting capital generation.
Low risk model recognised by the market	Group's low risk model recognised by the market; tight credit default swap (CDS) spreads and resilient credit ratings confer tangible funding cost benefits to the Group.

Based on a full assessment of performance, the Committee agreed an individual rating for 2016 of Strong plus for the CRO.

Expected outcomes are based on individual performance, before taking into account a modifier based on underlying profit and the Risk division's BSC, as follows:

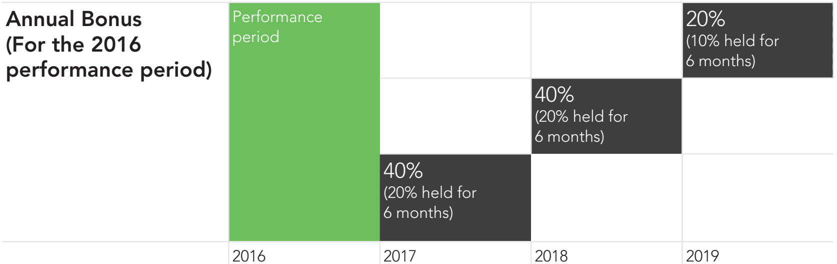
Rating	Under	Developing	Good	Strong	Top
Expected outcome as % of salary	0%	0%	30%	65%	100%

Following the Committee's assessment of performance against the underlying profit target and the Risk division's BSC objectives, and taking into account the collective performance adjustment of 19 per cent and the individual rating of Strong plus, the Committee determined a 2016 bonus award for the CRO of £577,676 (78 per cent of maximum).

Directors' remuneration report continued

Deferral

The 2016 annual bonus for all Executive Directors is awarded in a combination of cash and shares. 40 per cent of the annual bonus will be released in 2017 (£2,000 cash in March, the remainder in shares), 40 per cent will be released in 2018 and the remaining 20 per cent will be released in 2019, subject to remaining in the Group's employment. Any shares released are subject to a further holding period in line with regulatory requirements.



The Group's malus and clawback provisions cover all material risk takers, in line with regulatory requirements. Vested variable remuneration can be recovered from employees for a period of up to seven years after the date of award which may be extended to 10 years where there is an ongoing internal or regulatory investigation. The Committee reserves the right to exercise its discretion in reducing any payment that otherwise would have been earned, if it deems appropriate as a result of an event occurring before vesting.

Long-term awards made in March 2014 vesting for the period ended on 31 December 2016 (audited)

Awards (in the form of conditional rights to free shares) in 2014 were made over shares with a value of 300 per cent of reference salary for the GCE and 275 per cent of salary for the CFO and CRO.

The Group has delivered a good financial performance over the performance period of the 2014 Long-Term Incentive Plan (LTIP) awards, continuing to transform the business for the benefit of our shareholders. Performance was measured over three financial years ended 31 December 2016. The performance conditions attached to these awards and actual performance are set out in the table below. At the end of the performance period, it has been assessed that awards will vest at 55 per cent of maximum. Executive Directors are required to retain any shares vesting for a further two years post vesting.

		Performance achievement versus targets			
Weighting	Measure	Threshold	Maximum	Actual	Vesting as % maximum (for that element)
30%	Economic profit	£2,154m	£3,231m	Actual: £3,377m	30%
30%	Absolute TSR	8% p.a	16% p.a.	Actual: (5%)	0%
10%	Cost:income ratio[1]	48.9%	46.5%	Actual: 50.5%	0%
10%	Customer satisfaction[2]	0.54	0.50	Actual: 0.46	10%
10%	Net promotor score	3rd place	1st place	Actual: 1st place	10%
5%	SME lending	14%	18%	Actual: 13.4%	0%
5%	Share of first-time buyer market	20%	25%	Actual: 25.5%	5%
LTIP (% maximum) vesting					55%

1 Adjusted total costs.
2 FCA reportable complaints per 1,000 for the period up to and including H1 2016 and formally closed FCA complaints per 1,000 accounts for the period from H2 2016. Both exclude PPI complaints, any complaints received via Claims Management Companies (CMC) and any complaints relating to TSB activity. With the introduction of the FCA guidance contained in PS15/19 applicable from 1 July 2016, the complaint classification and reporting for the original metric ceased on 30 June 2016. Accordingly, the Remuneration Committee has rebased the original 2014 metrics in line with the new FCA reporting regime. The Remuneration Committee considers the rebased targets equally stretching.

Percentage change in remuneration of the Group Chief Executive versus the wider employee population

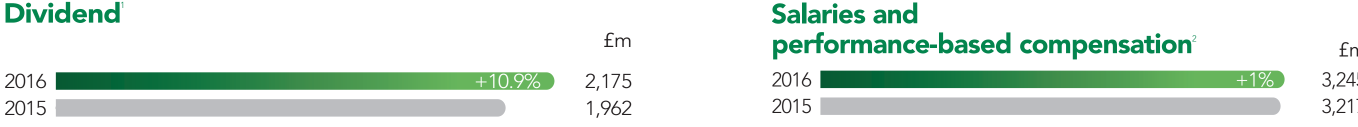
Figures for 'All Employees' are calculated using figures for UK-based colleagues subject to the Group Annual Bonus Plan. This population is considered to be the most appropriate group of employees for these purposes because its remuneration structure is consistent with that of the GCE. For 2016, 46,963 colleagues were included in this category.

	% change in base salary (2015 – 2016)	% change in bonus (2015 – 2016)	% change in benefits (2015 – 2016)
GCE	8.4%[1]	44%[2]	2%
All employees	2%[3]	17%[3]	2%[3]

1 2 per cent delivered in cash (in line with other colleagues) the remainder in shares.
2 The performance rating for the GCE improved from Strong in 2015 to Strong plus in 2016.
3 Adjusted for movements in staff numbers and other impacts to ensure a like-for-like comparison.

Relative spend on pay (£m)

The graph below illustrates the relative importance of spend on pay (total remuneration of all Group employees) compared with distributions to shareholders. Distributions to shareholders are ordinary and special dividends.



1 2016: Ordinary and special dividend in respect of the financial year ended 31 December 2016, partly paid in 2016 and partly to be paid in 2017. 2015: Ordinary and special dividend in respect of the financial year ended 31 December 2015, partly paid in 2015 and partly paid in 2016.
2 In addition to the annual bonus of £392.9 million awarded in respect of 2016 performance, the Group made Group Ownership Share awards of £47.6 million and paid approximately £84 million under variable pay arrangements used to incentivise customer-facing colleagues, primarily in the Retail division.

Loss of office payments and payments within the reporting year to past Directors (audited)

There were no payments for the loss of office or any other payments made to former Directors during 2016.

External appointments held by the Executive Directors

António Horta-Osório – During the year ended 31 December 2016, the Group Chief Executive served as a Non-Executive Director of Exor, Fundação Champalimaud, Stichting INPAR and Sociedade Francisco Manuel dos Santos for which he received fees of £217,098 in total.

Chairman and Non-Executive Directors (audited)

	Fees £000		Taxable benefits £000		Total £000	
	2016	2015	**2016**	2015	**2016**	2015
Chairman and current Non-Executive Directors						
Lord Blackwell	**714**	700	**12[1]**	12[1]	**726**	712
Alan Dickinson	**195**	144	**–**	–	**195**	144
Anita Frew	**295**	236	**–**	–	**295**	236
Simon Henry	**135**	105	**–**	–	**135**	105
Nick Luff	**165**	135	**–**	–	**165**	135
Deborah McWhinney	**135**	9	**–**	–	**135**	9
Nick Prettejohn	**412**	350	**–**	–	**412**	350
Stuart Sinclair	**135**	–	**–**	–	**135**	–
Anthony Watson	**230**	209	**–**	–	**230**	209
Sara Weller	**171**	135	**–**	–	**171**	135
Former Non-Executive Directors						
Carolyn Fairbairn (retired October 2015)	**–**	88	**–**	–	**–**	88
Dyfrig John (retired May 2016)	**49**	105	**–**	–	**49**	105
Total	**2,636**	2,216	**12**	12	**2,648**	2,228

1 Car allowance.

Breakdown of Non-Executive Directors' fees (£000s)

	Board fee	Deputy Chairman	Senior Independent Director	Audit Committee	Remuneration Committee	Board Risk Committee	SWG Board fees[1]	Other Committees	2016 Total
Alan Dickinson[2]	75			30	30	60			195
Anita Frew[2,3]	75	100		30	60	30			295
Simon Henry	75			30		30			135
Dyfrig John	27				11	11			49
Nick Luff[2]	75			60		30			165
Deborah McWhinney	75			30		30			135
Nick Prettejohn	75			30		30	277		412
Stuart Sinclair	75				30	30			135
Anthony Watson	75		60	30	30	30		5[4]	230
Sara Weller	75				30	30		36[5]	171

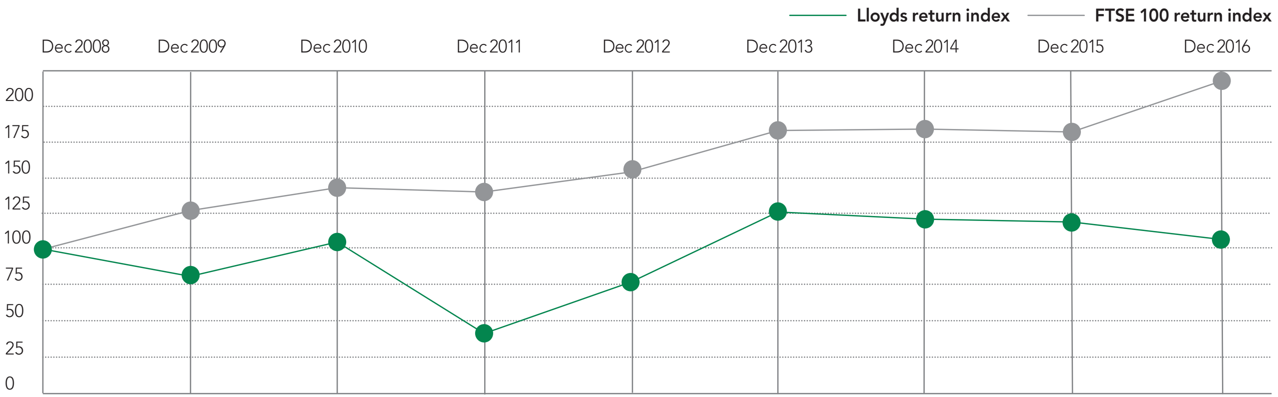
1 Scottish Widows Group Limited.
2 Due to their role as Chairmen of other Board Committees, Alan Dickinson, Anita Frew and Nick Luff do not receive any fees for their membership of the Nomination and Governance Committee.
3 As Deputy Chairman, Anita Frew does not receive any fee for membership of the Responsible Business Committee.
4 Nomination and Governance Committee.
5 Responsible Business Committee.

Directors' remuneration report continued

Historical total shareholder return (TSR) performance

The chart below shows the historical TSR of Lloyds Banking Group plc compared with the FTSE 100 as required by the regulations, rebased as at 31 December 2008. The FTSE 100 index has been chosen as it is a widely recognised equity index of which Lloyds Banking Group plc has been a constituent throughout this period.

Total shareholder return indices – Lloyds Banking Group and FTSE 100



Rebased to 100 on 31 December 2008.
Source: Kepler

Historical Group Chief Executive (GCE) remuneration outcomes

	GCE	2009	2010	2011	2012	2013	2014	2015	2016
GCE single figure of remuneration £000	J E Daniels	1,121	2,572	855	–	–	–	–	–
	António Horta-Osório	–	–	1,765	3,398	7,475	11,540	8,704	5,541
Annual bonus payout (% of maximum opportunity)	J E Daniels	Waived	62%	0%	–	–	–	–	–
	António Horta-Osório	–	–	Waived	62%	71%	54%	57%	77%
Long-term incentive vesting (% of maximum opportunity)	J E Daniels	0%	0%	0%	–	–	–	–	–
	António Horta-Osório	–	–	0%	0%	54%	97%	94.18%	55%

Notes: J E Daniels served as GCE until 28 February 2011; António Horta-Osório was appointed GCE from 1 March 2011. J E Daniels declined to take a bonus in 2009 and António Horta-Osório declined to take a bonus in 2011.

Outstanding share awards

Directors' interests (audited)

Shareholding guidelines

Executive Directors were required to build up a holding in Lloyds Banking Group plc shares of value equal to 150 per cent of base salary (200 per cent for the GCE) within three years from the later of 1 January 2012 or their date of joining the Board. Following the introduction of the fixed share award in 2014, the gross annual value of this award was added to salary to determine the personal shareholding requirement.

For the purposes of assessing the additional shareholding requirement related to the fixed share award, Executive Directors had up to three years from 1 January 2014 to build up the additional shareholding created by the addition of the fixed share award. As at 31 December 2016, all Executive Directors significantly exceeded the requirements.

In order to provide greater transparency in the measurement of the shareholding requirements, from 1 January 2017 the measure is to be focused on base salary only. There will be a consequent increase in the percentage required as a multiple of salary; however the number of shares required to be held will remain approximately the same. The new requirements are 350 per cent of base salary for the GCE and 250 per cent of base salary for the other Executive Directors.

Executive Directors are required to retain any shares vesting from 2014 LTIP awards onwards for a further two years post vesting (although vested shares count towards the shareholding requirement immediately after vesting).

	Number of shares			Number of options		Total shareholding[1]		Value
	Owned outright	Unvested subject to continued employment	Unvested subject to performance	Unvested subject to continued employment	Vested unexercised	Totals at 31 December 2016	Totals at 21 February 2017	Expected value at 31 December 2016 (£000s)[2]
Executive Directors								
António Horta-Osório[3]	17,893,726	4,212,594	14,234,293	29,549	–	36,370,162	36,370,757[6]	18,286
George Culmer	10,547,315	1,253,398	7,754,781	29,549	–	19,585,043	19,585,562[6]	9,819
Juan Colombás	6,362,996	1,209,441	7,406,515	29,109	–	15,008,061	15,008,580[6]	7,067
Non-Executive Directors								
Lord Blackwell	100,000	–	–	–	–	100,000	n/a[6]	n/a
Alan Dickinson	200,000	–	–	–	–	200,000	n/a[6]	n/a
Anita Frew	450,000	–	–	–	–	450,000	n/a[6]	n/a
Simon Henry	200,000	–	–	–	–	200,000	n/a[6]	n/a
Dyfrig John[4]	27,385	–	–	–	–	27,385	n/a[6]	n/a
Nick Luff	400,000	–	–	–	–	400,000	n/a[6]	n/a
Deborah McWhinney[3]	250,000	–	–	–	–	250,000	n/a[6]	n/a
Nick Prettejohn[5]	69,280	–	–	–	–	69,280	n/a[6]	n/a
Stuart Sinclair	–	–	–	–	–	–	n/a[6]	n/a
Anthony Watson	576,357	–	–	–	–	576,357	n/a[6]	n/a
Sara Weller	340,000	–	–	–	–	340,000	n/a[6]	n/a

1 Including holdings of connected persons.
2 Awards subject to performance under the LTIP had an expected value of 50 per cent of face value at grant (in line with the Remuneration Policy). Values are based on the 31 December 2016 closing price of 62.51 pence. Full face value of awards are £22,734,988 for António Horta-Osório, £12,242,610 for George Culmer and £9,381,538 for Juan Colombás.
3 Shareholdings held by António Horta-Osório and Deborah McWhinney are either wholly or partially in the form of ADRs.
4 Shares held as at date of retirement.
5 In addition, Nick Prettejohn held 400 6.475% preference shares at 1 January 2016 and 31 December 2016.
6 The changes in beneficial interests for António Horta-Osório (595 shares), George Culmer (519 shares) and Juan Colombás (519 shares) relate to 'partnership' and 'matching' shares acquired under the Lloyds Banking Group Share Incentive Plan between 31 December 2016 and 21 February 2017. There have been no other changes up to 21 February 2017.

A summary of transactions undertaken in the year, including share plan awards vested plus open market purchases and sales made by Directors, is shown on page 111.

As a result of the above shareholdings, the position for each Executive Director is as follows:

		2016 Shareholding requirement		Current shareholding			New shareholding requirement from 1 January 2017		Current shareholding (based on new requirement)	
	Base salary plus fixed share award (£000s)	% of base salary plus fixed share award	Number of shares[1]	% of base salary plus fixed share award[1]	Number of shares as at 31/12/16[2]	Old requirement met	% of base salary	Number of shares1	% of base salary[1]	New requirement met
Executive Directors										
António Horta-Osório	2,025	200%	6,560,829	545%	17,891,894	Yes	350%	6,917,220	905%	Yes
George Culmer	1,253	150%	3,044,925	519%	10,545,483	Yes	250%	3,094,403	852%	Yes
Juan Colombás	1,236	150%	3,002,634	318%	6,361,547	Yes	250%	3,051,426	521%	Yes

1 Number of shares required and current shareholding percentage of base salary plus fixed share award figures are calculated using the average share price for the period 1 January 2016 to 31 December 2016 (61.73 pence).
2 Includes shares owned outright reduced by forfeitable 'matching' shares under the Share Incentive Plan.

None of those who were Directors at the end of the year had any other interest in the capital of Lloyds Banking Group plc or its subsidiaries.

Directors' remuneration report continued

Breakdown of shares interests and interests in share options (audited)

	At 1 January 2016	Granted/ awarded	Dividends awarded	Vested / exercised	Lapsed	At 31 December 2016	Exercise price	Exercise periods From	Exercise periods To	Notes
António Horta-Osório										
LTIP 2013-2015	**7,425,441**	–	130,641	6,993,280	432,161	**–**				1, 2, 3
LTIP 2014-2016	**4,640,077**	–	–	–	–	**4,640,077**				3
LTIP 2015-2017	**4,579,006**	–	–	–	–	**4,579,006**				3
LTIP 2016-2018		5,015,210	–	–	–	**5,015,210**				3, 4
Deferred bonus awarded in 2016		1,164,253	–	–	–	**1,164,253**				5
2013 Sharesave	**22,156**	–	–	22,156	–	**–**	40.62p			8
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave		14,554	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	10
George Culmer										
LTIP 2013-2015	**4,017,041**	–	70,674	3,783,249	233,792	**–**				1, 2, 3
LTIP 2014-2016	**2,510,205**	–	–	–	–	**2,510,205**				3
LTIP 2015-2017	**2,477,167**	–	–	–	–	**2,477,167**				3
LTIP 2016-2018		2,767,409	–	–	–	**2,767,409**				3, 4
Deferred bonus awarded in 2016		632,856	–	–	–	**632,856**				5
2013 Sharesave	**22,156**	–	–	22,156	–	**–**	40.62p			9
2014 Sharesave	**14,995**	–	–	–	–	**14,995**	60.02p	01/01/2018	30/06/2018	
2016 Sharesave		14,554	–	–	–	**14,554**	47.49p	01/01/2020	30/06/2020	10
Juan Colombás										
LTIP 2013-2015	**3,576,283**	–	62,920	3,368,143	208,140	**–**				1, 2, 3
LTIP 2014-2016	**2,234,780**	–	–	–	–	**2,234,780**				3
LTIP 2015-2017	**2,442,762**	–	–	–	–	**2,442,762**				3
LTIP 2016-2018		2,728,973	–	–	–	**2,728,973**				3, 4
Deferred bonus awarded in 2016		624,065	–	–	–	**624,065**				5
Share buy-out award (share options)	**235,499**	–	–	235,499	–	**–**				6, 7
Share buy-out award (share options)	**299,732**	–	–	299,732	–	**–**				6, 7
2014 Sharesave	**29,990**	–	–	–	29,990	**–**	60.02p			
2016 Sharesave		29,109	–	–	–	**29,109**	47.49p	01/01/2020	30/06/2020	10

1 The shares awarded in March 2013 vested on 7 March 2016. The closing market price of the Group's ordinary shares on that date was 72.75 pence. Shares vested are subject to a further two-year holding period.
2 2013 LTIP award was eligible to receive an amount equal in value to any dividends paid during the performance period. Dividend equivalents have been paid based on the number of shares vested and have been paid in shares. The dividend equivalent shares were paid on 7 March 2016. The closing market price of the Group's ordinary shares on that date was 72.75 pence. The dividend equivalent shares are not subject to any holding period.
3 All LTIPs have performance periods ending 31 December at the end of the three-year period. Awards were made in the form of conditional rights to free shares.
4 Awards (in the form of conditional rights to free shares) in 2016 were made over shares with a value of 300 per cent of reference salary for António Horta-Osório (5,015,210 shares with a face value of £3,660,000); 275 per cent for George Culmer (2,767,409 shares with a face value of £2,019,600); and 275 per cent for Juan Colombás (2,728,973 shares with a face value of £1,991,550). The share price used to calculate face value is the average price over the five days prior to grant (1 March to 7 March 2016), which was 72.978 pence. This was the average share price used to determine the number of shares awarded. Performance conditions for this award have been disclosed in last year's annual report on remuneration (page 91).
5 Bonus is deferred into shares. The face value of the share awards in respect of bonuses granted in March 2016 was £849,649 (1,164,253 shares) for António Horta-Osório; £461,846 (632,856 shares) for George Culmer; and £455,431 (624,065 shares) for Juan Colombás. The share price used to calculate the face value is the average price over the five days prior to grant (1 March to 7 March 2016), which was 72.978 pence.
6 Share buy-out award granted on 30 March 2011 for the loss of deferred share awards forfeited on leaving the Santander Group. Awards are consistent with those forfeited and have a nil option price.
7 Options exercised on 8 March 2016. The closing market price of the Group's ordinary shares on that date was 70.63 pence.
8 Options exercised on 6 June 2016. The closing market price of the Group's ordinary shares on that date was 69.64 pence.
9 Options exercised on 1 June 2016. The closing market price of the Group's ordinary shares on that date was 71.34 pence.
10 Sharesave options granted on 10 October 2016.

The aggregate amount of gains made by Directors on the exercise of share options was £391,270.

None of the other Directors at 31 December 2016 had options to acquire shares in Lloyds Banking Group plc or its subsidiaries.

Directors' interests – summary of awards vested, purchases and sales made by directors in 2016 (unaudited)

	Holding at 1 January 2016 (or appointment date)	Transactions during the year	Number of shares[1]	Notes	Holding at 31 December 2016
Executive Directors					
António Horta-Osório[2]	11,761,072	08/03/2016	3,706,439	Vesting of 2013 LTIP	
		08/03/2016	69,239	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	173,707	Fixed Share Award	
		18/03/2016	8,256	Salary for shares	
		18/04/2016	2,803	Salary for shares	
		16/05/2016	1,437,096	Release of 2012 Deferred Bonus	
		16/05/2016	2,873	Salary for shares	
		06/06/2016	22,156	2013 Sharesave	
		17/06/2016	2,920	Salary for shares	
		17/06/2016	184,317	Fixed Share Award	
		28/06/2016	100,000	Share purchase	
		18/07/2016	3,377	Salary for shares	
		17/08/2016	3,482	Salary for shares	
		19/09/2016	3,330	Salary for shares	
		19/09/2016	210,206	Fixed Share Award	
		18/10/2016	3,549	Salary for shares	
		16/11/2016	3,069	Salary for shares	
		14/12/2016	2,994	Salary for shares	
		14/12/2016	189,000	Fixed Share Award	
		Monthly	3,841	Share Incentive Plan purchase and matching shares	**17,893,726**
George Culmer	7,090,093	08/03/2016	295,534	Release of 2013 Deferred Bonus	
		08/03/2016	2,005,122	Vesting of 2013 LTIP	
		08/03/2016	37,457	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	97,276	Fixed Share Award	
		19/05/2016	210,244	Dividend Reinvestment	
		02/06/2016	22,156	2013 Sharesave	
		17/06/2016	103,218	Fixed Share Award	
		30/06/2016	50,000	Share purchase	
		19/09/2016	295,534	Release of 2013 Deferred Bonus	
		19/09/2016	117,715	Fixed Share Award	
		28/09/2016	113,779	Dividend Reinvestment	
		14/12/2016	105,840	Fixed Share Award	
		Monthly	3,347	Share Incentive Plan purchase and matching shares	**10,547,315**
Juan Colombás	3,145,458	08/03/2016	44,355	Release of 2012 Deferred Bonus	
		08/03/2016	277,981	Release of 2013 Deferred Bonus	
		08/03/2016	1,785,116	Vesting of 2013 LTIP	
		08/03/2016	33,347	Dividend equivalent shares paid on 2013 LTIP	
		16/03/2016	282,898	Exercise of Share buy out	
		16/03/2016	95,924	Fixed Share Award	
		17/06/2016	101,784	Fixed Share Award	
		30/06/2016	50,000	Share purchase	
		19/09/2016	44,355	Release of 2012 Deferred Bonus	
		19/09/2016	277,981	Release of 2013 Deferred Bonus	
		19/09/2016	116,080	Fixed Share Award	
		14/12/2016	104,370	Fixed Share Award	
		Monthly	3,347	Share Incentive Plan purchase and matching shares	**6,362,996**

Directors' remuneration report continued

	Holding at 1 January 2016 (or appointment date)	Transactions during the year	Number of shares	Notes	Holding at 31 December 2016
Non-Executive Directors					
Lord Blackwell	50,000	05/05/2016	50,000	Share purchase	**100,000**
Alan Dickinson	100,000	29/06/2016	100,000	Share purchase	**200,000**
Anita Frew	300,000	29/06/2016	150,000	Share purchase	**450,000**
Simon Henry	100,000	30/06/2016	100,000	Share purchase	**200,000**
Dyfrig John[3]	27,385	–	–	–	**27,385**
Nick Luff	300,000	29/06/2016	100,000	Share purchase	**400,000**
Deborah McWhinney[4]	200,000	29/06/2016	50,000	Share purchase	**250,000**
Nick Prettejohn	–	26/02/2016	69,280	Share purchase	**69,280**
Stuart Sinclair	–	–	–	–	**–**
Anthony Watson	476,357	29/06/2016	100,000	Share purchase	**576,357**
Sara Weller	200,000	04/05/2016	100,000	Share purchase	
		29/06/2016	40,000	Share purchase	**340,000**

1 After the settlement of tax and National Insurance contributions, where applicable.
2 Part of António Horta-Osório's 2016 salary increase was delivered in shares.
3 Shares held as at date of retirement.
4 Held in the form of ADRs.

Additional disclosures

Total remuneration of the eight highest paid senior executives[1]

The following table sets out the total remuneration of the eight highest paid senior executives (excluding Executive Directors) in respect of the 2016 performance year.

	Executive							
	8 £000	7 £000	6 £000	5 £000	4 £000	3 £000	2 £000	1 £000
Fixed								
Cash-based	305	589	300	740	799	315	330	420
Share-based	200	406	250	490	500	500	740	650
Total fixed	505	995	550	1,230	1,299	815	1,070	1,070
Variable								
Upfront cash	2	2	2	2	2	2	2	2
Deferred cash	0	0	0	0	0	0	0	0
Upfront shares	273	152	416	187	217	462	658	238
Deferred shares	213	231	432	284	328	196	165	360
Long-term incentive plan[2]	1,042	744	884	833	780	2,020	2,571	2,886
Total variable pay	1,530	1,129	1,734	1,306	1,327	2,680	3,396	3,486
Pension cost[3]	46	147	45	181	182	63	66	84
Total remuneration	2,081	2,271	2,329	2,717	2,808	3,558	4,532	4,640

1 Includes members of the Group Executive Committee and Senior Executive level colleagues.
2 Values shown reflect awards for which the performance period ended on 31 December 2016, including the 2014 LTIP and 2014 Commercial Banking Transformation Plan. Dividend equivalents are included where applicable.
3 Pension costs based on a percentage of salary according to level.

Total remuneration of employees across the Group

Total remuneration[1]	Number of employees
£0 to £100,000	**73,415**
£100,001 to £500,000	**4,432**
£500,001 to £1,000,000	**145**
Above £1,000,000	**58**

1 Total remuneration of UK-based colleagues. Includes base salary, bonus awards for the 2016 performance year, the estimated values of LTIP and Commercial Banking Transformation Plan awards for the performance period ended 31 December 2016 (including dividend equivalents where applicable), pension and benefits.

Remuneration Committee

Committee purpose and responsibilities

The Remuneration Committee has responsibility for setting remuneration for all Executive Directors and the Chairman, including pension rights and any compensation payments. The Committee also recommends and monitors the level and structure of remuneration for senior management and material risk takers.

The Committee's purpose is to consider, agree and recommend to the Board an overall remuneration policy and philosophy for the Group that is aligned with its long-term business strategy, its business objectives, its risk appetite, values and the long-term interests of the Group that recognises the interests of relevant stakeholders. The Committee's Terms of Reference can be found on the Company's website at www.lloydsbankinggroup.com/our-group/corporate-governance

The Directors who served on the Committee during the year and their attendance at Committee meetings is set out in the table below.

	Remuneration Committee meetings	
	Eligible to attend	Attended
Committee Chairman		
Anita Frew	7	7
Committee members who served during 2016		
Lord Blackwell	7	7
Alan Dickinson	7	7
Stuart Sinclair[1]	7	7
Anthony Watson[2]	7	6
Sara Weller	7	7
Former members who served during 2016		
Dyfrig John[3]	3	3

1 Joined the Committee on 4 January 2016.
2 Anthony Watson was unable to attend the Committee meeting in May 2016 due to a prior commitment.
3 Retired on 11 May 2016.

Committee composition, skills and experience

The Committee comprises Non-Executive Directors from a wide background to provide a balanced and independent view on remuneration matters. Stuart Sinclair was appointed as an independent Non-Executive Director and as a member of the Committee on 4 January 2016. Dyfrig John retired as an independent Non-Executive Director and as a member of the Committee on 11 May 2016.

How Committee meetings are run

The management of the Committee is in keeping with the basis on which meetings of the Board are managed, as detailed on page 62, with a structure which facilitates open discussion and debate, with steps taken to ensure adequate time for members of the Committee to consider proposals which are put forward.

During 2016, the Committee met its key objectives and carried out its responsibilities effectively, as confirmed by the annual effectiveness review.

Matters considered by the Committee

The Committee had seven scheduled meetings during 2016 to consider the following principal matters:

- Review of remuneration arrangements for senior executives;
- Determination of 2015 bonus outcome based on divisional and functional performance and adjustment for risk;
- Review of the Balanced Scorecard for the determination of 2016 bonuses in divisions and functions;
- Vesting of the 2013 long-term incentive plan (LTIP);
- Performance conditions for the 2016 LTIP;
- Bonus and salary awards for Executive Directors and key senior managers;
- Performance adjustments in respect of staff, in relation to risk matters in its purview;
- Feedback from the Committee Chairman on her meetings with the PRA and shareholders;
- Review of services and consideration of a number of advisors with subsequent appointment of Kepler, a brand of Mercer (Kepler);
- Results of the Remuneration Committee effectiveness review and the suggestions for improvement;
- Variable remuneration and simplification of reward principles;
- Approval of the 2015 and 2016 Directors' remuneration report for publication within the annual report and Form 20-F;
- Review and approval of material risk taker identification and approval of the Remuneration Policy Statement; and
- Remuneration governance in the light of regulatory changes.

In addition to the scheduled meetings, the Committee met on a number of other occasions to allow the Directors greater time to discuss their views and for an in-depth review of key areas including this year the review of the Directors' Remuneration Policy.

The Committee appoints independent consultants to provide advice on specific matters according to their particular expertise. In May 2016, the Committee conducted a review of their independent advisers and appointed Kepler to advise the Committee following a competitive tendering process. Kepler has voluntarily signed up to the Remuneration Consultants' Code of Conduct and is judged by the Committee to be independent. Kepler is not connected with the Group. Kepler's fees for services to the Committee in 2016 were on a time and materials basis and amounted to £175,400. Kepler did not provide any other services to the Group. Mercer provides unrelated advice regarding pensions and investments to the Group.

Directors' remuneration report continued

The Committee has not formally evaluated Kepler's performance since their appointment in mid-2016. A review is due to be undertaken in early 2017. Deloitte LLP, independent consultants to the Committee since 2010, provided advice for the first five months of the year. Deloitte LLP is not connected with the Group. Deloitte's fees for services to the Committee in 2016 were on a time and materials basis and amounted to £240,800. In addition, Deloitte LLP provided the Group with advice on taxation and other consulting services, and assurance services.

António Horta-Osório (Group Chief Executive), Simon Davies (Chief People, Legal and Strategy Officer), Paul Hucknall (People Director, Centres of Excellence), Chris Evans (Director, Reward Policy and Partnering), Stuart Woodward (Head of Reward Regulation and Governance) and Matthew Elderfield (Group Director, Conduct, Compliance and Operational Risk) (until September 2016) and Letitia Smith thereafter provided guidance to the Committee (other than for their own remuneration).

Juan Colombás (Chief Risk Officer) and George Culmer (Chief Financial Officer) also attended the Committee to advise as and when necessary on risk and financial matters.

Statement of voting at Annual General Meeting

The Group's remuneration policy, which was effective during 2016, was detailed within the Directors' remuneration report for 2013 and voted on at the 2014 AGM. The remuneration awarded to the Executive Directors in 2015 was disclosed in last year's annual report on remuneration and was voted on at the 2016 AGM. The shareholder votes submitted at the meetings, either directly, by mail or by proxy, were as follows:

	Votes cast in favour		Votes cast against		Votes withheld
	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)	Percentage of votes cast	Number of shares (millions)
Remuneration policy (2014 vote)	48,261	97.97%	999	2.03%	1,391
Annual report on remuneration (2016 vote)	48,674	97.67%	1,163	2.33%	176

On behalf of the Board

Anita Frew
Chairman, Remuneration Committee

RISK MANAGEMENT

All narrative and quantitative tables are unaudited unless otherwise stated. The audited information is required to comply with the requirements of relevant International Financial Reporting Standards.

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Pillar 3 Report: www.lloydsbankinggroup.com	

BOOSTING BRITAIN'S HOUSING STOCK

AMA Home is one of many smaller construction businesses benefiting from our Housing Growth Partnership with the Government. We have invested more than £30 million through the Partnership and have a target to reach 1,500 homes by 2017.

1,500

new homes to be built by 2017

Risk management

Risk management is at the heart of our strategy to become the best bank for customers

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

The risk overview (pages 26 to 31) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, risk achievements in 2016 along with a brief overview of the Group's risk governance structure and the principal risks faced by the Group and key mitigating actions.

This full risk management section provides a more in-depth picture of how risk is managed within the Group, detailing the Group's emerging risks, approach to stress testing, risk governance, committee structure, appetite for risk (pages 116 to 122) and a full analysis of the primary risk drivers (pages 123 to 169) – the framework by which risks are identified, managed, mitigated and monitored.

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

THE GROUP'S APPROACH TO RISK

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

Risk culture

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

As part of a conservative business model that embodies a risk culture founded on a prudent approach to managing risk, the Group reviewed its Codes of Business and Personal Responsibility in 2016 reinforcing its approach where colleagues are accountable for the risks they take and where the needs of customers are paramount.

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

Risk appetite

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

Risk appetite is documented in a Board Risk Appetite Statement which is reviewed by the Board Risk Committee and approved annually by the Board.

The Board metrics are supported by more detailed sub-Board functional and divisional risk appetite metrics.

The Board Risk Appetite is aligned to the Risk Appetite Framework, and in turn the Risk Management Framework and Group Risk Principles.

Risk appetite is embedded within principles, policies, authorities and limits across the Group and continues to evolve to reflect external market developments and composition of the Group.

The Group's strategy operates in tandem with the Board Risk Appetite and business planning is undertaken with a view to meeting the requirements of the Board Risk Appetite.

Performance is optimised by allowing business units to operate within approved risk appetite and limits.

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

Board Risk Appetite includes the following areas:

- Credit – the Group has a conservative and well balanced credit portfolio through the economic cycle.
- Conduct – the Group's product design and sales practices ensure that products are transparent and meet customer needs.
- Market – the Group takes minimal proprietary trading risk, reflecting the customer focused nature of the Group's activities.
- Operational – the Group has robust controls in place to manage operational losses, reputational events and regulatory breaches. It identifies and assesses emerging risks and acts to mitigate these.
- Funding and liquidity – the Group maintains a prudent liquidity profile to ensure it can survive under stressed conditions, and a balance sheet structure that limits its reliance on potentially volatile sources of funding.
- Capital and earnings – the Group maintains capital levels commensurate with a prudent level of solvency, even under stressed conditions. It aims to deliver consistent and high quality earnings and has low appetite for earnings shocks or surprises from any risk type.
- Regulatory and legal – the Group complies with all relevant regulation and all applicable laws (including Codes of Practice which could have legal implications) and/or legal obligations.
- People – the Group leads responsibly and proficiently, manages its people resource effectively, supports and develops colleague talent, and meets legal and regulatory obligations related to its people.
- Financial reporting – the Group meets regulatory reporting and tax requirements in jurisdictions where it operates and ensures the timely and transparent disclosure and dissemination of information relating to its listed debt or equity.
- Governance – the Group has governance arrangements that support the effective long-term operation of the business, maximise shareholder value and meet regulatory and societal expectations.
- As a separate regulated entity with its own Board, the Insurance business has its own Risk Appetite and maintains its own Risk Appetite framework, aligned to the Group Risk Appetite framework.

Governance and control

- The Group's approach to risk is founded on a robust control framework and a strong risk management culture which are the foundation for the delivery of effective risk management and guide the way all employees approach their work, behave and make decisions.
- Governance is maintained through delegation of authority from the Board down to individuals through the management hierarchy. Senior executives are supported by a committee based structure which is designed to ensure open challenge and support effective decision making.
- The Group's risk appetite, principles, policies, procedures, controls and reporting are regularly reviewed and updated where needed to ensure they remain fully in line with regulations, law, corporate governance and industry good-practice.
- The interaction of the executive and non-executive governance structures relies upon a culture of transparency and openness that is encouraged by both the Board and senior management.
- Board-level engagement, coupled with the direct involvement of senior management in Group-wide risk issues at Group Executive Committee level, ensures that escalated issues are promptly addressed and remediation plans are initiated where required.
- Line management is directly accountable for identifying and managing risks in their individual businesses, ensuring that business decisions strike an appropriate balance between risk and reward consistent with the Group's risk appetite.
- Clear responsibilities and accountabilities for risk are defined across the Group through a Three Lines of Defence model which ensures effective independent oversight and assurance in respect of key decisions.

Risk decision making and reporting

- Taking risks which are well understood, consistent with strategy and with appropriate return is a key driver of shareholder value.
- Risk analysis and reporting supports the identification of opportunities as well as risks.
- An aggregate view of the Group's overall risk profile, key risks and management actions, and performance against risk appetite, is reported to and discussed monthly at the Group Risk Committee (and a subset at the Group Asset and Liability Committee), with regular reporting to the Board Risk Committee and the Board.
- Rigorous stress testing exercises are carried out to assess the impact of a range of adverse scenarios with different probabilities and severities to inform strategic planning.
- The Chief Risk Officer regularly informs the Board Risk Committee (BRC) of the aggregate risk profile and as a member of the Board, has direct access to the Chairman and members of BRC.

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

The table below provides a high level guide to how the Group's business activities are reflected in its risk measures and balance sheet. Details of the business activities for each division are provided in the Divisional Results on pages 40 to 48.

	Retail £bn	Commercial Banking £bn	Consumer Finance £bn	Run-off £bn	Central Items[1] £bn	Insurance[2] £bn	Group £bn
Risk-weighted assets (RWAs)							
– Credit risk	39.7	78.2	28.6	8.3	11.9	–	166.7
– Counterparty credit risk[3]	–	8.6	–	–	1.0	–	9.6
– Market risk	–	3.1	–	–	–	–	3.1
– Operational risk	15.5	6.1	3.5	0.2	–	–	25.3
Total (excluding threshold)	55.2	96.0	32.1	8.5	12.9	–	204.7
– Threshold[4]	–	–	–	–	10.8	–	10.8
Total	55.2	96.0	32.1	8.5	23.7	–	215.5

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

2 As a separate regulated business, Insurance maintains its own regulatory solvency requirements, including appropriate management buffers, and reports directly to the Insurance Board. Insurance does not hold any RWAs, as its assets are removed from the Banking Group's regulatory capital calculations. However, part of the Group's investment in Insurance is included In the calculation of Threshold RWAs, subject to CRD IV rules, while the remainder is taken as a capital deduction.

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

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

Principal risks

The Group's principal risks are shown in the risk overview (pages 28 to 31). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk drivers is on pages 123 to 169.

Risk management continued

EMERGING RISKS

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group.

These risks are considered alongside the Group's operating plan.

Risk	Key mitigating actions
Regulatory and legal: The industry continues to witness increased government and regulatory intervention in the financial sector with increasing regulatory rules and laws from both the UK and overseas affecting the Group's operation.	– We continue to embed the strategic conduct agenda across all areas of the Group ensuring that the customer is at the heart of our business planning, whilst working closely with regulatory authorities and industry bodies to ensure that the Group can identify and respond to the evolving regulatory and legal landscape. – Programmes in place to deliver regulatory and legal change requirements.
Macroeconomic headwinds and political uncertainties: Political uncertainties over the UK's relationship with EU Countries remains with US election outcomes and European elections adding to a globally uncertain political and macroeconomic outlook.	– Internal contingency plans recalibrated and regularly reviewed for potential strategic, operational and reputational impacts. – Engagement with politicians, officials, media, trade and other bodies to reassure our commitment to Helping Britain Prosper. – Wide array of risks considered in setting strategic plans. – Capital and Liquidity is reviewed regularly through committees, ensuring compliance with risk appetite/regulatory requirements.
IT resilience and cyber: Increasing digitisation places greater reliance on the provision of resilient and secure services to customers. Potential increases in the volume of cyber-attacks could disrupt service for customers, causing financial loss/reputational damage.	– Continued delivery of cyber control framework and investment in Cyber programme. – Operational Resilience activities will be combined with currency upgrades to form a new Technology Resilience programme.
Response to market changes (agility): As technology and customer needs change, the typical banking model is evolving and as such, operational complexity has the potential to restrict our speed of response.	– Organisational and behavioural effectiveness is regularly reviewed, ensuring simplicity/efficiency, supporting the Group's strategy. – Sustained and continuing investment in digital capability and customer channels; plans updated to reflect market trends/customer behaviour.
Strategic use of customer data: Impacts of Data Regulation in respect of data sharing, data privacy and data loss, noting the need to defend against dynamic external challengers and consumer expectations. Failure to address growth in data movement or understand the Supply Chain/Third party controls may increase exposure to Cyber/Fraud leading to conduct/reputational issues.	– Assessment of the possible impacts of legislation is ongoing; delivery of enhanced systems and processes to fulfil related regulatory requirements. – Chief Data Officer reviewing operating model and identifying opportunities to enhance the associated control environment.
Ring-fencing: Legislation and rules impact the business and operating model and cost of serving customers effectively. EU Exit/heightened implementation risk may require a change to target business/operational model adding complexity, timescales and execution costs.	– Updates reported to Board and GEC on key components of non ring-fence programmes. – The Group is actively engaged with HM Treasury, the PRA and FCA to ensure that it is able to fully implement the restructuring required to implement ring-fencing by the January 2019 deadline.
Resolution: Plans are in place to deliver on bail-in-able debt (MREL) for the Group by 1 January 2022 (interim target 1 January 2020); uncertainty surrounds investor appetite/pricing as many banks will approach the same investor base over a similar period.	– Early engagement with investors; capitalising on our name in the market, and spread issuance over the time window available.
Geopolitical shocks: Current uncertainties could further impede the global economic recovery. Events in China, Russia, the Middle-East, as well as terrorist activity, have the potential to worsen economic outlook and funding conditions.	– Risk appetite criteria limits single counterparty bank/non-bank exposures complemented by a UK-focused strategy. – Financial Stability Forum develops and maintains Stability Response Plan; acting as a Rapid Reaction Group, when external crises occur.

CAPITAL STRESS TESTING

Overview

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

The Group uses scenario stress testing for:

Risk identification:

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

Risk appetite:

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

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

Strategic and capital planning:

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

– Support the Internal Capital Adequacy Assessment Process (ICAAP) by demonstrating capital adequacy, and meet the requirements of regulatory stress tests that are used to inform the setting of the Group's PRA and management buffers (see Capital Risk on pages 159 to 166).

Risk mitigation:

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

Regulatory stress tests

During 2016, the Group was subject to the European Banking Authority's Europe-wide stress test with the Group's results significantly above our minimum capital requirements. The concurrent UK stress test run by the Bank of England was also undertaken in 2016. As announced in November, the Group comfortably exceeded the capital thresholds set by the Prudential Regulation Authority and was not required to take any action as a result of this test.

Internal stress tests

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

Reverse stress testing

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

Other stress testing activity

The Group's stress testing programme also involves undertaking assessment of liquidity scenarios, market risk sensitivities and scenarios and business specific scenarios (see the principal risks on pages 123 to 169 for further information on risk specific stress testing). If required, ad hoc stress testing exercises are also undertaken to assess emerging risks, as well as in response to regulatory requests. This wide ranging programme provides a comprehensive view of the potential impacts arising from the risks to which the Group is exposed and reflects the nature, scale and complexity of the Group.

Methodology

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

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

Governance

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

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

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

HOW RISK IS MANAGED IN LLOYDS BANKING GROUP

The Group's Risk Management Framework (RMF) (see risk overview, page 27) is structured around the following nine components which meet and align with the industry-accepted internal control framework issued by the Committee of Sponsoring Organisations of the Treadway Commission.

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

Role of the Board and senior management

Key responsibilities of the Board and senior management include:

– setting risk appetite and approval of the RMF;

– approval of Group-wide risk principles and policies;

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

– effective oversight over risk management consistent with the risk appetite.

Risk appetite

– Risk appetite is defined within the Group as 'the amount and type of risk that the Group is prepared to seek, accept or tolerate' (see The Group's approach to Risk page 116).

Risk management continued

Governance frameworks

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

Three Lines of Defence model – the RMF is implemented through a 'Three Lines of Defence' model which defines clear responsibilities and accountabilities and ensures effective independent oversight and assurance activities take place covering key decisions.

– Business lines (first line) have primary responsibility for risk decisions, identifying, measuring, monitoring and controlling risks within their areas of accountability. They are required to establish effective governance, and control frameworks for their business to be compliant with Group Policy requirements, to maintain appropriate risk management skills, mechanisms and toolkits, and to act within Group risk appetite parameters set and approved by the Board.
– Risk Division (second line) is a centralised function providing oversight and independent constructive challenge to the effectiveness of risk decisions taken by business management, providing proactive advice and guidance, reviewing challenging and reporting on the risk profile of the Group and ensuring that mitigating actions are appropriate.
– Group Audit (third line) provides independent and objective assurance designed to add value and improve the organisation's operations. It helps the Group accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Group Audit provides independent assurance to the Audit Committee and the Board that risks within the Group are recognised, monitored and managed within acceptable parameters. Group Audit is fully independent of the business and the Risk Division, and seeks to ensure objective challenge to the effectiveness of the risk governance framework.

Mandate of the Risk Division – the objective of Risk Division is to provide both proactive advice and constructive challenge to the business. It also has a key role in promoting the implementation of a strategic approach to risk management reflecting the risk appetite and RMF agreed by the Board that encompasses:

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

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

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

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

The Risk Directors:

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

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

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

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

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

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

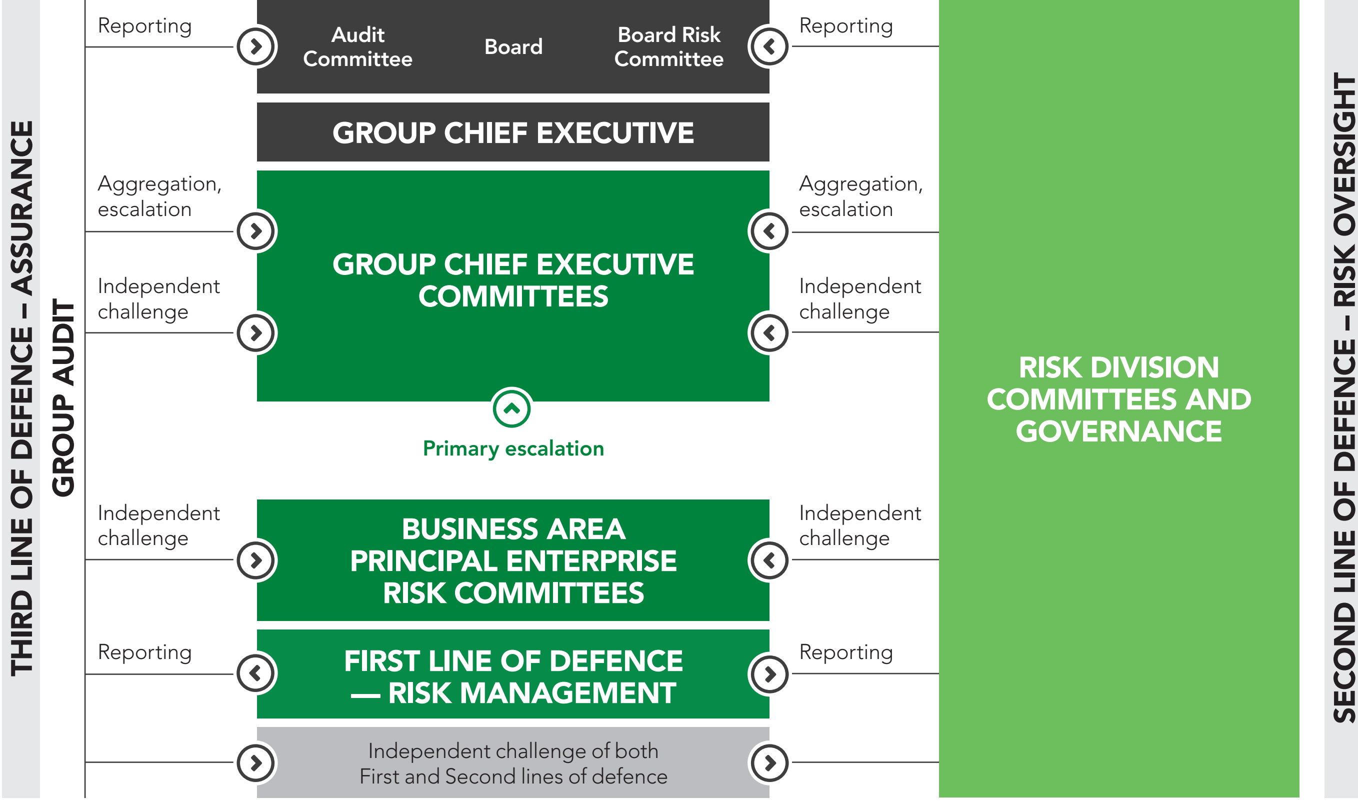
There is ongoing investment in risk systems and models alongside the Group's investment in customer and product systems and processes. This drives improvements in risk data quality, aggregation and reporting leading to effective and efficient risk decisions.

RISK GOVERNANCE

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

Company Secretariat support senior and Board level committees, and support the Chairs in agenda planning. This gives a further line of escalation outside the Three Lines of Defence.

Table 1.2: **Risk governance structure**



Group Chief Executive Committees

Group Executive Committee (GEC)

Group Risk Committee (GRC)

Group Asset and Liability Committee (GALCO)

Group Customer First Committee

Group Cost Management Committee

Conduct Review Committee

Executive Compensation Committee

Responsible Business Management Committee

Business area principal Enterprise Risk Committees

Retail Risk Committee

Consumer Finance Risk Committee

Customer Products and Markets Risk Committee

Commercial Banking Risk Committee

Digital Risk Committee

Insurance Risk Committee

Finance Risk Committee

Group Operations Risk Committee

Group Functions Executive/Risk Committees

Risk Division Risk Committee

Risk Division Committees and Governance

Credit Risk
– Executive Credit Approval Committee
– Commercial Banking Credit Risk Committees
– Retail & Consumer Credit Risk Committees

Market Risk
– Group Market Risk Committee

Conduct, Compliance and Operational Risk
– Group Conduct, Compliance & Operational Risk Committee

Fraud and Financial Crime Risk
– Group Financial Crime Prevention Committee
– Group Fraud Committee

Financial Risk
– Group Financial Risk Committee

Capital Risk
– Group Capital Risk Committee

Model Risk
– Group Model Governance Committee

Insurance Risk through the governance arrangements for Insurance Group
(Insurance Group is a separate regulated entity with its own Board, governance structure and Chief Risk Officer)

Risk management continued

Board, Executive and Risk Committees

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

Assisted by the Board Risk and Audit Committees, the Board approves the Group's overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 60 to 80, for further information on Board committees.

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

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

Table 1.3: **Executive and Risk Committees**

The Group Chief Executive is supported by the following:

Committees	Risk focus
Group Executive Committee (GEC)	Supports the Group Chief Executive in exercising his authority in relation to material matters having strategic, cross-business area or Group-wide implications.
Group Risk Committee (GRC)	Reviews and recommends the Group's risk appetite and governance, risk and control frameworks, material Group policies and the allocation of risk appetite. The committee also regularly reviews risk exposures and risk/reward returns and approves material risk models.
Group Asset and Liability Committee (GALCO)	Responsible for the strategic management of the Group's assets and liabilities and the profit and loss implications of balance sheet management actions. It is also responsible for the risk management framework for market risk, liquidity risk, capital risk and earnings volatility.
Group Customer First Committee (GCFC)	Provides a Group-wide perspective on the progress of Group's, Divisions' and Functions' implementation of initiatives which enhance the delivery of customer outcomes and customer trust, and set and promote the appropriate tone from the top to fulfil the Group's vision to become the best bank for customers and Help Britain Prosper.
Group Cost Management Committee	Leads and shapes the Group's approach to cost management, ensuring appropriate governance and process over Group-wide cost management activities and effective control of the Group's cost base.
Conduct Review Committee	Provides oversight and challenge in connection with the Group's engagement with conduct review matters as agreed with the Group Chief Executive.
Executive Compensation Committee	Provides governance and oversight for Group-wide remuneration matters and policies.
Responsible Business Management Committee	Recommends and implements the strategy and plans to deliver the Group's aspiration to be a leader in responsible business as part of the objective of helping Britain prosper.
The Group Risk Committee is supported through escalation and ongoing reporting by business area risk committees, cross-divisional committees addressing specific matters of Group-wide significance and the following Risk committees which ensure effective oversight of risk management:	
Credit Risk Committees	Responsible for the development and effectiveness of the relevant credit risk management framework, clear description of the Group's credit risk appetite, setting of credit policy, and compliance with regulatory credit requirements.
Group Market Risk Committee (GMRC)	Monitors and reviews the Group's aggregate market risk exposures and concentrations and provides a proactive and robust challenge around business activities giving rise to market risks.
Group Conduct, Compliance and Operational Risk Committee	Responsible for monitoring breaches, material events and risk issues and conducting deep dive assessments on specific Conduct, Compliance or Operational Risk subjects to inform corrective action along with the sharing of information and best practice.
Group Financial Crime Prevention Committee	Reviews and challenges the management of financial crime risk including the overall strategy and performance and engagement with financial crime authorities. The committee is accountable for ensuring that, at Group level, financial crime risks are effectively identified and managed within risk appetite and that strategies for financial crime prevention are effectively co-ordinated and implemented across the Group.
Group Fraud Committee	Is responsible for ensuring that the development and application of fraud risk management complies with the Group's strategic aims and risk appetite, and our broader corporate responsibilities. The committee provides direction and focus to priorities which enhance the Group's fraud risk management capabilities in line with business and customer objectives, including engagement with external fraud detection and prevention bodies.
Group Financial Risk Committee	Responsible for reviewing, challenging and recommending to GEC/GRC/GALCO, the Group Individual Liquidity Adequacy Assessment and Internal Capital Adequacy Assessment Process (ICAAP) submissions, the Group Recovery Plan, and the annual stress testing of the Group's operating plan, PRA and EBA stress tests, and any other analysis as required.
Group Capital Risk Committee	Provides oversight of capital matters within the Group including the Group's capital position, Pillar 2 requirements, regulatory reform and accounting developments specific to capital, and reviews regulatory submissions including the ICAAP and Recovery Plan prior to submission to GFRC.
Group Model Governance Committee	Responsible for setting the framework and standards for model governance across the Group, including establishing appropriate levels of delegated authority and principles underlying the Group's risk modelling framework, specifically regarding consistency of approach across business units and risk types. It approves risk models other than material models which are approved by GRC.

FULL ANALYSIS OF RISK DRIVERS

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

Primary risk drivers

Credit risk	Conduct risk	Market risk	Operational risk	Funding and liquidity risk	Capital risk	Regulatory and legal risk	Insurance risk	People risk	Financial reporting risk	Governance risk
Page 124	Page 145	Page 146	Page 152	Page 154	Page 159	Page 166	Page 167	Page 168	Page 168	Page 169

Secondary risk drivers

Credit risk	Conduct risk	Market risk	Operational risk	Funding and liquidity risk	Capital risk	Regulatory and legal risk	Insurance risk	People risk	Financial reporting risk	Governance risk
Portfolio concentration risk	Customer risk	Interest rate risk	Regulatory and legal process	Funding risk	Capital sufficiency	Compliance risk	Longevity risk	Resourcing	Financial and prudential regulatory reporting	Governance
Counterparty credit risk	Product risk	Equity risk	Client money/ fiduciary obligations	Liquidity risk	Capital efficiency	Competition risk	Mortality risk	Performance and reward	Tax reporting and compliance	Disclosure
Country risk	Product distribution/ advice risk	Foreign exchange risk	Conduct process			Legal risk	Morbidity risk	Culture and engagement	Pillar 3 disclosure	Model risk
Collateral management risk		Credit spread risk	Financial crime				Customer behaviour risk (including persistency risk)	Talent and succession		Ethics
		Inflation risk	Fraud				Property insurance risk	Learning		
		Property risk	People process				Expenses risk	Well-being		
		Alternative asset risk	Sourcing					Legal and regulatory (people)		
		Basis risk	Internal service provision							
		Commodity risk	External service provision (divested clients)							
			Physical security and health and safety							
			Information security and cyber							
			IT systems							
			Change							
			Business process							
			Financial reporting process							
			Governance process							
			Risk process							
			Operational resilience							

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

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Risk management continued

CREDIT RISK

Definition

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

Exposures

The principal sources of credit risk within the Group arise from loans and advances, contingent liabilities, commitments, debt securities and derivatives to customers, financial institutions and sovereigns. The credit risk exposures of the Group are set out in note 52 on page 261. Credit risk exposures are categorised as 'retail', arising primarily in the Retail, Consumer Finance and Run-off divisions, and some small and medium sized enterprises (SMEs) and 'corporate' (including larger SMEs, corporates, banks, financial institutions and sovereigns) arising primarily in the Commercial Banking, Run-off and Insurance Divisions and Group Corporate Treasury (GCT).

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

Credit risk also arises from debt securities and derivatives. The total notional principal amount of interest rate, exchange rate, credit derivative and other contracts outstanding at 31 December 2016 is shown on page 131. 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 52 on page 261.

Additionally, credit risk arises from leasing arrangements where the Group is the lessor. Note 2(J) on page 190 provides details on the Group's approach to the treatment of leases.

Credit risk exposures in the Insurance Division largely result from holding bond and loan assets in the shareholder funds (including the annuity portfolio) and from exposure to reinsurers.

The investments held in the Group's defined benefit pension schemes also expose the Group to credit risk. Note 36 on page 222 provides further information on the defined benefit pension schemes' assets and liabilities.

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

Measurement

In measuring the credit risk of loans and advances to customers and to banks at a counterparty level, the Group reflects three components:

(i) the 'probability of default' by the counterparty on its contractual obligations; (ii) current exposures to the counterparty and their likely future development, from which the Group derives the 'exposure at default'; and (iii) the likely loss ratio on the defaulted obligations (the 'loss given default').

For regulatory capital purposes the Group's rating systems assess probability of default and if appropriate, exposure at default and loss given default, in order to derive Risk Weighted Assets (RWAs) and regulatory Expected Loss (EL). If not appropriate, regulatory prescribed exposure at default and loss given default values are used in order to derive RWAs and EL.

Impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the regulatory expected loss models. Note 2(H) on page 189 provides details of the Group's approach to the impairment of financial assets.

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

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

In the principal retail portfolios, exposure at default and loss given default models are in use. For regulatory reporting purposes, counterparties are segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes. The Retail Master scale comprises 13 non-default ratings and one default rating.

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

Mitigation

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

Prudent, through the cycle credit principles, risk policies and appetite statements: The independent Risk Division sets out the credit principles, risk policies and risk appetite statements. Principles and policies are reviewed regularly, and any changes are subject to a review and approval process. Policies and risk appetite statements, where appropriate, are supported by procedures, which provide a disciplined and focused benchmark for credit decisions. Risk oversight teams monitor credit performance trends, review and challenge exceptions to planned outcomes, and test the adequacy of credit risk infrastructure and governance processes throughout the Group, which includes tracking portfolio performance against an agreed set of key appetite tolerances. Oversight and reviews are also undertaken by Credit Risk Oversight and Group Audit.

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

Limitations on concentration risk: Credit risk management includes portfolio controls on certain industries, sectors and product lines to reflect risk appetite as well as individual, customer and bank limit guidelines. Credit policies and appetite statements are aligned to the Group's risk appetite and restrict exposure to higher risk countries and more vulnerable sectors and asset classes. Note 18 on page 208 provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent both an excessive concentration of risk and single name concentrations. These concentration risk controls are not necessarily in the form of a maximum limit on exposure, but may instead require new business in concentrated sectors to fulfil additional minimum policy and/or guideline requirements. The Group's large exposures are detailed to the Board and reported in accordance with regulatory reporting requirements.

Robust country risk management: The Board sets country risk appetite. Within this, country limits are authorised by the Group Country Risk Appetite Committee, taking into account economic, financial, political and social factors. Group policies stipulate that these limits must be consistent with, and support, the approved business and strategic plans of the Group.

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

Stress testing and scenario analysis: The Group's credit portfolios are also subjected to regular stress testing, with stress scenario assessments run at various levels of the organisation. Exercises focused on individual Divisions and portfolios are performed in addition to the Group led and regulatory stress tests. For further information on the stress testing process, methodology and governance refer to page 119.

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

Group Audit performs the third line of credit risk assurance. A specialist team within Group Audit, comprising experienced credit professionals, is in place to carry out independent risk based internal control audits, providing an assessment of the effectiveness of internal credit controls, across the full credit lifecycle including the raising of impairment provisions. These audits cover the diverse range of the Group's businesses and activities, and include both 'standard' risk based audits and reviews as well as agreed upon procedures to respond to any emerging risks or regulatory requirement. The work of Group Audit therefore continues to provide executive, senior management and Board Audit Committee with assurance on effectiveness of credit risk controls, as well as appropriateness of impairments.

Additional mitigation for Retail and Consumer Finance customers

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

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

In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are policy limits above which the Group will reject borrowing applications. The Group also applies certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant.

For UK Secured, the Group's policy permits owner occupier applications with a Loan to Value (LTV) maximum of 95 per cent. Applications with an LTV above 90 per cent are subject to enhanced underwriting criteria, including higher scorecard cut-offs. Loans above £500,000 are subject to a range of further controls, including reduced maximum income multiples, and increased case review via manual underwriting.

Buy-to-let mortgages are limited to a maximum loan size of £1,000,000 and 75 per cent LTV. Buy-to-let applications must pass a minimum Rental Cover Ratio of 125 per cent under stressed interest rates, after applicable tax liabilities.

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

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

Additional mitigation for Commercial customers

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

Counterparty 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 against agreed confidence intervals. Aggregate facility levels by counterparty are set and limit breaches are subject to escalation procedures.

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

Risk management continued

Collateral

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

- properties;
- charges over business assets such as premises, inventory and accounts receivables;
- financial instruments such as debt securities;
- vehicles;
- cash; and
- guarantees received from third parties.

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

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

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

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

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

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

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

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

Refer to note 52 for further information on collateral.

Master netting agreements

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

Other credit risk transfers

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

Monitoring

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

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

Intensive care of customers in financial difficulty

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

Retail and Consumer Finance customers

The Group's aim in offering forbearance and other assistance to customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and by bringing customer facilities back into a sustainable position which, for residential mortgages, also means keeping customers in their homes. The Group offers a range of tools and assistance to support customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance and the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

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

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

- Reduced payment arrangements: a temporary arrangement for customers in financial distress where arrears accrue at the contractual payment, for example short-term arrangements to pay.
- Term extensions: a permanent account change for customers in financial distress where the overall term of the mortgage is extended, resulting in a lower contractual monthly payment.
- Repair: a permanent account change used to repair a customer's position when they have emerged from financial difficulty, for example capitalisation of arrears.

Forbearance identification, classification and measurement

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

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

The Group measures the success of a forbearance scheme for Secured customers based upon the proportion of customers performing (less than or equal to three months in arrears) over the 24 months following the exit from a forbearance treatment. For temporary treatments, 80 per cent of customers accepting reduced payment arrangements are performing. For permanent treatments, 83 per cent of customers who have accepted capitalisations of arrears and 84 per cent of customers who have accepted term extensions are performing.

Customers receiving support from UK government sponsored programmes

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

- Unemployed customers claiming Jobseekers Allowance: Qualifying customers are able to claim for mortgage interest at 3.12 per cent on up to £200,000 of the mortgage. There is a two year time limit on claims.
- Pension Credit customers: Qualifying customers are able to claim for mortgage interest at 3.12 per cent on up to £100,000 of the mortgage and there is no time limit as to how long they can claim.

For both categories, all decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the government. Payments are made directly to the Group by the Department of Work and Pensions. The Group estimates that customers representing approximately £1.8 billion of its mortgage exposures are receiving this benefit, including those who are also receiving other treatments for financial difficulty.

Commercial customers

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

Risk management continued

Those customers deemed higher risk where there is cause for concern over future repayment capability or where there is a risk of the asset becoming impaired will be transferred to the Business Support Unit (BSU) at an early stage. BSU will take over the 'credit' responsibility for the customer relationship whilst the 'servicing' responsibility remains with the original Relationship Manager. The over-arching aim of the BSU is to provide support and work consensually with each customer to try and resolve the issues, restore the business to a financially viable position and thereby bring about a business turnaround. This may involve a combination of restructuring, work out strategies and other types of forbearance.

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

A detailed assessment is undertaken for cases in BSU to assist in reducing and minimising risk exposure and to also highlight potential strategic options. A range of information is required to fully appraise and understand the customer's business and cashflow (and therefore debt serviceability) and may involve the Group, in addition to using its own internal sector experts, engaging professional advisers to perform asset valuations, strategic reviews and where applicable, independent business reviews. The assessment may also involve:

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

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

The level of Commercial Banking Division BSU gross lending to customers reduced from £4.2 billion to £3.4 billion between 31 December 2015 and 31 December 2016. The net reduction of £0.8 billion in BSU managed lending in Commercial Banking was driven by returns to mainstream, disposals, write-offs and repayments.

The Group's treatment of loan renegotiations is included in the impairment policy in note 2(H) on page 189. Income statement information set out in the credit risk tables is on an underlying basis (see page 37).

Forbearance

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

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

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

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

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

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

Types of forbearance

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

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

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

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

– Covenants: This includes temporary and permanent waivers, amendment or resetting of non-payment contractual covenants (including LTV and interest cover). The granting of this type of concession in itself would not result in the loan being classified as impaired and the customer is kept under review in the event that further forbearance is necessary;
– Extensions/Alterations: This includes extension and/or alteration of repayment terms to a level outside of market or the Group's risk appetite due to the customer's inability to make existing contractual repayment terms; amendments to an interest rate to a level considered outside of market or the Group's risk appetite, or other amendments such as changes to capital and/or interest servicing arrangements including capital repayment holidays or conversion to interest only terms; and
– Multiple type of forbearance (a combination of the above two).

Forbearance identification, classification and measurement

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

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

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

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

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

Exit from forbearance

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

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

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

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

The Group credit risk portfolio in 2016

Overview

- Asset quality remains strong with portfolios continuing to benefit from the Group's pro-active approach to risk management, continued low interest rates and a resilient UK economic environment.
- The impairment charge increased by 14 per cent to £645 million in 2016 compared to £568 million in 2015. Gross charges remained broadly flat with the increase in net charges largely due to lower levels of releases and write-backs.
- The asset quality ratio for 2016 was 15 basis points compared to 14 basis points during 2015 and the gross asset quality ratio (excluding releases and write-backs) was stable at 28 basis points.
- Looking forward the 2017 full year asset quality ratio is expected to increase to around 25 basis points primarily reflecting lower releases and write-backs.
- Impaired loans as a percentage of closing loans and advances reduced to 1.8 per cent at 31 December 2016, from 2.1 per cent at 31 December 2015, with impaired loans reducing by £1,095 million to £8,495 million during the period, due to further reductions in the Commercial Banking, Consumer Finance and Run-off portfolios.

Low risk culture and prudent risk appetite

- The Group continues to operate a prudent approach to credit risk, with the portfolios benefiting from the focus on credit at origination and a prudent through the cycle approach to credit risk appetite. The Group's portfolios are well positioned against current economic concerns and market volatility.
- The Group's credit processes and controls ensure effective risk management, including early identification and management of customers and counterparties who may be showing signs of distress.
- The Group has delivered lending growth in key segments without relaxing credit criteria despite terms and conditions in some of the Group's markets being impacted by increased competition and, in Commercial Banking, uncertainty in some sectors.
- Sector concentrations within the lending portfolios are closely monitored and controlled, with mitigating actions taken where appropriate. Sector and product caps limit exposure to certain higher risk and vulnerable sectors and asset classes. In particular:
  - The average indexed LTV of the Retail UK Secured portfolio at 31 December 2016 was 44.0 per cent (31 December 2015: 46.1 per cent). The percentage of closing loans and advances with an indexed LTV greater than 100 per cent was 0.7 per cent (31 December 2015: 1.1 per cent).
  - Total UK Direct Real Estate gross lending across the Group was £19.9 billion (31 December 2015: £19.7 billion). This mainly includes Commercial Banking lending of £18.5 billion, £0.5 billion booked in the Islands Commercial business and £0.2 billion within Retail Business Banking (within Retail Division) with the Group continuing to write new business within conservative risk appetite parameters. The Group's significantly reduced legacy run-off direct real estate portfolio has continued to fall to £0.7 billion at 31 December 2016 (31 December 2015: £1.1 billion), and now represents a very modest element of the total UK Direct Real Estate lending portfolio.
- Run-off net external assets stood at £11,336 million at 31 December 2016, down from £12,154 million at 31 December 2015. The portfolio represents only 2.1 per cent of the overall Group's loans and advances (31 December 2015: 2.3 per cent).

Risk management continued

Table 1.4: Group impairment charge

2016	Loans and advances to customers £m	Debt securities classified as loans and receivables £m	Available-for-sale financial assets £m	Other credit risk provisions £m	Total £m	2015[1] £m
Retail	**373**	**–**	**–**	**–**	**373**	349
Commercial Banking	**21**	**–**	**–**	**(5)**	**16**	(22)
Consumer Finance	**282**	**–**	**–**	**–**	**282**	235
Run-off	**(17)**	**–**	**–**	**(9)**	**(26)**	8
Central items	**(2)**	**–**	**–**	**2**	**–**	(2)
Total impairment charge	**657**	**–**	**–**	**(12)**	**645**	568
Asset quality ratio					**0.15%**	0.14%
Gross asset quality ratio					**0.28%**	0.28%

1 Restated.

Table 1.5: Movement in gross impaired loans

	2016					
	Retail £m	Commercial Banking £m	Consumer Finance £m	Run-off £m	Total £m	2015 Total £m
At 1 January[1]	**4,112**	**2,543**	**910**	**2,025**	**9,590**	14,308
Classified as impaired during the year	**1,947**	**671**	**425**	**111**	**3,154**	3,401
Transferred to not impaired during the year	**(800)**	**(112)**	**(81)**	**(54)**	**(1,047)**	(1,358)
Repayments	**(517)**	**(595)**	**(121)**	**(94)**	**(1,327)**	(1,729)
Amounts written off	**(391)**	**(311)**	**(285)**	**(485)**	**(1,472)**	(1,503)
Impact of disposal of business and asset sales	**–**	**(33)**	**(49)**	**(410)**	**(492)**	(3,403)
Exchange and other movements	**3**	**16**	**(54)**	**124**	**89**	(126)
At 31 December	**4,354**	**2,179**	**745**	**1,217**	**8,495**	9,590

1 Restated.

Table 1.6: Group impaired loans and provisions

	Loans and advances to customers £m	Impaired Loans £m	Impaired loans as % of closing advances %	Impairment provisions[1] £m	Provision as % of impaired loans[2] %
At 31 December 2016					
Retail	**299,493**	**4,354**	**1.5**	**1,630**	**38.2**
Commercial Banking	**101,176**	**2,179**	**2.2**	**824**	**37.8**
Consumer Finance	**35,494**	**745**	**2.1**	**396**	**85.0**
Run-off	**10,259**	**1,217**	**11.9**	**682**	**56.0**
Reverse repos and other items[3]	**15,249**				
Total gross lending	**461,671**	**8,495**	**1.8**	**3,532**	**43.4**
Impairment provisions	**(3,532)**				
Fair value adjustments[4]	**(181)**				
Total Group	**457,958**				
At 31 December 2015[5]					
Retail	307,500	4,112	1.3	1,564	39.2
Commercial Banking	103,082	2,543	2.5	1,091	42.9
Consumer Finance	31,827	910	2.9	367	75.5
Run-off	11,422	2,025	17.7	1,150	56.8
Reverse repos and other items[3]	5,798				
Total gross lending	459,629	9,590	2.1	4,172	46.1
Impairment provisions	(4,172)				
Fair value adjustments[4]	(282)				
Total Group	455,175				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries in Retail (31 December 2016: £86 million; 31 December 2015: £118 million) and in Consumer Finance (31 December 2016: £279 million; 31 December 2015: £424 million).

3 Includes £6.7 billion (December 2015: £5.7 billion) of lower risk loans sold by Commercial Banking and Retail to Insurance to back annuitant liabilities.

4 The fair value adjustments relating to loans and advances were those required to reflect the HBOS assets in the Group's consolidated financial records at their fair value and took into account both the expected losses and market liquidity at the date of acquisition. The fair value unwind in respect of impairment losses incurred was £70 million for the year ended 31 December 2016 (31 December 2015: £97 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years and will reduce to zero over time.

5 Restated.

Table 1.7: Derivative credit risk exposures

	2016	2016 Traded over the counter			2015	2015 Traded over the counter		
	Traded on recognised exchanges £m	Settled by central counterparties £m	Not settled by central counterparties £m	Total £m	Traded on recognised exchanges £m	Settled by central counterparties £m	Not settled by central counterparties £m	Total £m
Notional balances								
Foreign exchange	**–**	**254**	**369,368**	**369,622**	6,568	–	383,722	390,290
Interest rate	**167,399**	**3,023,742**	**423,709**	**3,614,850**	31,128	3,598,307	791,351	4,420,786
Equity and other	**32,172**	**–**	**11,046**	**43,218**	4,837	–	9,337	14,174
Credit	**–**	**–**	**8,098**	**8,098**	–	–	4,566	4,566
Total	**199,571**	**3,023,996**	**812,221**	**4,035,788**	42,533	3,598,307	1,188,976	4,829,816
Fair values								
Assets		**262**	**35,563**			103	28,811	
Liabilities		**(1)**	**(34,506)**			(131)	(26,149)	
Net asset		**261**	**1,057**			(28)	2,662	

The total notional principal amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2016 and 31 December 2015 is shown in the table above. The notional principal amount does not, however, represent the Group's credit risk exposure, which is limited to the current cost of replacing contracts with a positive value to the Group. Such amounts are reflected in note 52 on page 261.

Risk management continued

Retail

– Asset quality remains strong across all portfolios, with stable new business quality and fewer loans entering arrears.
– The impairment charge increased by £24 million to £373 million for 2016, an increase of 7 per cent compared to 2015.
– The Overdrafts impairment charge increased by £12 million to £241 million, driven by a change to collections entry criteria.
– The Secured impairment charge increased by £6 million to £104 million, reflecting a continued prudent approach to provisioning.
– The Retail Business Banking impairment charge increased by £6 million to £27 million, following a revised modelling approach and an increase in lending balances.
– Impairment provisions as a percentage of impaired loans decreased to 38.2 per cent from 39.2 per cent at the end of 2015.

Table 1.8: **Retail impairment charge**

	2016 £m	2015[1] £m	Change %
Secured	**104**	98	(6)
Overdrafts	**241**	229	(5)
Wealth	**1**	1	–
Retail Business Banking	**27**	21	(29)
Total impairment charge	**373**	349	(7)
Asset quality ratio	**0.12%**	0.11%	1bp

1 Restated.

Table 1.9: **Retail impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2016					
Secured	**294,503**	**4,104**	**1.4**	**1,503**	**36.6**
Overdrafts	**1,952**	**179**	**9.2**	**90**	**82.6**
Wealth	**2,034**	**44**	**2.2**	**15**	**34.1**
Retail Business Banking	**1,004**	**27**	**2.7**	**22**	**200.0**
Total gross lending	**299,493**	**4,354**	**1.5**	**1,630**	**38.2**
Impairment provisions	**(1,630)**				
Fair value adjustments	**(181)**				
Total	**297,682**				
At 31 December 2015[3]					
Secured	302,413	3,818	1.3	1,431	37.5
Overdrafts	2,028	211	10.4	95	78.5
Wealth	2,164	40	1.8	19	47.5
Retail Business Banking	895	43	4.8	19	126.7
Total gross lending	307,500	4,112	1.3	1,564	39.2
Impairment provisions	(1,564)				
Fair value adjustments	(273)				
Total	305,663				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Overdrafts (31 December 2016: £70 million; 31 December 2015: £90 million) and Retail Business Banking (31 December 2016: £16 million; 31 December 2015: £28 million).

3 Restated.

Secured

– The impairment charge increased by £6 million to £104 million in 2016 (31 December 2015: £98 million).
– Loans and advances reduced by 2.6 per cent on the Secured book to £295 billion, with reductions in both the Mainstream and buy-to-let portfolios. The closed Specialist portfolio has continued to run-off, reducing by 10.0 per cent to £18 billion.
– Impaired loans increased by £286 million to £4,104 million in 2016 and the value of mortgages greater than three months in arrears (excluding repossessions) increased by £128 million to £6,033 million at 31 December 2016 (31 December 2015: £5,905 million). These are both principally due to delayed litigation while changes were made to legal processes. New business quality remained stable and flows into arrears improved.
– Impairment provisions as a percentage of impaired loans was 36.6 per cent (31 December 2015: 37.5 per cent).
– Against a backdrop of strong improvement in the housing market, with UK prices rising 6 per cent over 2016 (on a quarterly non-seasonally adjusted basis), provisions remain prudent and reflect the latent risks of the current low interest rate environment.
– The average indexed LTV of the portfolio at 31 December 2016 improved to 44.0 per cent compared with 46.1 per cent at 31 December 2015. The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent improved to 0.7 per cent at 31 December 2016, compared with 1.1 per cent at 31 December 2015.
– The average LTV for new mortgages written in 2016, including participation in the UK Government's Help To Buy scheme, was 64.4 per cent compared with 64.7 per cent for 2015.
– Additional controls for new buy-to-let lending were implemented ahead of the regulatory deadline, with no relaxation in risk appetite.

Table 1.10: **Retail Secured loans and advances to customers**

	At 31 Dec 2016 £m	At 31 Dec 2015 £m
Mainstream	222,450	227,267
Buy-to-let	54,460	55,598
Specialist[1]	17,593	19,548
Total Secured	294,503	302,413

1 Specialist lending has been closed to new business since 2009.

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

	Number of cases		Total mortgage accounts %		Value of loans[1]		Total mortgage balances %	
At 31 Dec	2016 Cases	2015 Cases	2016 %	2015 %	2016 £m	2015 £m	2016 %	2015 %
Mainstream	35,254	34,850	1.7	1.6	3,865	3,803	1.7	1.7
Buy-to-let	5,324	5,021	1.1	1.0	660	626	1.2	1.1
Specialist	9,078	8,777	7.2	6.4	1,508	1,476	8.6	7.6
Total	49,656	48,648	1.8	1.7	6,033	5,905	2.0	2.0

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

The stock of repossessions increased to 678 cases at 31 December 2016 compared to 654 cases at 31 December 2015.

Risk management continued

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

	Mainstream %	Buy-to-let %	Specialist %	Total %	Unimpaired %	Impaired %
At 31 December 2016						
Less than 60%	**56.8**	**52.0**	**53.8**	**55.8**	**56.0**	**38.3**
60% to 70%	**17.8**	**25.4**	**17.8**	**19.2**	**19.3**	**18.4**
70% to 80%	**14.0**	**14.4**	**13.6**	**14.0**	**14.0**	**15.3**
80% to 90%	**8.4**	**6.1**	**8.6**	**8.0**	**7.9**	**11.9**
90% to 100%	**2.4**	**1.5**	**3.1**	**2.3**	**2.2**	**6.8**
Greater than 100%	**0.6**	**0.6**	**3.1**	**0.7**	**0.6**	**9.3**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Outstanding loan value (£m)	**222,450**	**54,460**	**17,593**	**294,503**	**290,399**	**4,104**
Average loan to value:[1]						
Stock of residential mortgages	**41.8**	**53.7**	**49.2**	**44.0**		
New residential lending	**65.0**	**61.9**	**n/a**	**64.4**		
Impaired mortgages	**51.8**	**69.0**	**61.9**	**55.8**		
At 31 December 2015						
Less than 60%	52.2	45.4	43.7	50.4	50.7	30.9
60% to 70%	19.1	26.8	19.7	20.6	20.6	17.5
70% to 80%	15.5	15.0	15.5	15.4	15.4	16.9
80% to 90%	9.0	8.0	11.6	9.0	8.9	13.3
90% to 100%	3.2	3.9	5.5	3.5	3.4	9.5
Greater than 100%	1.0	0.9	4.0	1.1	1.0	11.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Outstanding loan value (£m)	227,267	55,598	19,548	302,413	298,595	3,818
Average loan to value:[1]						
Stock of residential mortgages	43.6	56.3	53.3	46.1		
New residential lending	65.2	63.0	n/a	64.7		
Impaired mortgages	55.6	74.6	66.8	60.0		

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

Interest only mortgages

The Group provides interest only mortgages to owner occupier mortgage customers whereby only payments of interest are made for the term of the mortgage with the customer responsible for repaying the principal outstanding at the end of the loan term. At 31 December 2016, interest only balances as a proportion of total owner occupier balances had reduced to 31.3 per cent (31 December 2015: 33.9 per cent). The average indexed loan to value improved to 43.8 per cent (31 December: 46.6 per cent).

New owner occupier interest only mortgages are subject to conservative underwriting criteria with rigorous controls on customers' ability to repay the principal at the end of term. New interest only mortgages, including those with any element of capital repayments represented 1.9 per cent of new residential mortgages in 2016 (2.8 per cent in 2015[2]).

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

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

Table 1.13: **Analysis of owner occupier interest only mortgages**

	2016	2015
Interest only balances (£m)[1]	**72,651**	81,558
Of which, impaired (%)	**3.1**	2.5
Average loan to value (%)	**43.8**	46.6
Maturity profile (£m)[2]:		
1 year	**2,496**	1,709
2-5 years	**9,877**	10,123
6-10 years	**16,990**	17,084
>11 years	**41,927**	51,502
Past term interest only balances (£m)[3]	**1,361**	1,140
Of which, impaired (%)	**10.5**	9.7
Average loan to value (%)	**31.5**	32.5
Negative equity (%)	**1.4**	1.8

1 In addition the Group has buy-to-let interest only balances of £48,575 million (2015: £49,751 million) and certain other interest only balances of £3,703 million (2015: £3,705 million).

2 December 2015 values have been restated to now include the interest only elements of mortgage accounts which consist of partial interest only and partial capital repayment.

3 Past term interest only balances are reported excluding any element being repaid on a capital and interest basis. December 2015 balances have been restated on the same basis.

Forborne loans

UK Secured forborne loans and advances reduced by £1,006 million in 2016 to £2,096 million, primarily due to a reduction in recapitalisations with higher levels of historic cases exiting the two year probation period, and a tightening of eligibility criteria during the year. At 31 December 2016, UK Secured loans and advances currently or recently subject to forbearance improved to 0.7 per cent (31 December 2015: 1.0 per cent) of total UK Secured loans and advances.

Overdrafts forborne loans and advances have reduced by £9 million in 2016 to £78 million. At 31 December 2016, Overdrafts loans and advances currently or recently subject to forbearance were 4.0 per cent (31 December 2015: 4.3 per cent) of total overdrafts loans and advances.

Further analysis of the Retail forborne loan balances is set out below:

Table 1.14: **UK Retail forborne loans and advances (audited)**

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as % of loans and advances which are forborne	
	At Dec 2016 £m	At Dec 2015 £m	**At Dec 2016 £m**	At Dec 2015 £m	**At Dec 2016 %**	At Dec 2015 %
UK Secured lending:						
Temporary forbearance arrangements						
Reduced payment arrangements[1]	**428**	414	**101**	41	**4.9**	4.2
Permanent treatments						
Repair and term extensions[2]	**1,668**	2,688	**116**	132	**4.7**	4.2
Total	**2,096**	3,102	**217**	173	**4.7**	4.2
Overdrafts[3]	**78**	87	**61**	63	**38.0**	35.0

1 Includes customers who had an arrangement to pay less than the contractual amount at 31 December or where an arrangement ended within the previous three months.

2 Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and where the borrowers remain as customers at 31 December.

3 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months.

Risk management continued

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

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

	2016		2015	
	UK Secured £m	Overdrafts £m	UK Secured £m	Overdrafts £m
At 1 January	3,102	87	4,394	89
Classified as forborne during the year	975	50	1,290	53
Written-off/sold	(12)	(31)	(25)	(26)
Exit from forbearance	(1,741)	(24)	(2,252)	(22)
Redeemed or repaid	(200)	–	(263)	–
Exchange and other movements	(28)	(4)	(42)	(7)
At 31 December	2,096	78	3,102	87

Commercial Banking

- The Commercial Banking net impairment charge was £16 million in 2016, compared to a net impairment release of £22 million in 2015, with the increase largely due to one material charge related to a case within the oil & gas sector, rather than a deterioration in the underlying portfolio. Other than this, gross charges remained relatively low in 2016.
- The portfolio continues to benefit from effective risk management and the continued low interest rate environment.
- Credit quality of the portfolio and new business remains generally good.
- Impaired loans reduced by 14 per cent to £2,179 million at 31 December 2016 compared with £2,543 million at 31 December 2015 and as a percentage of closing loans and advances reduced to 2.2 per cent from 2.5 per cent at 31 December 2015.
- Impairment provisions reduced to £824 million at 31 December 2016 (31 December 2015: £1,091 million) and includes collective unidentified impairment provisions of £183 million (31 December 2015: £229 million). Provisions as a percentage of impaired loans reduced from 42.9 per cent to 37.8 per cent during 2016, heavily influenced by the net movement of three material cases with different coverage levels that has impacted the portfolio average.
- The UK faces a number of significant headwinds including the changing global economic outlook and the impact of the EU Exit referendum outcome which have the ability to impact the Commercial Banking portfolios.
- Commercial Banking remains disciplined within its low risk appetite approach and key credit risks continue to be effectively managed, including early identification and management of potential concern customers. We manage and limit exposure to certain sectors and asset classes, and closely monitor credit quality, sector and single name concentrations.
- Detailed EU Exit portfolio impact assessments have been undertaken and internal and external key performance indicators are being monitored closely to help identify early signs of any deterioration.
- Despite the uncertain economic headwinds, the portfolios are well positioned and monitoring confirms that we have yet to see any material deterioration in the credit quality of our portfolios. However, given the challenging environment our portfolios will not be immune and impairments are likely to increase from their historic low levels, driven mainly by lower levels of releases and write-backs and an element of credit normalisation.

Table 1.16: **Commercial Banking impairment charge**

	2016 £m	2015 £m	Change %
SME	(7)	(22)	(68)
Other	23	–	
Total impairment charge	16	(22)	
Asset quality ratio[1]	0.02%	0.01%	1bp

1 In respect of loans and advances to customers.

Table 1.17: **Commercial Banking impaired loans and provisions**

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans %
At 31 December 2016					
SME	**29,959**	**923**	**3.1**	**173**	**18.7**
Other	**71,217**	**1,256**	**1.8**	**651**	**51.8**
Total gross lending	**101,176**	**2,179**	**2.2**	**824**	**37.8**
Impairment provisions	**(824)**				
Total	**100,352**				
At 31 December 2015[2]					
SME	29,393	1,149	3.9	213	18.5
Other	73,689	1,394	1.9	878	63.0
Total gross lending	103,082	2,543	2.5	1,091	42.9
Impairment provisions	(1,091)				
Total	101,991				

1 Impairment provisions include collective unidentified impairment provisions.

2 Restated.

SME

- The SME Banking portfolio continues to grow within prudent credit risk appetite parameters.
- Portfolio credit quality has remained stable or improved across all key metrics.
- SME continues to benefit from write-backs/releases. There was a net impairment release of £7 million in 2016 compared to a net release of £22 million during 2015.

Other Commercial Banking

- Other Commercial Banking comprises £71,217 million of gross loans and advances to customers in Mid Markets, Global Corporates and Financial Institutions.
- The Mid Markets business remains UK-focused and credit quality has been generally stable during 2016. The downturn in global oil and gas prices, which began in 2015, has created pressure on some parts of the oilfield services portfolio but this has not translated into a significant increase in defaults or impairment in the Mid Markets book. Political events during 2016, in particular the EU Exit referendum outcome, have brought volatility to financial markets but to date this has not led to a material increase in stress within the Mid Markets portfolio.
- The Global Corporates business continues to have a predominance of investment grade clients, primarily UK based. The portfolio remains of good quality despite the current global economic headwinds particularly relating to the EU Exit referendum outcome and volatile commodity prices in the oil & gas and mining sectors.
- The real estate business within the Group's Mid Markets and Global Corporate portfolio is focused on clients operating in the UK commercial property market ranging in size from medium sized private real estate entities up to publicly listed property companies. The uncertainties created by the EU Exit referendum outcome have reduced activity in the second half of 2016 but the market for UK real estate has continued to be resilient and credit quality remains good with minimal impairments/stressed loans. Recognising this is a cyclical sector, appropriate caps are in place to control exposure and business propositions continue to be written in line with a prudent, through the cycle risk appetite with conservative LTVs, strong quality of income and proven management teams.
- Financial Institutions serves predominantly investment grade counterparties with whom relationships are either client focused or held to support the Group's funding, liquidity or general hedging requirements. Overall limits have been relatively stable as we continue to prudently manage the portfolio within our conservative risk appetite and clearly defined sector strategies.
- The Group continues to adopt a conservative stance across the Eurozone maintaining close portfolio scrutiny and oversight particularly given the current macro environment and horizon risks.

Commercial Banking UK Direct Real Estate LTV analysis

- The Group classifies Direct Real Estate as exposure which is directly supported by cash flows from property activities (as opposed to trading activities, such as hotels, care homes and housebuilders).
- Focus remains on the UK market, on good quality customers, with a proven track record in Real Estate and where cash flows are robust.
- Commercial Banking saw some growth in its UK Direct Real Estate core portfolio during 2016 with business continuing to be written within conservative risk appetite parameters. Excluding £0.5 billion in the Islands Commercial business, Commercial Banking UK Direct Real Estate gross lending stood at £18.5 billion at 31 December 2016.
- Approximately 70 per cent of loans and advances to UK Direct Real Estate relate to commercial real estate with the remainder relating to residential real estate. The portfolio continues to be heavily weighted towards investment real estate (c.90 per cent) over development.
- The LTV profile of the UK Direct Real Estate portfolio in Commercial Banking continues to improve.

Risk management continued

Table 1.18: LTV – UK Direct Real Estate

	At 31 December 2016[1]				At 31 December 2015[1]			
	Unimpaired £m	Impaired £m	Total £m	%	Unimpaired £m	Impaired £m	Total £m	%
UK exposures >£5m								
Less than 60%	**5,721**	**14**	**5,735**	**67.2**	4,989	72	5,061	63.7
60% to 70%	**1,470**	**–**	**1,470**	**17.2**	1,547	6	1,553	19.5
70% to 80%	**506**	**9**	**515**	**6.1**	610	13	623	7.9
80% to 100%	**20**	**6**	**26**	**0.3**	75	36	111	1.4
100% to 120%	**–**	**–**	**–**	**–**	–	8	8	0.1
120% to 140%	**–**	**–**	**–**	**–**	–	–	–	–
Greater than 140%	**–**	**68**	**68**	**0.8**	5	100	105	1.3
Unsecured[2]	**689**	**26**	**715**	**8.4**	487	–	487	6.1
	8,406	**123**	**8,529**	**100.0**	7,713	235	7,948	100.0
UK exposures <£5m[3]	**9,563**	**429**	**9,992**		9,656	508	10,164	
Total	**17,969**	**552**	**18,521**		17,369	743	18,112	

1 Excludes Islands Commercial UK Direct Real Estate.

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

3 December 2016 <£5m exposures include £9.4 billion within SME which has an LTV profile broadly similar to the >£5m exposures.

Forborne loans

Commercial Banking forbearance

At 31 December 2016, £2,645 million (31 December 2015: £3,529 million) of total loans and advances were forborne of which £2,179 million (31 December 2015: £2,543 million) were impaired. Impairment provisions as a percentage of forborne loans and advances increased marginally from 30.9 per cent at 31 December 2015 to 31.2 per cent at 31 December 2016.

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

	Total loans and advances which are forborne		Impairment provisions as % of loans and advances which are forborne	
	2016 £m	2015[1] £m	2016 %	2015[1] %
Impaired	**2,179**	2,543	**37.8**	42.9
Unimpaired	**466**	986	**–**	–
Total	**2,645**	3,529	**31.2**	30.9

1 Restated.

All impaired assets are considered forborne.

Impaired loans and advances

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

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

	2016 £m	2015[1] £m
At 1 January	**2,543**	3,241
Classified as impaired during the year:		
Exposures >£5m	**547**	505
Exposures <£5m	**124**	126
	671	631
Transferred to unimpaired:		
Exposures >£5m but still reported as forborne	**–**	(15)
Exposures >£5m no longer reported as forborne	**(31)**	(20)
Exposures <£5m	**(81)**	(111)
	(112)	(146)
Written-off	**(311)**	(225)
Asset disposal/sales of impaired assets	**(33)**	(48)
Drawdowns/repayments	**(595)**	(693)
Exchange and other movements	**16**	(217)
At 31 December	**2,179**	2,543

1 Restated.

Unimpaired loans and advances

Unimpaired forborne loans and advances were £466 million at 31 December 2016 (31 December 2015: £986 million).

The table below sets out the largest unimpaired forborne loans and advances to Commercial Banking customers (exposures over £5 million) as at 31 December 2016 by type of forbearance:

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

	31 Dec 2016 £m	31 Dec 2015 £m
Type of unimpaired forbearance:		
Exposures >£5m		
Covenants	**153**	310
Extensions/alterations	**7**	350
Multiple	**21**	9
	181	669
Exposures <£5m	**285**	317
Total	**466**	986

1 Material portfolios only.

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

	2016 £m	2015 £m
At 1 January	**669**	1,450
Classified as impaired during the year	**(63)**	(141)
Cured no longer forborne	**(413)**	(655)
Classified as forborne during the year	**88**	156
Transferred from impaired but still reported as forborne[1]	**–**	15
Asset disposal/sales	**–**	–
Net drawdowns/repayments	**(100)**	(153)
Exchange and other movements	**–**	(3)
At 31 December	**181**	669

1 Balances exclude intra-year movements.

Consumer Finance

- UK Loans and advances increased during 2016, driven by strong growth ahead of the market in the UK Motor Finance portfolio, and continued growth in line with the market in the Credit Cards portfolio.
- Asset quality remains strong, and the quality of new business continues to be good.
- Credit risk appetite has been maintained, and the Group has robust indebtedness and affordability controls to ensure new lending is sustainable for our customers.
- The impairment charge increased by £47 million to £282 million largely due to the UK Motor Finance portfolio, in which there was overall growth as well as the non-recurrence of a favourable one-off in 2015.
- Credit Cards balances grew broadly in line with the market, and underlying credit quality remained strong. Impaired loans fell by £59 million due to continued reductions in recoveries, and impairment provisions as a percentage of impaired loans remained stable.
- Loans balances contracted marginally and underlying credit quality remained strong. Impaired loans fell by £90 million largely due to reductions in recoveries, and impairment provisions as a percentage of impaired loans remained broadly stable.
- Growth in UK Motor Finance loans and advances was ahead of the market, in part due to strategic relationships with business partners such as Jaguar Land Rover, which also contributed to the strong underlying credit quality in the portfolio. Impaired loans fell by £14 million largely due to a reclassification of impaired balances for some finance leases, and on an underlying basis grew broadly in line with the portfolio. Impairment provisions as a percentage of impaired loans increased, reflecting the reclassification of impaired balances, and portfolio growth coupled with a prudent approach to residual value.

Table 1.23: Consumer Finance impairment charge

	2016 £m	2015 £m	Change %
Credit Cards	**136**	129	(5)
Loans	**70**	83	16
UK Motor Finance	**75**	22	
Europe	**1**	1	–
	282	235	(20)
Asset quality ratio	**0.83%**	0.77%	6bp

Risk management continued

Table 1.24: Consumer Finance impaired loans and provisions

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions[1] £m	Impairment provisions as a % of impaired loans[2] %
At 31 December 2016					
Credit cards	**9,843**	**307**	**3.1**	**157**	**81.8**
Loans	**7,767**	**277**	**3.6**	**92**	**81.4**
UK Motor Finance	**11,555**	**120**	**1.0**	**127**	**105.8**
Europe	**6,329**	**41**	**0.6**	**20**	**48.8**
Total gross lending	**35,494**	**745**	**2.1**	**396**	**85.0**
Impairment provisions	**(396)**				
Fair value adjustments	**–**				
Total	**35,098**				
At 31 December 2015[3]					
Credit cards	9,425	366	3.9	153	81.8
Loans	7,889	367	4.7	102	83.6
UK Motor Finance	9,582	134	1.4	90	67.2
Europe	4,931	43	0.9	22	51.2
Total gross lending	31,827	910	2.9	367	75.5
Impairment provisions	(367)				
Fair value adjustments	(9)				
Total	31,451				

1 Impairment provisions include collective unidentified impairment provisions.

2 Impairment provisions as a percentage of impaired loans are calculated excluding loans in recoveries for Cards (31 December 2016: £115 million; 31 December 2015: £179 million) and Loans (31 December 2016: £164 million; 31 December 2015: £245 million).

3 Restated.

Forborne loans

At 31 December 2016, total loans and advances currently or recently subject to forbearance as a percentage of total loans and advances had reduced across the major Consumer Finance portfolios with decreases in Consumer Credit Cards and Loans offset by an increase in UK Motor Finance. (31 December 2016: 1.4 per cent; 31 December 2015: 1.6 per cent).

Table 1.25: Consumer Finance forborne loans and advances (audited)

	Total loans and advances which are forborne		Total forborne loans and advances which are impaired		Impairment provisions as % of loans and advances which are forborne	
	31 Dec 2016 £m	31 Dec 2015 £m	**31 Dec 2016 £m**	**31 Dec 2015 £m**	**31 Dec 2016 %**	31 Dec 2015 %
Consumer Credit Cards[1]	**212**	225	**119**	120	**29.0**	26.8
Loans[2]	**49**	60	**46**	56	**44.4**	47.2
UK Motor Finance Retail[2]	**117**	100	**62**	51	**27.0**	25.5

1 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes, such as returning a Card account in arrears to an in-order status, which commenced during the last 24 months for existing customers as at 31 December are also included.

2 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes, such as refinancing, for existing customers as at 31 December are also included.

The movements in forborne loans and advances during the year were:

Table 1.26: **Movement in Consumer Finance forborne loans and advances (audited)**

	2016			2015		
	Consumer credit cards £m	**Loans £m**	**UK Motor Finance Retail £m**	Consumer credit cards £m	Loans £m	UK Motor Finance Retail £m
At 1 January	**225**	**60**	**100**	234	73	109
Classified as forborne during the year	**110**	**34**	**82**	108	16	61
Written off/sold	**(46)**	**(24)**	**(16)**	(48)	(29)	(15)
Exit from forbearance	**(43)**	**(4)**	**(22)**	(36)	(4)	(21)
Redeemed or repaid	**(9)**	**(6)**	**(16)**	(9)	(6)	(19)
Exchange and other movements	**(25)**	**(11)**	**(11)**	(24)	10	(15)
At 31 December	**212**	**49**	**117**	225	60	100

Run-off

- The Ireland retail portfolio continues to reduce in volume due to closed book attrition (3 per cent year on year), however exposure has increased by £457 million to £4,497 million in 2016 (31 December 2015: £4,040 million) due to the foreign exchange impact of sterling weakening, partly offset by capital repayments.
- Ireland retail loans and advances with an indexed LTV in excess of 100 per cent improved to £1,240 million (27.8 per cent) at 31 December 2016, compared with £1,269 million (31.4 per cent) at 31 December 2015. Of this amount £70 million were impaired (31 December 2015: £71 million).
- The Corporate real estate and other corporate portfolio has continued to reduce in line with expectations. Net loans and advances reduced by £337 million, from £1,128 million at 31 December 2015 to £791 million at 31 December 2016.
- Total net external assets for the Specialist finance asset based run-off portfolio reduced to £4,668 million at 31 December 2016 (gross £4,779 million), from £5,552 million (gross £5,742 million) for 2015. Assets include Ship Finance, Aircraft Finance, Leasing and Infrastructure loans and advances, as well as the reducing Treasury Asset legacy investment portfolio and operating leases.

Table 1.27: **Run-off impairment charge**

	2016 £m	2015 £m	Change %
Ireland retail	**(1)**	(5)	(80)
Ireland corporate and commercial real estate	**(13)**	72	
Corporate real estate and other corporate	**1**	21	95
Specialist finance	**(2)**	(45)	(96)
Other	**(11)**	(35)	(69)
Total	**(26)**	8	
Asset quality ratio[1]	**(0.15%)**	0.20%	(35)bp

1 In respect of loans and advances to customers.

Risk management continued

Table 1.28: Run-off impaired loans and provisions

	Loans and advances to customers £m	Impaired loans £m	Impaired loans as a % of closing advances %	Impairment provisions £m	Impairment provisions as a % of impaired loans %
At 31 December 2016					
Ireland retail	**4,497**	**138**	**3.1**	**133**	**96.4**
Ireland corporate	**1**	**1**	**100.0**	**–**	**–**
Corporate real estate and other corporate	**1,190**	**896**	**75.3**	**399**	**44.5**
Specialist finance	**3,374**	**99**	**2.9**	**111**	**112.1**
Other	**1,197**	**83**	**6.9**	**39**	**47.0**
Total gross lending	**10,259**	**1,217**	**11.9**	**682**	**56.0**
Impairment provisions	**(682)**				
Total	**9,577**				
At 31 December 2015					
Ireland retail	4,040	132	3.3	120	90.9
Ireland corporate	29	–		–	
Ireland commercial real estate	8	5	62.5	–	
Corporate real estate and other corporate	1,873	1,410	75.3	745	52.8
Specialist finance	4,190	361	8.6	189	52.4
Other	1,282	117	9.1	96	82.1
Total gross lending	11,422	2,025	17.7	1,150	56.8
Impairment provisions	(1,150)				
Total	10,272				

Forborne loans

Run-off Ireland retail lending

At 31 December 2016, £156 million or 3.5 per cent (31 December 2015: £169 million or 4.2 per cent) of Irish retail secured loans and advances were subject to current or recent forbearance. Of this amount, £19 million (31 December 2015: £26 million) were impaired.

Run-off Corporate real estate, other corporate and Specialist Finance

At 31 December 2016 £998 million (31 December 2015 £1,780 million) of total loans and advances were forborne of which £995 million (31 December 2015: £1,771 million) were impaired. Impairment provisions as a percentage of forborne loans and advances decreased from 52.5 per cent at 31 December 2015 to 51.1 per cent at 31 December 2016.

Unimpaired forborne loans and advances were £3 million at 31 December 2016 (31 December 2015: £9 million).

Impaired loans and advances

The movements in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances were as follows:

Table 1.29: Movement in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances (audited)

	2016 £m	2015 £m
At 1 January	**1,771**	1,912
Classified as impaired during the year:		
Exposures >£5m	**20**	414
Exposures <£5m	**19**	11
	39	425
Transferred to unimpaired:		
Exposures >£5m but still reported as forborne during the year	**–**	(13)
Exposures <£5m	**(8)**	(11)
	(8)	(24)
Write offs	**(478)**	(238)
Asset disposal/sales of impaired assets	**(405)**	(763)
Drawdowns/repayments	**(24)**	(19)
Exchange and other movements	**100**	478
At 31 December	**995**	1,771

Eurozone exposures

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2016. The exposures comprise on balance sheet exposures based on their balance sheet carrying values net of provisions and off balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

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

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

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

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

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

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

Exposures to selected Eurozone countries

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

Table 1.30: **Selected Eurozone exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal[2] £m	Insurance assets[1] £m	Total £m
At 31 December 2016									
Ireland	**–**	**–**	**215**	**512**	**91**	**929**	**4,363**	**–**	**6,110**
Spain	**23**	**–**	**76**	**126**	**–**	**630**	**41**	**19**	**915**
Portugal	**–**	**–**	**7**	**–**	**–**	**22**	**7**	**–**	**36**
Italy	**–**	**–**	**38**	**–**	**–**	**59**	**–**	**67**	**164**
Greece	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	23	**–**	**336**	**638**	**91**	**1,640**	**4,411**	**86**	**7,225**
At 31 December 2015									
Ireland	–	–	748	445	87	731	3,921	–	5,932
Spain	–	–	77	102	–	870	39	9	1,097
Portugal	–	–	7	–	–	86	6	–	99
Italy	–	–	32	–	–	51	–	73	156
Greece	–	–	–	–	–	1	–	–	1
	–	–	864	547	87	1,739	3,966	82	7,285

1 Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £14,506 million (2015: £11,267 million) on a gross basis.

2 Ireland Retail exposures have increased by c.£0.4 billion as a result of the depreciation of sterling against the Euro c.£0.7 billion offset by asset reductions primarily driven by repayments of c.£0.3 billion.

Risk management continued

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

Table 1.31: **Other Eurozone exposures**

	Sovereign debt		Financial institutions						
	Direct sovereign exposures £m	Cash at central banks £m	Banks £m	Other[1] £m	Asset backed securities £m	Corporate £m	Personal £m	Insurance assets £m	Total £m
At 31 December 2016									
Netherlands	**–**	**8,795**	**343**	**324**	**50**	**1,610**	**6,315**	**423**	**17,860**
France	**–**	**–**	**1,907**	**620**	**41**	**2,648**	**96**	**851**	**6,163**
Germany	**1,543**	**93**	**538**	**31**	**224**	**1,598**	**443**	**477**	**4,947**
Luxembourg	**7**	**–**	**306**	**1,484**	**619**	**923**	**–**	**–**	**3,339**
Belgium	**35**	**–**	**1,009**	**300**	**–**	**114**	**–**	**49**	**1,507**
All other Eurozone countries	**38**	**–**	**95**	**–**	**–**	**354**	**–**	**62**	**549**
	1,623	**8,888**	**4,198**	**2,759**	**934**	**7,247**	**6,854**	**1,862**	**34,365**
At 31 December 2015									
Netherlands	281	11,515	328	164	37	1,275	4,863	428	18,891
France	173	–	1,809	216	98	1,953	64	953	5,266
Germany	151	97	888	21	66	1,924	177	573	3,897
Luxembourg	–	–	74	1,178	618	1,614	–	36	3,520
Belgium	20	–	830	1	–	298	–	51	1,200
All other Eurozone countries	15	–	403	–	–	342	–	80	840
	640	11,612	4,332	1,580	819	7,406	5,104	2,121	33,614

1 Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £2,679 million (2015: £1,955 million) on a gross basis.

Environmental risk management

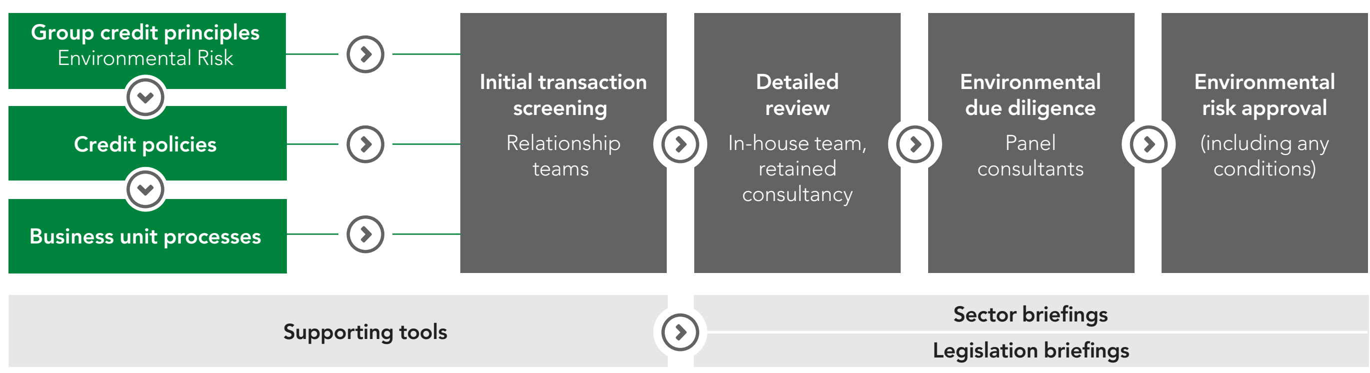
The Group ensures appropriate management of the environmental impact of its lending activities. The Group-wide credit risk principles require all credit risk to be incurred with due regard to environmental legislation and the Group's Code of Business Responsibility.

Within Commercial Banking, an electronic environmental risk screening system has been the primary mechanism for assessing environmental risk in lending transactions. This system provides screening of location specific and sector based risks that may be present in a transaction. Identified risk results in the transaction referred to the Group's expert in-house environmental risk team for further review and assessment, as outlined below. Where required, the Group's panel of environmental consultants provide additional expert support.

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

The Group has been a signatory to the Equator Principles since 2006 and has adopted and applied the expanded scope of Equator Principles III. The Equator Principles support the Group's approach to assessing and managing environmental and social issues in Project Finance, Project-Related Corporate loans and Bridge loans.

Table 1.32: **Environmental risk management approach**



CONDUCT RISK

Definition

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

Exposures

The Group faces significant conduct risks, which affect all aspects of the Group's operations, all types of customers and other stakeholders. These can be considered across two main categories; customer conduct risks and market conduct risks. Customer conduct risks are those that have a direct impact on a customer – or group of customers – and can materialise through products or services not meeting the needs of its customers; sales processes resulting in poor customer outcomes; or the failure to deal with a customer's complaint effectively which in turn may lead to a referral to the Financial Ombudsman Service. Market conduct risks can exist where activity taken can disrupt the fair and effective operation of a market in which the Group is active. Market conduct risks can arise from the mismanagement of market sensitive information, the failure to identify and report suspicious transactions or orders, or through inaccurate benchmark submissions.

There is an ongoing high level of scrutiny regarding financial institutions' treatment of customers, including those in vulnerable circumstances, from regulatory bodies, the media, politicians and consumer groups. As a result, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority, other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or in a manner that fails to deliver fair and reasonable customer treatment. The Group may also be liable for damages to third parties harmed by the conduct of its business. There is also a significant regulatory focus on market misconduct, resultant from previous issues around LIBOR and FX.

Measurement

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite. Conduct Risk Appetite Metrics (CRAMs) have been designed for all product families offered by the Group; a set of common metrics have been agreed for all products to support a consistent approach. These contain a range of product design, sales and post-sales metrics to provide a more holistic view of conduct risks; each product also has additional bespoke metrics. The common metrics are sales volume, product governance adherence, target market, outcome testing: meets customer needs, outcome testing: information disclosure, outcome testing: regulatory compliance, retention, usage, claims (decline rates), complaints, Financial Ombudsman Service uphold rate and complaints outcome testing. Each of the tolerances for the metrics are agreed for the individual product and are tracked monthly. At a consolidated level these metrics are part of the Board approved risk appetite. The Group also continues to measure the effectiveness of the overall strategic focus on conduct within the divisions and functions and its impact on customer outcomes and the effective implementation of the Customer Vulnerability agenda through the Group Customer First Committee (GCFC).

In relation to market conduct, relevant metrics are being established, and will continue to evolve in line with external developments. These cover a range of topics including the management of confidential and market sensitive information; and the way in which conflicts of interest are managed.

Mitigation

The Group takes a range of mitigating actions with respect to this risk. The transition of the customer-focused UK centric strategy into the Business has strengthened its culture and values, improved systems and processes, and implemented more effective controls. These actions are being further embedded throughout the Group (across all business areas and all supporting functional areas) through the continued evolution of the strategic focus on conduct within business as usual supported by the GCFC, including:

- Conduct risk appetite established at Group and business area level, with metrics included in the Board Risk Appetite to ensure ongoing due-focus;
- Customer needs explicitly considered within business and product level planning and strategy, with Divisional plans reviewed and challenged by the GCFC;
- Cultural transformation, supported by strong direction and tone from senior executives and the Board. This is underpinned by the Group's values and Codes of Responsibility, to deliver the best bank for customers;
- Establishment of the Customer Vulnerability Framework, which operates at a senior level to prioritise change, drive implementation and ensure consistency across the Group;
- Development of the Group's Customer Journey Strategy and Framework to support our focus on conduct from an end-to-end customer perspective;
- Enhanced product governance framework to ensure products continue to offer customers fair value, and consistently meet their needs throughout their product life cycle;
- Enhanced complaints management through effectively responding to, and learning from, root causes to reduce complaint volumes and the Financial Ombudsman Service change rate;
- Enhanced recruitment and training, with a focus on how the Group manages colleagues' performance with clearer customer accountabilities; and
- Ongoing focus on the strategic conduct agenda in our interactions with third parties involved in serving the Group's customers to ensure consistent delivery of needs met.

The Group has also prioritised activity designed to reinforce good conduct in its engagement with the markets in which it operates. This has included the creation of a Market Conduct Steering Committee, training for relevant colleagues, the development of enhanced procedures, and the enhancement of preventative and detective controls including the Group's trade surveillance and continuous surveillance capability.

The Group's leadership team, through the GCFC, has oversighted and approved the transition of the Conduct Strategy within the business as usual to support the development of the right customer centric culture. The Board and Group Risk Committee receive regular qualitative and quantitative reports to track progress on how the Group is meeting customer needs and minimising conduct risk across all areas of the business.

The Group actively engages with regulatory bodies and other stakeholders in developing its understanding of current customer treatment concerns, and those relating to the fairness and effectiveness of markets, to ensure that the Group's strategic conduct focus in business as usual continues to meet evolving stakeholder expectations.

Monitoring

Monitoring and reporting is undertaken at Board, Group and business area committees. As part of the reporting of CRAMs, a robust outcomes testing regime, for both sales and complaints processes, is in place to test performance of customer critical activities. The GCFC has responsibility for monitoring and reviewing integrated measurement of enhanced outcomes, customer views and cultural transformation, including challenging Divisions to make changes based on key learnings to support the delivery of the Group's vision and foster a customer centric culture. Monitoring activity has also increased in scope to cover trading and communication surveillance, and the monitoring and testing of controls relevant to our market conduct agenda.

Risk management continued

MARKET RISK

Definition

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

Balance sheet linkages

The information provided in table 1.33 (below) aims to facilitate the understanding of linkages between banking, trading, and insurance balance sheet items and the positions disclosed in the Group's market risk disclosures.

Table 1.33: **Market risk linkage to the balance sheet**

		Banking			
2016	Total £m	Trading book only £m	Non-trading £m	Insurance £m	Primary market risk factor
Assets					
Cash and balances at central banks	**47,452**	–	**47,452**	–	Interest rate
Trading and other financial assets at fair value through profit or loss	**151,174**	**45,247**	**4,039**	**101,888**	Interest rate, foreign exchange, credit spread
Derivative financial instruments	**36,138**	**30,951**	**2,713**	**2,474**	Interest rate, foreign exchange, credit spread
Loans and receivables:					
Loans and advances to banks	**26,902**	–	**5,583**	**21,319**	Interest rate
Loans and advances to customers[1]	**457,958**	–	**457,958**	–	Interest rate
Debt securities	**3,397**	–	**3,397**	–	Interest rate, credit spread
	488,257	–	**466,938**	**21,319**	
Available-for-sale financial assets	**56,524**	–	**56,522**	**2**	Interest rate, foreign exchange, credit spread
Value of in-force business	**5,042**	–	–	**5,042**	Equity
Other assets	**33,206**	–	**16,811**	**16,395**	Interest rate
Total assets	**817,793**	**76,198**	**594,475**	**147,120**	
Liabilities					
Deposits from banks	**16,384**	–	**16,384**	–	Interest rate
Customer deposits	**415,460**	–	**415,460**	–	Interest rate
Trading and other financial liabilities at fair value through profit or loss	**54,504**	**45,079**	**9,425**	–	Interest rate, foreign exchange
Derivative financial instruments	**34,924**	**30,143**	**1,967**	**2,814**	Interest rate, foreign exchange, credit spread
Debt securities in issue	**76,314**	–	**76,314**	–	Interest rate, credit spread
Liabilities arising from insurance and investment contracts	**114,502**	–	–	**114,502**	Credit spread
Subordinated liabilities	**19,831**	–	**18,012**	**1,819**	Interest rate, foreign exchange
Other liabilities	**37,059**	–	**9,376**	**27,683**	Interest rate
Total liabilities	**768,978**	**75,222**	**546,938**	**146,818**	

1 Includes £6.7 billion of lower risk loans within the banking book sold by Commercial Banking and Retail to Insurance to manage market risk arising from annuitant liabilities within the Insurance business.

The defined benefit pension schemes' assets and liabilities are included under Other assets and Other liabilities in this table and note 36 on page 222 provides further information.

The Group's trading book assets and liabilities are originated by Financial Markets within the Commercial Banking division. Within the Group's balance sheet these fall under the trading assets and liabilities and derivative financial instruments. The assets and liabilities are classified as trading books if they have been acquired or incurred for the purpose of selling or repurchasing in the near future. These consist of government, corporate and financial institution bonds and loans/deposits and repos. Further information on these activities can be found under the Trading portfolios section on page 151.

Derivative assets and liabilities are held by the Group for three main purposes; to provide risk management solutions for clients, to manage portfolio risks arising from client business and to manage and hedge the Group's own risks. The majority of derivatives exposure arises within Financial Markets. Insurance business assets and liabilities relate to policyholder funds, as well as shareholder invested assets, including annuity funds. The Group recognises the value of in-force business in respect of Insurance's long-term life assurance contracts as an asset in the balance sheet (see note 24, page 213).

The Group ensures that it has adequate cash and balances at central banks and stocks of high quality liquid assets (e.g. Gilts or US Treasury Securities) that can be converted easily into cash to meet liquidity requirements. The majority of these assets are held as available-for-sale with the remainder held as financial assets at fair value through profit and loss. Further information on these balances can be found under the Funding and Liquidity Risk on page 155. Interest rate risk in the asset portfolios is swapped into a floating rate.

The majority of debt issuance originates from the Issuance, Capital Vehicles and Medium Term Notes desks and the interest rate risk of the debt issued is hedged by swapping them into a floating rate.

The non trading book primarily consists of customer on balance sheet activities and the Group's capital and funding activities, which expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices, as described in further detail within the Banking activities section (page 148).

Table 1.34 shows the key material market risks for the Group's banking, defined benefit pension schemes, Insurance and trading activities.

Table 1.34: Key material market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)

	Risk type					
2016	Interest Rate	Basis Risk	FX	Credit Spread	Equity	Inflation
Banking activities[1]	● (light green)	● (grey)	–	● (dark green)	● (light green)	–
Defined benefit pension scheme[1]	● (grey)	–	–	■ (grey)	–	–
Insurance portfolios[1]	● (grey)	–	–	● (dark green)	● (dark green)	–
Trading portfolios[2]	–	–	–	–	–	–

Profit before tax	Loss	Gain
>£500m	● (dark green)	■ (dark green)
£250m – £500m	● (light green)	■ (light green)
£50m – <£250m	● (grey)	■ (grey)
Immaterial/zero	–	–

1 Banking Activities: Insurance and Pensions stresses; Interest rate -100 bps, Basis 3 month Libor +100bps/Bank Base Rate -25bps, FX -15 per cent GBP. Credit Spread +100 per cent, Equity -30 per cent, Inflation +50 bps.

2 Trading Portfolios; Interest rate -30bps, FX -5 per cent GBP, Credit spread +20 per cent, Inflation +30bps.

Measurement

In addition to measuring single factors, board risk appetite is calibrated primarily to five economic multirisk scenarios, and is supplemented with sensitivity based measures. The scenarios assess the impact of unlikely, but plausible adverse stresses on income, with the worst case for banking activities, defined benefit pensions, insurance and trading portfolios reported against independently, and across the Group as a whole.

The Board risk appetite is cascaded first to the Group Asset and Liability Committee (GALCO), chaired by the Chief Financial Officer, where risk appetite is approved and monitored by risk type, and then to Group Market Risk Committee (GMRC) where risk appetite is sub allocated by Division. These metrics are reviewed regularly by senior management to inform effective decision making.

Mitigation

GALCO is responsible for approving and monitoring group market risks, management techniques, market risk measures, behavioural assumptions, and the market risk policy. Various mitigation activities are assessed and undertaken across the Group to manage portfolios and seek to ensure they remain within approved limits. The mitigation actions will vary dependent on exposure, but will, in general, look to reduce risk in a cost effective manner, by offsetting balance sheet exposures and externalising through to the financial markets dependent on market liquidity. The market risk policy is owned by Group Corporate Treasury (GCT) and refreshed annually. The policy is underpinned by supplementary market risk procedures, which define specific market risk management and oversight requirements.

Monitoring

GALCO and the GMRC regularly review high level market risk exposure, as part of the wider risk management framework. They also make recommendations to the Group Chief Executive concerning overall market risk appetite and Group Market Risk Policy. Exposures at lower levels of delegation are monitored at various intervals according to their volatility, from daily in the case of trading portfolios to monthly or quarterly in the case of less volatile portfolios. Levels of exposures compared to approved limits and triggers are monitored by Risk Division and where appropriate, escalation procedures are in place.

How market risks arise and are managed across the Group's activities is considered in more detail below.

Risk management continued

Banking activities

Exposures

The Group's banking activities expose it to the risk of adverse movements in market prices, predominantly interest rates, credit spreads, exchange rates and equity prices. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset or liability.

Interest rate risk

Interest rate risk in the Group's divisional portfolios and in the Group's capital and funding activities arises from the different repricing characteristics of the Group's non-trading assets, liabilities (see loans and advances to customers and customer deposits in table 1.36) and off balance sheet positions. Behavioural assumptions are applied to (i) embedded optionality within products; (ii) the duration of balances that are contractually repayable on demand, such as current accounts and overdrafts, together with net free reserves of the group; and (iii) to the re-pricing behaviour of managed rate liabilities namely variable rate savings.

Basis risk arises from the possible changes in spreads, for example where the bank lends with reference to a central bank rate but funds with reference to LIBOR and the spread between these two rates widens or tightens.

Prepayment risk arises, predominantly in the Retail division, as customer balances amortise more quickly or slowly than anticipated due to economic conditions or customer's response to changes in economic conditions. Pipeline and pre hedge risk arises where new business volumes are higher or lower than forecasted.

Foreign exchange risk

Economic foreign exchange exposure arises from the Group's investment in its overseas operations (net investment exposures are disclosed in note 52 on page 261). In addition, the Group incurs foreign exchange risk through non-functional currency flows from services provided by customer facing divisions and the Group's debt and capital management programmes.

Equity risk

Equity risk arises primarily from three different sources; (i) the Group's strategic equity holdings in Banco Sabadell, Aberdeen Asset Management, and Visa Europe; (ii) exposure to Lloyds Banking Group share price through deferred shares and deferred options granted to employees as part of their benefits package; and (iii) the Group's private equity investments held by Lloyds Development Capital.

Credit spread risk

Credit spread risk arises largely from (i) the liquid asset portfolio held in the management of Group liquidity, comprising of government, supranational, and other eligible assets; and (ii) the Credit Valuation Adjustment (CVA) and Debit Valuation Adjustment (DVA) sensitivity to credit spreads; and (iii) a number of the Group's structured medium term notes where we have elected to fair value the notes through the profit and loss account.

Measurement

Interest rate risk exposure is monitored monthly using, primarily:

(i) Market value sensitivity: this methodology considers all repricing mismatches (behaviourally adjusted where appropriate) in the current balance sheet and calculates the change in market value that would result from an instantaneous 25, 100 and 200 basis points parallel rise or fall in the yield curve (subject to an appropriate floor).

(ii) Interest income sensitivity: this measures the impact on future net interest income arising from an instantaneous 25, 100 and 200 basis points parallel rise or fall in all the yield curves over a rolling 12 month basis (subject to an appropriate floor). Unlike the market value sensitivities, the interest income sensitivities incorporate additional behavioural assumptions as to how and when individual products would reprice in response to such change.

(iii) Market Value limit: this caps the amount of conventional and inflation-linked government bonds held by the Group for liquidity purposes.

(iv) Structural hedge limits; these metrics enhance understanding of assumption and duration risk taken within the behaviouralisation of this portfolio.

The Group has an integrated Asset and Liability Management (ALM) system which supports non traded asset and liability management of the Group. This provides a single consolidated tool to measure and manage interest rate repricing profiles (including behavioural assumptions), perform stress testing and produce forecast outputs. The Group is aware that any assumptions based model is open to challenge. A full behavioural review is performed annually to ensure the assumptions remain appropriate.

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

Table 1.35 below shows, split by material currency, the Group's market value sensitivities to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.35: **Banking activities: market value sensitivity**

	2016				2015			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Sterling	**(11.4)**	**11.5**	**(45.1)**	**31.6**	48.7	(48.8)	194.2	(115.9)
US Dollar	**3.2**	**(3.2)**	**12.6**	**(13.7)**	1.9	(1.9)	7.5	(5.9)
Euro	**(6.0)**	**(3.7)**	**(23.2)**	**(12.1)**	1.7	(2.1)	6.9	(6.8)
Other	**(0.2)**	**0.2**	**(0.9)**	**0.6**	(0.4)	0.4	(1.6)	1.1
Total	**(14.4)**	**4.8**	**(56.6)**	**6.4**	51.9	(52.4)	207.0	(127.5)

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

The market value sensitivity is driven by temporary customer flow positions not yet hedged plus other positions occasionally held within limits, by the Group's wholesale funding desks in order to minimise overall funding and hedging costs. The level of risk is low relative to the size of the total balance sheet.

Table 1.36 below shows supplementary value sensitivity to a steepening and flattening in the yield curve. This ensures there are no unintended consequences to managing risk to parallel shifts in rates.

Table 1.36: **Banking activities: market value sensitivity to a steepening and flattening of the yield curve**

	2016		2015	
	Steepener £m	**Flattener £m**	Steepener £m	Flattener £m
Sterling	**(5.8)**	**(13.2)**	(105.7)	97.1
US Dollar	**0.7**	**(1.3)**	(3.4)	4.8
Euro	**(15.3)**	**(12.8)**	(0.5)	2.0
Other	**(0.2)**	**0.2**	0.2	(0.2)
Total	**(20.6)**	**(27.1)**	(109.4)	103.7

The table below shows the banking book income sensitivity to an instantaneous parallel up and down 25 and 100 basis points change to all interest rates.

Table 1.37: **Banking activities: net interest income sensitivity (audited)**

	2016				2015			
	Up 25bps £m	**Down 25bps £m**	**Up 100bps £m**	**Down 100bps £m**	Up 25bps £m	Down 25bps £m	Up 100bps £m	Down 100bps £m
Client facing activity and associated hedges	**176.8**	**(286.1)**	**724.9**	**(408.0)**	152.4	(140.1)	604.7	(464.2)

Income sensitivity is measured over a rolling 12 month basis.

The interest income sensitivity continues to reflect structural hedging against margin compression. The increased sensitivity reflects both the timing of margin management, and the level of floors giving rise to increased compression risk in the Group.

Basis risk, foreign exchange, equity, and credit spread risks are measured primarily through scenario analysis by assessing the impact on profit before tax over a 12 month horizon arising from a change in market rates, and reported within the Board Risk Appetite on a monthly basis. Supplementary measures such as sensitivity and exposure limits are applied where they provide greater insight into risk positions. Frequency of reporting supplementary measures varies from daily to quarterly appropriate to each risk type.

Mitigation

The Group's policy is to optimise reward whilst managing its market risk exposures within the risk appetite defined by the Board. The Group Market Risk policy and procedures outlines the hedging process, and the centralisation of risk from divisions into GCT, e.g. via Transfer Pricing Framework. GCT is responsible for managing the centralised risk and does this through natural offsets of matching assets and liabilities, and appropriate hedging activity of the residual exposures, subject to the authorisation and mandate of GALCO within the Board risk appetite. Derivative desks in Financial Markets will then externalise the hedges to the market. The Group has hedge accounting solutions in place, which reduce the accounting volatility arising from the Group's economic hedging activities by utilising both Libor based and Bank base rate assets.

The largest residual risk exposure arises from balances that are deemed to be insensitive to changes in market rates (including current accounts, a portion of variable rate deposits and investable equity), and is managed through the Group's structural hedge. Consistent with the Group's strategy to deliver stable returns, GALCO seeks to minimise large reinvestment risk, and to smooth earnings over a range of investment tenors. The amount and duration of the hedging activity is reviewed regularly by GALCO, with current maximum duration of around four years.

Whilst the bank faces margin compression in the current low rate environment, its exposure to pipeline and prepayment risk are not considered material, and are hedged in line with expected customer behaviour. These are appropriately monitored and controlled through Divisional ALCOs.

Net investment foreign exchange exposures are managed centrally by GCT, by hedging non GBP asset values with currency borrowing. Economic foreign exchange exposures arising from non-functional currency flows are identified by divisions and transferred and managed centrally. The Group also has a policy of forward hedging its forecasted currency profit and loss to year end.

Monitoring

The appropriate limits and triggers are monitored by senior executive Committees within the Banking divisions. Banking assets, liabilities and associated hedging are actively monitored and if necessary rebalanced to be within agreed tolerances.

Defined benefit pension schemes

Exposures

The Group's defined benefit pension schemes are exposed to significant risks from their assets and liabilities. The liability discount rate provides exposure to interest rate risk and credit spread risk, which are partially offset by fixed interest assets (such as gilts and corporate bonds) and swaps. Equity and alternative asset risk arises from direct asset holdings.

For further information on defined benefit pension scheme assets and liabilities please refer to note 36 on page 222.

Measurement

Management of the assets is the responsibility of the Trustees of the schemes who are responsible for setting the investment strategy and for agreeing funding requirements with the Group. Should a funding deficit arise, the Group will be liable for meeting it, and as part of a triennial valuation process will agree with the Trustees a funding strategy to eliminate the deficit over an appropriate period.

Risk management continued

Mitigation

The Group takes an active involvement in agreeing risk management and mitigation strategies with the schemes' Trustees. An interest rate and inflation hedging programme is in place to reduce liability risk. In recent years the schemes have also reduced equity allocation and invested the proceeds in credit assets as part of a programme to de-risk the portfolio.

Monitoring

In addition to the wider risk management framework, governance of the schemes includes two specialist pensions committees (one Group executive sub-committee and a supporting management committee).

The surplus or deficit in the schemes is tracked on a monthly basis along with various single factor and scenario stresses which consider the assets and liabilities holistically. The impact on Group capital resources of the schemes is monitored monthly. Performance against risk appetite triggers is also monitored monthly. Hedges are in place and asset/liability matching positions are also actively monitored.

Insurance portfolios

Exposures

The main elements of market risk to which the Group is exposed through the Insurance business are equity, credit spread, interest rate and inflation.

- Equity risk arises indirectly through the value of future management charges on policyholder funds. These management charges form part of the value of in-force business (see note 24 on page 213). Equity risk also arises in the with-profits funds but is less material.
- Credit spread risk mainly arises from annuities where policyholders' future cashflows are guaranteed at retirement. Exposure arises if the market value of the assets which are held to back these liabilities, mainly corporate bonds and loans, do not perform in line with expectations. Within the Group accounts a large amount of the exposure to market value movements, but not actual default losses, is removed as accounting rules require that assets Insurance have acquired from Group are maintained at the original amortised book value.
- Interest rate risk arises through holding credit and interest assets mainly in the annuity book and also to cover general insurance liabilities, capital requirements and risk appetite.
- Inflation exposure arises from a combination of inflation linked policyholder benefits and inflation assumptions used to project future expenses.

Measurement

Current and potential future market risk exposures within Insurance are assessed using a range of stress testing exercises and scenario analyses.

Risk measures include 1-in-200 year stresses used for regulatory capital assessments and single factor stresses for profit before tax.

Table 1.38 demonstrates the impact of the Group's UK Recession stress scenario (with no diversification benefit) on Insurance's portfolio; this is the most onerous scenario for Insurance out of the Group scenarios. The amounts include movements in assets, liabilities and the value of in-force business in respect of insurance contracts and participating investment contracts.

Table 1.38: **Insurance business: profit before tax sensitivities**

	Increase (reduction) in profit before tax	
	2016 £m	2015[1] £m
Interest rates – decrease 100 basis points	**(142)**	9
Inflation – increase 50 basis points	**(34)**	(23)
Credit spreads – 100% widening	**(812)**	(864)
Equity – 30% fall	**(681)**	(616)
Property – 25% fall	**(58)**	(51)

1 Restated. The most onerous scenario has changed to UK Recession from Fiscal Solvency.

Further stresses that show the effect of reasonably possible changes in key assumptions, including the risk-free rate, equity investment volatility, widening of credit default spreads on corporate bonds and an increase in illiquidity premia, as applied to profit before tax are set out in note 33.

Mitigation

Equity and credit spread risks are closely monitored and, where appropriate, asset liability matching is undertaken to mitigate risk. A hedging strategy is in place to reduce exposure from the with-profit funds.

Interest rate risk in the annuity book is mitigated by investing in assets whose cash flows closely match those on the projected future liabilities. It is not possible to eliminate risk completely as the timing of insured events is uncertain and bonds are not available at all of the required maturities. As a result, the cash flows cannot be precisely matched and so sensitivity tests are used to test the extent of the mismatch.

Other market risks (e.g. interest rate exposure outside the annuity book and inflation) are also closely monitored and where considered appropriate, hedges are put in place to reduce exposure.

Monitoring

Market risks in the Insurance business are monitored by Insurance senior executive committees and ultimately the Insurance Board. Monitoring includes the progression of market risk capital against risk appetite limits, as well as the sensitivity of profit before tax to combined market risk stress scenarios and in year market movements. Asset/liability matching positions and hedges in place are actively monitored and if necessary rebalanced to be within agreed tolerances. In addition market risk is controlled via approved investment policies and mandates.

Trading portfolios

Exposures

The Group's trading activity is small relative to its peers and the Group does not have a programme of proprietary trading activities. The Group's trading activity is undertaken solely to meet the financial requirements of commercial and retail customers for foreign exchange, credit and interest rate products. These activities support customer flow and market making activities.

All trading activities are performed within the Commercial Banking division. While the trading positions taken are generally small, any extreme moves in the main risk factors and other related risk factors could cause significant losses in the trading book depending on the positions at the time. The average 95 per cent 1-day trading VaR (diversified across risk factors) was £1.3 million for year end 2016 compared to £1.4 million for year end 2015. This decrease was due to the significant de-risking activities that took place at the portfolio level.

Trading market risk measures are applied to all the Group's regulatory trading books and they include daily VaR (table 1.39), sensitivity based measures, and stress testing calculations.

Measurement

The Group internally uses VaR as the primary risk measure for all trading book positions.

Table 1.39 shows some relevant statistics for the Group's 1-day 95 per cent confidence level VaR that are based on 300 historical consecutive business days to year end 2016 and year end 2015.

The risk of loss measured by the VaR model is the minimum expected loss in earnings given the 95 per cent confidence. The total and average trading VaR numbers reported below have been obtained after the application of the diversification benefits across the five risk types. The maximum and minimum VaR reported for each risk category did not necessarily occur on the same day as the maximum and minimum VaR reported at Group level.

Table 1.39: **Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)**

	At 31 December 2016				At 31 December 2015			
	Close £m	**Average £m**	**Maximum £m**	**Minimum £m**	Close £m	Average £m	Maximum £m	Minimum £m
Interest rate risk	**0.7**	**1.3**	**7.7**	**0.5**	0.8	1.4	3.5	0.8
Foreign exchange risk	**0.1**	**0.3**	**0.8**	**0.1**	0.2	0.3	0.8	0.1
Equity risk	**–**	**–**	**–**	**–**	–	–	–	–
Credit spread risk	**0.2**	**0.2**	**0.4**	**0.1**	0.2	0.4	1.0	0.2
Inflation risk	**0.2**	**0.3**	**5.9**	**0.1**	0.1	0.3	1.6	0.1
All risk factors before diversification	**1.2**	**2.1**	**14.3**	**1.1**	1.3	2.3	6.2	1.3
Portfolio diversification	**(0.5)**	**(0.8)**			(0.4)	(0.9)		
Total VaR	**0.7**	**1.3**	**5.7**	**0.6**	0.9	1.4	3.1	0.8

The market risk for the trading book continues to be low with respect to the size of the Group and compared to our peers. This reflects the fact that the Group's trading operations are customer-centric and focused on hedging and recycling client risks. Note that the maximum VaR reported at £5.7 million was due to the incomplete booking of a position by end of day 22 March 2016 and hence did not reflect the true end of day position and was not a real limit breach. The VaR returned to normal levels once the booking was completed the next day. The next highest VaR was £3.8 million.

Although it is an important market standard measure of risk, VaR has limitations. One of them is the use of limited historical data sample which influences the output by the implicit assumption that future market behaviour will not differ greatly from the historically observed period. Another known limitation is the use of defined holding periods which assumes that the risk can be liquidated or hedged within that holding period. Also calculating the VaR at the chosen confidence interval does not give enough information about potential losses which may occur if this level is exceeded. The Group fully recognises these limitations and supplements the use of VaR with a variety of other measurements which reflect the nature of the business activity. These include detailed sensitivity analysis, position reporting and a stress testing programme.

Trading book VaR (1-day 99 per cent) is compared daily against both hypothetical and clean profit and loss. 1-day 99 per cent VaR charts for Lloyds Bank, HBOS and Lloyds Banking Group models can be found in the Group's Pillar 3 Report.

Mitigation

The level of exposure is controlled by establishing and communicating the approved risk limits and controls through policies and procedures that define the responsibility and authority for risk taking. Market risk limits are clearly and consistently communicated to the business. Any new or emerging risks are brought within risk reporting and defined limits.

Monitoring

Trading risk appetite is monitored daily with 1-day 95 per cent VaR and Stress Testing limits. These limits are complemented with position level action triggers and profit and loss referrals. Risk and position limits are set and managed at both desk and overall trading book levels. They are reviewed at least annually and can be changed as required within the overall Group risk appetite framework.

Risk management continued

OPERATIONAL RISK

Definition

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

The aim of operational risk management is to manage operational risks, protecting customers and the Group, whilst delivering sustainable growth. Operational risks are managed in line with defined appetites through the Group Operational Risk Management Framework, evaluating key exposures, measuring risks, mitigating risks, and monitoring risks on an ongoing basis, as set out below.

Exposures

The principal operational risks to the Group are:

- The risk that the Group is unable to provide services to customers as a result of an IT systems failure;
- Cyber risks associated with malicious attacks on the confidentiality or integrity of electronic data, or the availability of systems;
- Fraud and financial crime arising from acts of deception or omission;
- Ensuring compliance with increasingly complex and detailed anti-money laundering, anti-terrorism, sanctions and prohibitions laws and regulations, as failure to do so would adversely impact the Group's reputation and potentially incur fines and other legal enforcements;
- Risks arising from inadequate delivery of services to customers;
- The risk associated with the ongoing provision of services to TSB and other organisations; and
- Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events.

A number of these risks also apply where there is a reliance on third party suppliers to provide services to the Group or its customers.

Measurement

Operational risk is managed within a Board approved framework and risk appetite. A variety of measures are used such as: scoring of potential risks, using impact and likelihood, with impact thresholds aligned to risk appetite statements; assessment of the effectiveness of controls; monitoring of events and losses by size, business unit and internal risk categories.

Table 1.40 below shows high level loss and event trends for the Group using Basel II categories. Based on data captured on the Group's Operational Risk System, in 2016, the highest frequency of events occurred in external fraud (61.58 per cent) and execution, delivery and process management (24.80 per cent). Clients, products and business practices accounted for 77.62 per cent of losses by value, driven by legacy issues where impacts materialised in 2016 (excluding PPI).

Table 1.40: **Operational risk events by risk category (losses greater than or equal to £10,000), excluding PPI**

	% of total volume		% of total losses	
	2016	2015	**2016**	2015
Business disruption and system failures	**1.01**	0.40	**0.55**	0.13
Clients, products and business practices	**11.31**	11.46	**77.62**	83.43
Damage to physical assets	**1.05**	0.06	**0.27**	0.04
Employee practices and workplace safety	**0.04**	0.03	**–**	–
Execution, delivery and process management	**24.80**	15.81	**19.23**	11.08
External fraud	**61.58**	71.96	**2.31**	5.27
Internal fraud	**0.21**	0.28	**0.02**	0.05
Total	**100.00**	100.00	**100.00**	100.00

Operational risk scenario assessments and actual losses are used by the Group to calculate the appropriate holding of operational risk regulatory capital under the Internal Capital Adequacy Assessment Process (ICAAP). The Group calculates its minimum (Pillar I) operational risk capital requirements using The Standardised Approach (TSA), which the Basel Committee has stated as being appropriate for an 'internationally active' bank.

Mitigation

The Group continues to review and invest in its control environment to ensure it addresses the inherent risks faced. Risks are reported and discussed at local governance forums and escalated to executive management and Board as appropriate. This ensures the correct level of visibility and engagement. The Group employs a range of risk management strategies, including: avoidance, mitigation, transfer (which would also include insurance) and acceptance. Where there is a reliance on third party suppliers to provide services, the Group's Sourcing Policy ensures that outsourcing initiatives follow a defined sourcing process including due diligence and risk evaluation. Contingency plans are maintained for a range of potential scenarios, with regular disaster recovery and scenario testing scheduled to test and challenge the readiness of the Group to respond in the event of an incident.

- The Group continues to mature its approach to operational resilience by enhancing the resilience of systems that support the Group's critical business processes through the IT Resilience programme, with independent verification of progress on an annual basis. The Board recognises the role that resilient technology plays in achieving the Group's strategy of becoming the best bank for customers and in maintaining banking services across the wider industry. As such, the Board dedicates considerable time and focus to this subject at both the Board and the Board Risk Committee, and continues to sponsor key investment programmes that enhance its resilience.
- The threat landscape associated with cyber risk continues to evolve and regulatory attention continues. The Board has defined a Cyber Risk Appetite and is supporting initiatives to protect the Group against malicious cyber-attacks. The Group continues to invest in enhanced protection of customer information, including limiting access to key systems and enhancing the security, durability and accessibility of critical information.
- The Group adopts a risk based approach to mitigate the internal and external fraud risks it faces, reflecting the current and emerging fraud risks within the market. Fraud Risk Appetite metrics have been defined, holistically covering the impacts of fraud in term of losses to the Group, costs of fraud systems and operations, and customer experience of actual and attempted fraud. Oversight of the appropriateness and performance of these metrics is undertaken regularly through business area and Group-level committees. This approach drives a continual programme of prioritised enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real time detective controls wherever feasible. Group-wide policies and operational control frameworks are maintained and designed to provide customer confidence, protect the Group's commercial interests and reputation, comply with legal requirements and meet regulatory expectations. The Group's fraud awareness programme remains a key component of its fraud control environment, and awareness of fraud risk is supported by mandatory training for all colleagues.
- The Group has adopted policies and procedures designed to detect and prevent the use of its banking network for money laundering, terrorist financing, bribery and activities prohibited by legal and regulatory sanctions. The Group regularly reviews and assesses these policies to keep them current, effective and consistent across markets and jurisdictions, against a background of increasingly complex and detailed laws and regulations. The Group requires mandatory training on these topics for all employees. Specifically, the anti-money laundering procedures include 'know-your-customer' requirements, transaction monitoring technologies and reporting of suspicions of money laundering or terrorist financing to the applicable regulatory authorities and the Anti-Bribery Policy prohibits the payment, offer, acceptance or request of a bribe, including 'facilitation payments' by any employee or agent and provides a confidential reporting service for anonymous reporting for suspected or actual bribery activity. The Sanctions and Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.
- The Group remediates issues that are identified in its customer processes, addressing root cause and rectifying customers as required. Enhancing the overall servicing environment remains a focus of dedicated Group programmes such as Customer Journey Transformation.
- Following the successful divestment of TSB the Group retains responsibility for the ongoing provision of key services which are managed via robust service and change management processes. There are separate governance arrangements and additional controls in place to ensure contractual commitments are met.
- Operational resilience measures and recovery planning defined in the Group's Resilience & Continuity (including Incident Management) policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, cyber, economic instability, pandemic planning and operational incidents.

Monitoring

Monitoring and reporting is undertaken at Board, Group and business area committees, in accordance with delegated limits of authority which are regularly reviewed and refreshed. Business unit risk exposure is aggregated and discussed at oversight committees, and matters are escalated to the Chief Risk Officer, or higher committees, if appropriate. A combination of: regular management information and reporting from business areas, oversight and challenge from Risk Division, Group Audit and other assurance activities ensures that key risks are regularly presented and debated by executive management.

The Group maintains a formal approach to operational risk event escalation, whereby material events are identified, captured and escalated. Root causes of events are determined, where possible and action plans put in place to ensure an optimum level of control to keep customers and the business safe, reduce costs, and improve efficiency.

The insurance programme is monitored and reviewed regularly, with recommendations being made to the Group's senior management annually prior to each renewal. Insurers are monitored on an ongoing basis, to ensure counterparty risk is minimised. A process is in place to manage any insurer rating changes or insolvencies.

Risk management continued

FUNDING AND LIQUIDITY RISK

Definition

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

Exposure

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

Measurement

Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. Note 52 on page 261 sets out an analysis of assets and liabilities by relevant maturity grouping. In order to reflect more accurately the expected behaviour of the Group's assets and liabilities, measurement and modelling of the behavioural aspects of each is constructed. Divisional teams form a view of customer behaviour based on quantitative and qualitative analysis.

Mitigation

The Group manages the liquidity profile of the balance sheet through short term liquidity management and over the life of the funding plan, combining business as usual and stressed conditions. Longer term funding, defined as having an original maturity of more than one year, is used to manage the Group's strategic liquidity profile, determined by the Group's balance sheet structure.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and is supported by strong relationships with corporate customers and certain wholesale market segments. A substantial proportion of the retail deposit base is made up of customers' current and savings accounts which, although mostly repayable on demand, have traditionally in aggregate provided a stable source of funding. Funding concentration by counterparty and currency is monitored on an ongoing basis. Where concentrations do exist (for example, maturity profile), these are limited by the internal risk appetite and considered manageable. The ability to deploy assets quickly, either through the repo market or through outright sale, is also an important source of liquidity for the Group's Banking businesses.

To assist in managing the balance sheet the Group operates a Liquidity Transfer Pricing (LTP) process which: allocates relevant interest expenses from the centre to the Group's Banking businesses within the internal management accounts in a manner consistent with the Group Funding and Liquidity Policy; helps drive the correct inputs to customer pricing and supports the overall Group balance sheet strategy; and is consistent with regulatory requirements. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits, modelled on data gathered over several years.

Liquidity risk within the Insurance business may result from: the inability to sell financial assets quickly at their fair values; an insurance liability falling due for payment earlier than expected; the inability to generate cash inflows as anticipated; an unexpected large operational event; or from a general insurance catastrophe e.g. a significant weather event. Following the implementation of Solvency II, the annuity portfolio is ring-fenced and assets held to match annuity liability cashflows are excluded from shareholder liquidity. In the event a liquidity shortfall arises on the annuity portfolio, shareholder liquidity will be required to support this. As a result, the shareholder's exposure to liquidity risk is through Insurance's non-annuity and surplus assets, any shortfall arising in the annuity portfolio and the investment portfolios within the general insurance business. Liquidity risk is actively managed and monitored within the Insurance business to ensure that, even under stress conditions, there is sufficient liquidity to meet obligations and remain within approved risk appetite.

Monitoring

Liquidity is actively monitored at Group level. Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. Liquidity policies and procedures are subject to independent internal oversight by Risk.

The Group carries out stress testing of its liquidity and potential cash flow mismatch position over both short (up to one month) and longer term (up to three months) horizons against a range of scenarios. The scenarios and the assumptions are reviewed at least annually to gain assurance that they continue to be relevant to the nature of the business. For further information on the Group's 2016 liquidity stress testing results refer to page 157. The Group funding plan is also stressed against a range of macroeconomic scenarios. Regulatory metrics are calculated and monitored over the life the plan under base and stress conditions.

The Group maintains a Contingency Funding Plan which is designed to identify emerging liquidity concerns at an early stage, so that mitigating actions can be taken to avoid a more serious crisis developing. Contingency Funding Plan invocation and escalation processes are based on analysis of five major quantitative and qualitative components, comprising assessment of: early warning indicators, prudential and regulatory liquidity risk limits and triggers, stress testing results, event and systemic indicators and market intelligence.

Funding and liquidity management in 2016

During 2016 the Group has maintained its strong funding and liquidity position, with a loan to deposit ratio of 108.9 per cent.

Total funded assets reduced by £5.8 billion to £465.4 billion during 2016. Loans and advances to customers, excluding reverse repos, reduced by £5.5 billion. Growth in Consumer Finance was strong at 11 per cent and SME lending growth was 3 per cent, both outperforming the market. This was offset by a reduction in mortgage balances as the Group continues to balance risk and margin considerations versus volumes in a competitive low growth market. Total customer deposits fell by £5.3 billion to £413.0 billion at 31 December 2016, largely due to lower Retail and Consumer Finance tactical balances.

Wholesale funding has decreased by £9.1 billion to £110.8 billion as excess liquidity is managed down; the amount with a residual maturity less than one year fell to £35.1 billion (£37.9 billion at 31 December 2015). The Group's term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) is unchanged at 68 per cent. During 2016 the Group's term issuance costs have remained broadly in line with other post-crisis years and significantly lower than levels seen during the economic downturn. The Group's overall cost of wholesale funding has reduced as more expensive funding raised in previous years mature. The Group's market capacity for term funding is considered across the planning horizon as part of the funding plan and the Group expects term funding requirements to remain stable.

The credit ratings on Lloyds Bank were unchanged over 2016, and the median credit rating among the three major credit rating agencies remains 'A+'. Following the EU referendum in June, both S&P and Moody's revised their outlooks on Lloyds Bank, among other UK banks, in order to reflect increased macroeconomic uncertainty. S&P revised the outlook on Lloyds Bank's 'A' rating to 'Negative' from 'Stable' whilst Moody's revised the outlook on Lloyds Bank's 'A1' rating to 'Stable' from 'Positive'. Moody's also revised their outlook on the UK banking system to 'Negative' from 'Stable'. Fitch's outlook on Lloyds Bank's 'A+' rating remained 'Stable' as Fitch expect the economic effects of the referendum to be manageable. The effects of a potential downgrade from all three credit rating agencies are included in Group liquidity stress testing.

The LCR became the Pillar 1 standard for liquidity in the UK in October 2015. The Group comfortably meets the requirements. Liquid asset holdings have fallen during the second half of 2016 as excess liquidity held during the EU Referendum is managed down. The Group continues to monitor the Net Stable Funding Ratio (NSFR) requirements and expects to meet them once confirmed by the PRA.

Table 1.41: **Group funding position**

	At 31 Dec 2016 £bn	At 31 Dec 2015 £bn	Change %
Funding requirement			
Loans and advances to customers[1]	449.7	455.2	(1)
Loans and advances to banks[2]	5.1	3.4	50
Debt securities	3.4	4.2	(19)
Reverse repurchase agreements	0.5	1.0	(50)
Available-for-sale financial assets – non-LCR eligible[3]	1.9	2.7	(30)
Cash and balances at central bank – non LCR eligible[4]	4.8	4.7	2
Funded assets	465.4	471.2	(1)
Other assets[5]	249.9	234.2	7
	715.3	705.4	1
On balance sheet LCR eligible liquidity assets			
Reverse repurchase agreements	8.7	–	
Cash and balances at central banks[4]	42.7	53.7	(20)
Available-for-sale financial assets[6]	54.6	30.3	80
Held-to-maturity financial assets[6]	–	19.8	
Trading and fair value through profit and loss	1.8	3.0	(40)
Repurchase agreements	(5.3)	(5.5)	(4)
	102.5	101.3	1
Total Group assets	817.8	806.7	1
Less: other liabilities[5]	(245.2)	(221.5)	11
Funding requirement	572.6	585.2	(2)
Funded by			
Customer deposits[7]	413.0	418.3	(1)
Wholesale funding[8]	110.8	119.9	(8)
	523.8	538.2	(3)
Repurchase agreements	–	–	
Total equity	48.8	47.0	4
Total funding	572.6	585.2	(2)

1 Excludes £8.3 billion (31 December 2015: £nil) of reverse repurchase agreements.

2 Excludes £20.9 billion (31 December 2015: £20.8 billion) of loans and advances to banks within the Insurance business and £0.9 billion (31 December 2015: £0.9 billion) of reverse repurchase agreements.

3 Non-LCR eligible liquid assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

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

5 Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

6 The Group reclassified gilts held within the liquidity portfolio as 'available-for-sale' (previously been classified as 'held-to-maturity') during the third quarter of 2016 as the Group has decided it is no longer appropriate to commit to holding any gilts to maturity.

7 Excludes £2.5 billion (31 December 2015: £nil) of repurchase agreements.

8 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.

Risk management continued

Table 1.42: Reconciliation of Group funding to the balance sheet (audited)

	At 31 December 2016				At 31 December 2015			
	Included in funding analysis £bn	Repos and cash collateral received by Insurance £bn	Fair value and other accounting methods £bn	Balance sheet £bn	Included in funding analysis £bn	Repos and cash collateral received by Insurance £bn	Fair value and other accounting methods £bn	Balance sheet £bn
Deposits from banks	**8.1**	**8.0**	**0.3**	**16.4**	8.5	8.4	–	16.9
Debt securities in issue	**83.0**	**–**	**(6.7)**	**76.3**	88.1	–	(6.0)	82.1
Subordinated liabilities	**19.7**	**–**	**0.1**	**19.8**	23.3	–	–	23.3
Total wholesale funding	**110.8**	**8.0**			119.9	8.4		
Customer deposits	**413.0**	**2.5**	**–**	**415.5**	418.3	–	–	418.3
Total	**523.8**	**10.5**			538.2	8.4		

Table 1.43: Analysis of 2016 total wholesale funding by residual maturity

	Less than one month £bn	One to three months £bn	Three to six months £bn	Six to nine months £bn	Nine months to one year £bn	One to two years £bn	Two to five years £bn	More than five years £bn	Total at 31 Dec 2016 £bn	Total at 31 Dec 2015 £bn
Deposit from banks	**6.1**	**1.0**	**0.5**	**0.4**	**–**	**0.1**	**–**	**–**	**8.1**	8.5
Debt securities in issue:										
Certificates of deposit	**0.4**	**2.1**	**3.0**	**1.7**	**0.3**	**–**	**–**	**–**	**7.5**	10.6
Commercial paper	**2.0**	**0.8**	**–**	**0.4**	**–**	**–**	**–**	**–**	**3.2**	6.6
Medium-term notes[1]	**–**	**1.5**	**2.7**	**1.4**	**0.3**	**5.1**	**12.3**	**13.6**	**36.9**	37.6
Covered bonds	**2.1**	**2.8**	**1.1**	**–**	**–**	**2.2**	**10.7**	**10.2**	**29.1**	25.8
Securitisation	**0.6**	**1.0**	**0.4**	**0.7**	**0.8**	**0.7**	**1.8**	**0.3**	**6.3**	7.5
	5.1	**8.2**	**7.2**	**4.2**	**1.4**	**8.0**	**24.8**	**24.1**	**83.0**	88.1
Subordinated liabilities	**–**	**0.5**	**0.1**	**0.4**	**–**	**2.4**	**3.7**	**12.6**	**19.7**	23.3
Total wholesale funding[2]	**11.2**	**9.7**	**7.8**	**5.0**	**1.4**	**10.5**	**28.5**	**36.7**	**110.8**	119.9
Of which issued by Lloyds Banking Group plc[3]	**–**	**–**	**–**	**–**	**–**	**–**	**1.7**	**5.7**	**7.4**	3.4

1 Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2016: £1.4 billion; 31 December 2015: £1.4 billion).
2 The Group's definition of wholesale funding aligns with that used by other international market participants; including interbank deposits, debt securities in issue and subordinated liabilities.
3 Consists of medium-term notes (£2.5 billion) and subordinated liabilities (£4.9 billion).

Table 1.44: Total wholesale funding by currency (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
At 31 December 2016	**30.6**	**33.0**	**41.4**	**5.8**	**110.8**
At 31 December 2015	34.9	37.6	41.3	6.1	119.9

Table 1.45: Analysis of 2016 term issuance (audited)

	Sterling £bn	US Dollar £bn	Euro £bn	Other currencies £bn	Total £bn
Securitisation	**0.3**	**0.4**	**–**	**–**	**0.7**
Medium-term notes	**–**	**1.5**	**1.2**	**0.4**	**3.1**
Covered bonds	**1.2**	**–**	**2.4**	**–**	**3.6**
Private placements[1]	**0.1**	**1.0**	**0.8**	**–**	**1.9**
Subordinated liabilities	**–**	**1.1**	**–**	**–**	**1.1**
Total issuance	**1.6**	**4.0**	**4.4**	**0.4**	**10.4**
Of which issued by Lloyds Banking Group plc[2]	**–**	**3.8**	**1.2**	**0.4**	**5.4**

1 Private placements include structured bonds and term repurchase agreements (repos).
2 Consists of medium-term notes (£2.5 billion) and subordinated liabilities (£3.0 billion).

Gross term issuance for 2016 totalled £10.4 billion. The Group maintained a diversified approach to funding markets with trades in public and private format, secured and unsecured products and a wide range of currencies and markets. In 2016, the Group drew down £1.0 billion under the Funding for Lending Scheme (FLS), taking peak usage to £33.1 billion, with £3.0 billion of maturities during the year. A further £4.5 billion was drawn under the Bank of England's Term Funding Scheme (TFS), underlining the Group's support to the UK economy. The maturities for the FLS and TFS are fully factored into the Group's funding plan.

Liquidity portfolio

At 31 December 2016, the Banking business had £120.8 billion of highly liquid unencumbered LCR eligible assets, of which £120.3 billion is LCR level 1 eligible and £0.5 billion is LCR level 2 eligible. These assets are available to meet cash and collateral outflows and PRA regulatory requirements. A separate liquidity portfolio to mitigate any insurance liquidity risk is managed within the Insurance business. LCR eligible liquid assets represent over 8 times the Group's money market funding less than one year maturity (excluding derivative collateral margins and settlement accounts) and exceed total wholesale funding, and thus provides a substantial buffer in the event of continued market dislocation.

Table 1.46: **LCR eligible assets**

	At 31 Dec 2016 £bn	At 31 Dec 2015 £bn	Change %	**Average 2016 £bn**	Average[1] 2015 £bn
Level 1					
Cash and central bank reserves	**42.7**	53.7	(20)	**53.7**	57.2
High quality government/MDB/agency bonds[2]	**75.3**	65.8	14	**72.4**	63.0
High quality covered bonds	**2.3**	3.4	(32)	**2.4**	3.3
Total	**120.3**	122.9	(2)	**128.5**	123.5
Level 2[3]	**0.5**	0.5	–	**0.5**	0.7
Total LCR eligible assets	**120.8**	123.4	(2)	**129.0**	124.2

1 Average for 2015 includes fourth quarter 2015 only.

2 Designated multilateral development bank (MDB).

3 Includes Level 2A and Level 2B.

Table 1.47: **LCR eligible assets by currency**

	Sterling £bn	**US Dollar £bn**	**Euro £bn**	**Other currencies £bn**	**Total £bn**
At 31 December 2016					
Level 1	**96.0**	**12.5**	**11.8**	**–**	**120.3**
Level 2	**0.2**	**0.3**	**–**	**–**	**0.5**
Total	**96.2**	**12.8**	**11.8**	**–**	**120.8**
At 31 December 2015					
Level 1	90.9	15.8	16.2	–	122.9
Level 2	0.1	-	0.4	–	0.5
Total	91.0	15.8	16.6	–	123.4

The Banking business also had £113.8 billion of secondary, non-LCR eligible liquidity, the vast majority of which is eligible for use in a range of central bank or similar facilities and the Group routinely makes use of as part of its normal liquidity management practices. Future use of such facilities will be based on prudent liquidity management and economic considerations, having regard for external market conditions.

The Group considers diversification across geography, currency, markets and tenor when assessing appropriate holdings of liquid assets. This liquidity is managed as a single pool in the centre and is under the control of the function charged with managing the liquidity of the Group. It is available for deployment at immediate notice, subject to complying with regulatory requirements.

Stress testing results

Internal stress testing results at 31 December 2016 showed that the Banking business had liquidity resources representing 167.0 per cent of modelled outflows from all wholesale funding sources, retail and corporate deposits, intraday requirements and rating dependent contracts under the Group's most severe liquidity stress scenario.

A hypothetical idiosyncratic two notch downgrade of the Group's current long-term debt rating and accompanying short-term downgrade implemented instantaneously by all major rating agencies, could result in a contractual outflow of £3.1 billion of cash over a period of up to one year, £1.8 billion of collateral posting related to customer financial contracts and £9.0 billion of collateral posting associated with secured funding.

Encumbered assets

This disclosure provides further detail on the availability of assets that could be used to support potential future funding requirements of the Group. The disclosure is not designed to identify assets that would be available in the event of a resolution or bankruptcy.

The Group's analysis separately identifies those assets held at central banks; assets not held at central banks are classified as either encumbered or unencumbered.

The Board and GALCO monitor and manage total balance sheet encumbrance via a number of risk appetite metrics. At 31 December 2016, the Group had £83.5 billion (31 December 2015: £77.4 billion) of externally encumbered on balance sheet assets with counterparties other than central banks. The increase in encumbered assets was driven by an increase in the use of on balance sheet available-for-sale financial assets for repo activity. The Group also had £580.9 billion (31 December 2015: £573.7 billion) of unencumbered on balance sheet assets, and £153.5 billion (31 December 2015: £155.6 billion) of pre-positioned and encumbered assets held with central banks. Primarily the Group encumbers mortgages, unsecured lending and credit card receivables through the issuance programmes and tradable securities through securities financing activity. The Group mainly positions mortgage assets at central banks.

Risk management continued

Table 1.48: **On balance sheet encumbered and unencumbered assets**

	Encumbered with counterparties other than central banks					Unencumbered assets not pre-positioned with central banks				
	Securitisations £m	Covered bond £m	Other £m	Total £m	Pre-positioned and encumbered assets held with central banks £m	Readily realisable £m	Other realisable assets £m	Cannot be used[1] £m	Total £m	Total £m
At 31 December 2016										
Cash and balances at central banks	**–**	**–**	**–**	**–**	**–**	**42,998**	**–**	**4,454**	**47,452**	**47,452**
Trading and other financial assets at fair value through profit or loss	**–**	**–**	**4,806**	**4,806**	**–**	**9,175**	**22**	**137,171**	**146,368**	**151,174**
Derivative financial instruments	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**36,138**	**36,138**	**36,138**
Loans and receivables:										
Loans and advances to banks	**–**	**–**	**32**	**32**	**–**	**528**	**1,825**	**24,517**	**26,870**	**26,902**
Loans and advances to customers	**14,542**	**30,883**	**7,305**	**52,730**	**153,482**	**7,032**	**152,997**	**91,717**	**251,746**	**457,958**
Debt securities	**–**	**–**	**904**	**904**	**–**	**2,344**	**5**	**144**	**2,493**	**3,397**
	14,542	**30,883**	**8,241**	**53,666**	**153,482**	**9,904**	**154,827**	**116,378**	**281,109**	**488,257**
Available-for-sale financial assets	**154**	**–**	**24,824**	**24,978**	**–**	**31,017**	**31**	**498**	**31,546**	**56,524**
Held-to-maturity investments	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Other[2]	**–**	**–**	**–**	**–**	**–**	**34**	**1,737**	**36,477**	**38,248**	**38,248**
Total assets	**14,696**	**30,883**	**37,871**	**83,450**	**153,482**	**93,128**	**156,617**	**331,116**	**580,861**	**817,793**
At 31 December 2015										
Cash and balances at central banks	–	–	–	–	–	56,323	–	2,094	58,417	58,417
Trading and other financial assets at fair value through profit or loss	–	–	6,922	6,922	–	7,459	17	126,138	133,614	140,536
Derivative financial instruments	–	–	–	–	–	–	–	29,467	29,467	29,467
Loans and receivables:										
Loans and advances to banks	–	–	37	37	–	431	910	23,739	25,080	25,117
Loans and advances to customers	13,668	32,641	7,418	53,727	150,086	7,678	159,510	84,174	251,362	455,175
Debt securities	–	–	855	855	–	3,150	62	124	3,336	4,191
	13,668	32,641	8,310	54,619	150,086	11,259	160,482	108,037	279,778	484,483
Available-for-sale financial assets	–	–	15,810	15,810	5,548	11,048	31	595	11,674	33,032
Held-to-maturity investments	–	–	–	–	–	19,808	–	–	19,808	19,808
Other[2]	–	–	–	–	–	10	2,716	38,219	40,945	40,945
Total assets	13,668	32,641	31,042	77,351	155,634	105,907	163,246	304,550	573,703	806,688

1 The following assets are classified as unencumbered – cannot be used: assets held within the Group's Insurance businesses which are generally held to either back liabilities to policyholders or to support the solvency of the Insurance subsidiaries; assets held within consolidated limited liability partnerships which provide security for the Group's obligations to its pension schemes; assets pledged to facilitate the use of intra-day payment and settlement systems; and reverse repos and derivatives balance sheet ledger items.

2 Other comprises: items in the course of collection from banks, investment properties, goodwill, value in-force business, other tangible assets, tangible fixed assets, current tax recoverable, deferred tax assets, retirement benefit assets and other assets.

The above table sets out the carrying value of the Group's encumbered and unencumbered assets, separately identifying those that are available to support the Group's funding needs. The table does not include collateral received by the Group (i.e. from reverse repos) that is not recognised on its balance sheet, the vast majority of which the Group is permitted to repledge.

CAPITAL RISK

Definition

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

Exposures

A capital risk exposure arises when the Group has insufficient capital resources to support its strategic objectives and plans, and to meet external stakeholder requirements and expectations. This could arise due to a depletion of the Group's capital resources as a result of the crystallisation of any of the risks to which it is exposed. Alternatively a shortage of capital could arise from an increase in the amount of capital that is needed to be held. The Group's capital management approach is focused on maintaining sufficient capital resources to prevent such exposures while optimising value for shareholders.

Measurement

The Group measures the amount of capital it holds using the regulatory framework defined by the Capital Requirements Directive and Regulation (CRD IV) as implemented in the UK by the Prudential Regulation Authority (PRA). Full details of the Group's regulatory capital and leverage frameworks will be provided in the Group's Pillar 3 Report.

The minimum amount of total capital, under Pillar 1 of the regulatory framework, is determined as 8 per cent of aggregate risk-weighted assets. At least 4.5 per cent of risk-weighted assets are required to be covered by common equity tier 1 (CET1) capital and at least 6 per cent of risk-weighted assets are required to be covered by tier 1 capital. These minimum Pillar 1 requirements are supplemented by additional minimum requirements under Pillar 2 of the regulatory framework and a number of regulatory capital buffers as described below.

Additional minimum requirements are set by the PRA by the issuance of bank specific Individual Capital Guidance (ICG). This reflects a point in time estimate by the PRA, which may change over time, of the minimum amount of capital that is needed by the bank. It includes the assessment of risks that are not fully covered by Pillar 1, such as credit concentration and operational risk, and those risks not covered at all by Pillar 1, such as pensions and interest rate risk in the banking book (IRRBB).

The Group is also required to maintain a number of regulatory capital buffers, which are required to be met with CET1 capital.

Systemic buffers are designed to hold systemically important banks to higher capital standards, so that they can withstand a greater level of stress before requiring resolution.

There are three systemic buffers in the Capital Requirements Directive:

- The G-SII buffer is applied to global systemically important institutions. The Group has not been classified as a G-SII.
- The O-SII buffer may be applied to other systemically important institutions. The Group has been classified as an O-SII by the PRA, but the O-SII buffer is set to zero in the UK.
- The Systemic Risk Buffer (SRB) will be applied to ring-fenced banks from 1 January 2019. In July 2016 the FPC published their methodology for quantifying the buffer for each ring-fenced bank and in December 2016 the PRA published their statement of policy on their approach for implementing the SRB. The size of buffer applied to the Group's ring-fenced bank (RFB) sub-group in 2019 will be dependent upon the total assets of the sub-group. The largest buffer the FPC anticipates applying to any ring-fenced bank is 2.5 per cent.

Although the SRB will apply at a sub consolidated level within the Group's structure, the PRA have indicated that they will include in the PRA Buffer that applies to the Group an amount equivalent to the RFB's Systemic Risk Buffer. The amount included in the PRA Buffer is expected to be lower as a percentage of Group RWAs reflecting the assets of the Group that will not be held in the RFB sub-group and for which the SRB will not apply to.

The capital conservation buffer (CCB) is a standard buffer of 2.5 per cent of risk-weighted assets designed to provide for losses in the event of stress and is being phased in over the period from 1 January 2016 to 1 January 2019. During 2016 it was 0.625 per cent and during 2017 it is 1.25 per cent.

The countercyclical capital buffer (CCYB) is time-varying and is designed to require banks to hold additional capital to remove or reduce the build-up of systemic risk in times of credit boom, providing additional loss absorbing capacity and acting as an incentive for banks to constrain further credit growth. The amount of the buffer is determined by reference to buffer rates set by the FPC for the individual countries where the Group has relevant credit risk exposures. The buffer is currently set at zero for the UK, however non-zero rates for Norway, Sweden and Hong Kong were in place at 31 December 2016. Given that the Group has minimal exposures to these jurisdictions, the overall requirement is negligible. The UK CCYB rate was set to increase from 0 per cent to 0.5 per cent of risk-weighted assets on 29 March 2017, at which time the overlapping aspects of Pillar 2 supervisory capital buffers would be removed or reduced. However, following the EU referendum, on 5 July 2016 the FPC announced in their Financial Stability Report that the planned 0.5 per cent UK CCYB would not be implemented in March 2017 and the zero per cent rate was expected to remain until at least June 2017. The FPC also recommended that where existing Pillar 2 supervisory buffers reflect risks that would be captured by a UK CCYB rate, the PRA should reduce those buffers by an amount of capital which is equivalent to the effect of a UK CCYB rate of 0.5 per cent. The FPC has also indicated that it expects to review the UK CCYB and to set a rate in the region of 1 per cent of risk-weighted assets when risks are judged to be neither subdued nor elevated, but the rate can be set in excess of this level. Any increase in CCYB would take effect 1 year after it is set.

The FPC can also set sectoral capital requirements which are temporary increases to banks' capital requirements on exposures to specific sectors, if the FPC judges that exuberant lending to those sectors poses risks to financial stability. No sectoral capital requirements currently apply to the Group.

As part of the capital planning process, forecast capital positions are subjected to extensive stress analyses to determine the adequacy of the Group's capital resources against the minimum requirements, including ICG. The PRA uses the outputs from some of these stress analyses as one of the inputs that inform the setting of a bank-specific capital buffer for the Group, known as the PRA Buffer. The PRA Buffer also takes into account the CCB, CCYB and any sectoral capital requirements that already apply to the Group. The PRA requires the PRA Buffer to remain confidential between the Group and the PRA.

All buffers are required to be met with CET1 capital. A breach of the PRA buffer would trigger a dialogue between the Group and the PRA to agree what action is required whereas a breach of the CRD IV combined buffer (all regulatory buffers excluding the PRA buffer) would give rise to automatic constraints upon any discretionary capital distributions by the Group.

In addition to the risk-based capital framework outlined above, the Group is also subject to minimum capital requirements under the UK's Leverage Ratio Framework. The leverage ratio is calculated by dividing fully loaded tier 1 capital resources by a defined measure of on balance sheet assets and off balance sheet items.

Risk management continued

The minimum leverage ratio in the UK is 3 per cent, in line with current Basel requirements. In addition the UK framework requires two buffers to be maintained: an Additional Leverage Ratio Buffer (ALRB), which is calculated as 35 per cent of the Systemic Risk Buffer (applicable from 2019) and a time-varying Countercyclical Leverage Buffer (CCLB) which is calculated as 35 per cent of the countercyclical capital buffer rate (currently set at 0 per cent). At least 75 per cent of the minimum 3 per cent requirement and the entirety of any buffers that may apply must be met by CET1 capital.

The leverage ratio framework does not currently give rise to higher capital requirements for the Group than the risk-based capital framework.

Mitigation

The Group has a capital management framework including policies and procedures that are designed to ensure that it operates within its risk appetite, uses its capital resources efficiently and continues to comply with regulatory requirements.

The Group is able to accumulate additional capital through the retention of profits over time, which can be enhanced through cutting costs and reducing or cancelling dividend payments, by raising new equity via, for example, a rights issue or debt exchange and by raising additional tier 1 or tier 2 capital through issuing tier 1 instruments or subordinated liabilities. The cost and availability of additional capital is dependent upon market conditions and perceptions at the time. The Group is also able to manage the demand for capital through management actions including adjusting its lending strategy, risk hedging strategies and through business disposals.

Additional measures to manage the Group's capital position include seeking to optimise the generation of capital demand within the Group's businesses to strike an appropriate balance of capital held within the Group's Insurance and banking subsidiaries and through improving the quality of its capital through liability management exercises.

Monitoring

Capital is actively managed and regulatory ratios are a key factor in the Group's planning processes and stress analyses. Multi-year forecasts of the Group's capital position, based upon the Group's operating plan, are produced at least annually to inform the Group's capital strategy whilst shorter term forecasts are more frequently undertaken to understand and respond to variations of the Group's actual performance against the plan. The capital plans are tested for capital adequacy using a range of stress scenarios covering adverse economic conditions as well as other adverse factors that could impact the Group and the Group maintains a Recovery Plan which sets out a range of potential mitigating actions that could be taken in response to a stress.

Regular reporting of actual and projected ratios, including those in stressed scenarios, is undertaken, including submissions to the Group Capital Risk Committee (GCRC), Group Financial Risk Committee (GFRC), Group Asset and Liability Committee (GALCO), Group Risk Committee (GRC), Board Risk Committee (BRC) and the Board. Capital policies and procedures are subject to independent oversight.

The regulatory framework within which the Group operates continues to evolve and further detail on this will be provided in the Group's Pillar 3 report. The Group continues to monitor these developments very closely, analysing the potential capital impacts to ensure that, through organic capital generation, the Group continues to maintain a strong capital position that exceeds the minimum regulatory requirements and the Group's risk appetite and is consistent with market expectations.

Target capital ratios

The Board's view of the current level of CET1 capital required to grow the business, meet regulatory requirements and cover uncertainties and future regulatory developments remains at around 13 per cent.

This takes into account, amongst other things:

– the Pillar 2A Individual Capital Guidance (ICG) set by the PRA, reflecting their point in time estimate, which may change over time, of the amount of capital that is needed in relation to risks not covered by Pillar 1. During the year the PRA updated the Group's ICG representing a reduction from 4.6 per cent to 4.5 per cent of risk-weighted assets at 31 December 2016, of which 2.5 per cent has to be covered by CET1 capital.

– the PRA Buffer, which they set taking into account the results of the PRA stress tests and other information, as well as outputs from our internal stress tests and other information. In November 2016 the PRA published the results of its 2016 stress tests which showed the Group's capital depletion to be 2.5 per cent after management actions compared to 3.3 per cent in the 2015 PRA stress tests and 4.8 per cent in the 2014 PRA stress tests. The PRA requires the PRA buffer to remain confidential between the Group and the PRA.

– future regulatory developments, including the introduction of the Systemic Risk Buffer in 2019.

In addition, the Group targets a transitional total capital ratio of around 20 per cent.

Dividend policy

The Group has established a dividend policy that is both progressive and sustainable. We expect ordinary dividends to increase over the medium term to a dividend payout ratio of at least 50 per cent of sustainable earnings. The Board interprets progressive to indicate a dividend per share that is expected to increase over the medium term. Sustainable earnings represents the long term earnings generation of the business. Sustainable earnings are defined as earnings after tax attributable to ordinary shareholders adjusted to remove the effects of market volatility, exceptional conduct or litigation events, major liability management or restructuring and other one off items such as the sale of businesses, and exceptional underlying business performance.

The Board also gives due consideration to the distribution of surplus capital through the use of special dividends or share buy-backs. Surplus capital represents capital over and above the amount management wish to retain to grow the business, meet regulatory requirements and cover uncertainties. The amount of required capital may vary from time to time depending on circumstances and the Board will continue to give due consideration, subject to the situation at the time, to the distribution of any surplus capital. By its nature, there can be no guarantee that this level of special dividends or any surplus capital distribution will be appropriate in future years.

The ability of the Group to pay a dividend is also subject to constraints including the availability of distributable reserves, legal and regulatory restrictions and the financial and operating performance of the entity.

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2016 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £8,500 million. Substantially all of the Company's merger reserve is available for distribution under UK company law as a result of transactions undertaken to recapitalise the Company in 2009.

Lloyds Banking Group plc acts as a holding company which also issues capital and other securities to capitalise and fund the activities of the Group. The profitability of the holding company, and consequently its ability to sustain dividend payments, is therefore dependent upon the continued receipt of dividends from its subsidiaries (representing both banking and insurance). A number of Group subsidiaries, principally those with banking and insurance activities, are also subject to regulatory capital requirements. These require entities to maintain minimum amounts of capital related to their size and risk. The principal operating subsidiary is Lloyds Bank plc which, at 31 December 2016, had a consolidated CET1 capital ratio of 15.2 per cent (31 December 2015: 15.2 per cent). The Group actively manages the capital of its subsidiaries, which includes monitoring the regulatory capital ratios for its banking and insurance subsidiaries against approved risk appetite limits. It operates a formal capital management policy which requires all subsidiary entities to remit any surplus capital to their parent companies.

During 2016 the Group has continued to simplify the Group's internal capital structure and to ensure that profits generated by subsidiary entities can be more easily remitted to the Company. This included the court approved capital reduction by Lloyds Bank plc.

Analysis of capital position

During 2016 the Group continued to strengthen its capital position with a fully loaded CET1 ratio, after accruing for foreseeable dividends, of 13.6 per cent and 13.8 per cent on a pro forma basis upon recognition of the dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings (31 December 2015: 13.0 per cent pro forma). The accrual for foreseeable dividends includes both the recommended full year ordinary dividend of 2.55 pence per ordinary share and a special dividend of 0.5 pence per ordinary share.

The CET1 ratio on a pro forma basis reflects the prudent retention of circa 0.8 per cent of capital, above the current target level, to cover the estimated capital impact of the MBNA acquisition that was announced in December 2016.

Over the year the Group generated around 1.9 per cent of CET1 capital on a pro forma basis, pre dividend, primarily as a result of the following:

- Strong underlying capital generation of 2.2 per cent, largely driven by underlying profits;
- The dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings of 0.2 per cent;
- Impact of conduct charges of (1.0) per cent;
- Impact of market movements, netting to 0.2 per cent. This included 0.8 per cent from the impact of the accounting reclassification of c.£20 billion of gilts within the liquidity portfolio from 'held-to-maturity' to 'available-for-sale', offset by a number of market related movements, including an adverse impact of movements in the defined benefit pension schemes of (0.4) per cent;
- Other items largely representing a reduction in risk-weighted assets, most notably in the fourth quarter, largely relating to active portfolio management, disposals, an improvement in credit quality and capital efficient securitisation activity, partially offset by model updates related to UK mortgage portfolios and the impact of the redemption of the remaining series of Enhanced Capital Notes in the first quarter.

After accruing for foreseeable dividends, the transitional total capital ratio reduced by 0.1 percentage points to 21.4 per cent, primarily reflecting managed reductions in tier 2 capital, largely due to calls and redemptions, offset by the increase in CET1 capital and the reduction in risk-weighted assets.

In 2020 the Group will have to meet a Minimum Requirement for Own Funds and Eligible Liabilities (MREL). During 2016 the Group commenced issuance of senior unsecured securities from Lloyds Banking Group plc, which, while not included in total capital, are eligible to meet MREL, £2.5 billion (Sterling equivalent) was issued in 2016 and a further £2.2 billion (Sterling equivalent) was issued in January 2017 leaving the Group well positioned to meet MREL requirements from 2020.

The leverage ratio, after accruing for foreseeable dividends, increased from 4.8 per cent to 4.9 per cent (5.0 per cent on a pro forma basis), largely reflecting the increase in tier 1 capital.

An analysis of the Group's capital position as at 31 December 2016 is presented in the following section applying CRD IV transitional arrangements and also on a fully loaded CRD IV basis, both as implemented in the UK by the PRA.

Risk management continued

The table below summarises the consolidated capital position of the Group. The Group's Pillar 3 Report will provide a comprehensive analysis of the own funds of the Group.

Table 1.49: **Capital resources (audited)**

	Transitional		Fully loaded	
	At 31 Dec 2016 £m	At 31 Dec 2015[1] £m	**At 31 Dec 2016 £m**	At 31 Dec 2015[1] £m
Capital resources				
Common equity tier 1				
Shareholders' equity per balance sheet	**43,020**	41,234	**43,020**	41,234
Adjustment to retained earnings for foreseeable dividends	**(1,568)**	(1,427)	**(1,568)**	(1,427)
Deconsolidation adjustments[1]	**1,342**	1,119	**1,342**	1,119
Adjustment for own credit	**87**	67	**87**	67
Cash flow hedging reserve	**(2,136)**	(727)	**(2,136)**	(727)
Other adjustments[1]	**(276)**	(97)	**(276)**	(97)
	40,469	40,169	**40,469**	40,169
less: deductions from common equity tier 1				
Goodwill and other intangible assets	**(1,623)**	(1,719)	**(1,623)**	(1,719)
Prudent valuation adjustment	**(630)**	(372)	**(630)**	(372)
Excess of expected losses over impairment provisions and value adjustments	**(602)**	(270)	**(602)**	(270)
Removal of defined benefit pension surplus	**(267)**	(721)	**(267)**	(721)
Securitisation deductions	**(217)**	(169)	**(217)**	(169)
Significant investments[1]	**(4,282)**	(4,500)	**(4,282)**	(4,529)
Deferred tax assets	**(3,564)**	(3,874)	**(3,564)**	(3,884)
Common equity tier 1 capital	**29,284**	28,544	**29,284**	28,505
Additional tier 1				
Other equity instruments	**5,320**	5,355	**5,320**	5,355
Preference shares and preferred securities[2]	**4,998**	4,728	**–**	–
Transitional limit and other adjustments	**(1,692)**	(906)	**–**	–
	8,626	9,177	**5,320**	5,355
less: deductions from tier 1				
Significant investments[1]	**(1,329)**	(1,177)	**–**	–
Total tier 1 capital	**36,581**	36,544	**34,604**	33,860
Tier 2				
Other subordinated liabilities[2]	**14,833**	18,584	**14,833**	18,584
Deconsolidation of instruments issued by insurance entities[1]	**(1,810)**	(1,665)	**(1,810)**	(1,665)
Adjustments for transitional limit and non-eligible instruments	**1,351**	(52)	**(1,694)**	(3,066)
Amortisation and other adjustments	**(3,447)**	(3,880)	**(3,597)**	(4,885)
	10,927	12,987	**7,732**	8,968
Eligible provisions	**186**	221	**186**	221
less: deductions from tier 2				
Significant investments[1]	**(1,571)**	(1,756)	**(2,900)**	(2,933)
Total capital resources	**46,123**	47,996	**39,622**	40,116
Risk-weighted assets	**215,534**	222,845	**215,534**	222,747
Common equity tier 1 capital ratio[3]	**13.6%**	12.8%	**13.6%**	12.8%
Tier 1 capital ratio	**17.0%**	16.4%	**16.1%**	15.2%
Total capital ratio	**21.4%**	21.5%	**18.4%**	18.0%

1 For regulatory capital purposes, the Group's Insurance business is deconsolidated and replaced by the amount of the Group's investment in the business. A part of this amount is deducted from capital (shown as 'significant investments' in the table above) and the remaining amount is risk-weighted, forming part of threshold risk-weighted assets. The presentation of the deconsolidation of the Group's insurance entities has been amended for 2016 with comparative figures restated accordingly.

2 Preference shares, preferred securities and other subordinated liabilities are categorised as subordinated liabilities in the balance sheet.

3 The common equity tier 1 ratio is 13.8 per cent on a pro forma basis upon recognition of the dividend paid by the Insurance business in February 2017 in relation to its 2016 earnings (31 December 2015: 13.0 per cent pro forma).

The key differences between the transitional capital calculation as at 31 December 2016 and the fully loaded equivalent are as follows:

– Capital securities that previously qualified as tier 1 or tier 2 capital, but do not fully qualify under CRD IV, can be included in tier 1 or tier 2 capital (as applicable) up to specified limits which reduce by 10 per cent per annum until 2022.
– The significant investment deduction from additional tier 1 (AT1) will gradually transition to tier 2.

The movements in the transitional CET1, AT1, tier 2 and total capital positions in the period are provided below.

Table 1.50: **Movements in capital resources**

	Common Equity Tier 1 £m	Additional Tier 1 £m	Tier 2 £m	Total capital £m
At 31 December 2015	28,544	8,000	11,452	47,996
Profit attributable to ordinary shareholders[1]	2,070	–	–	2,070
Movement in foreseeable dividends[2]	(141)	–	–	(141)
Dividends paid out on ordinary shares during the year	(2,014)	–	–	(2,014)
Dividends in respect of 2015 earnings received from the insurance business[1]	500	–	–	500
Movement in treasury shares and employee share schemes	134	–	–	134
Pension movements:				
Removal of defined benefit pension surplus	454	–	–	454
Movement through other comprehensive income	(954)	–	–	(954)
Available-for-sale reserve	1,197	–	–	1,197
Prudent valuation adjustment	(258)	–	–	(258)
Deferred tax asset	310	–	–	310
Goodwill and other intangible assets	96	–	–	96
Excess of expected losses over impairment provisions and value adjustments	(332)	–	–	(332)
Significant investments	218	(152)	185	251
Eligible provisions	–	–	(35)	(35)
Movements in subordinated debt:				
Repurchases, redemptions and other	–	(551)	(3,211)	(3,762)
Issuances	–	–	1,151	1,151
Other movements	(540)	–	–	(540)
At 31 December 2016	**29,284**	**7,297**	**9,542**	**46,123**

1 Under the regulatory framework, profits made by Insurance are removed from CET1 capital. However, when dividends are paid to the Group by Insurance these are recognised through CET1 capital.

2 Includes the accrual for the 2016 full year ordinary and special dividends and the reversal of the accrual for the 2015 full year ordinary and special dividends which were paid during the year.

CET1 capital resources have increased by £740 million in the year largely as a result of profit generation in the year, dividends received from the Insurance business and the favourable movement in the available-for-sale reserve following the accounting reclassification of gilts within the liquidity portfolio from held-to-maturity. These movements in CET 1 capital were partially offset by dividends paid out during the year, movements in the defined benefit pension schemes largely driven by the impact of credit spreads, an increase in the excess of expected losses over impairment provisions and value adjustments primarily as a result of the implementation of recently published EBA guidance restricting prudent valuation adjustments eligible for offset against expected losses, and the accrual of the full year ordinary and special dividends, representing returns to ordinary shareholders following strong capital generation.

AT1 capital resources have reduced by £703 million in the year, primarily reflecting the annual reduction in the transitional limit applied to grandfathered AT1 capital instruments and an increase in the significant investments deduction.

Tier 2 capital resources have reduced by £1,910 million in the year largely reflecting calls and redemptions, including the redemption of all remaining series of Enhanced Capital Notes (ECNs) under the Regulatory Call Right, and the amortisation of dated tier 2 instruments, partly offset by the issuance of a new dated tier 2 instrument, foreign exchange movements on subordinated debt, the transitioning of grandfathered AT1 instruments to tier 2 and a reduction in the significant investments deduction.

The redemption of the remaining series of ECNs followed the decision of the Court of Appeal in December 2015 that a Capital Disqualification Event (CDE) in relation to the ECNs had occurred. The Group subsequently exercised its option to redeem them in the first quarter of 2016. In June 2016 the Supreme Court confirmed the decision of the Court of Appeal.

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Risk management continued

Table 1.51: Risk-weighted assets

	At 31 Dec 2016 £m	At 31 Dec 2015 £m
Foundation Internal Ratings Based (IRB) Approach	64,907	68,990
Retail IRB Approach	64,970	63,912
Other IRB Approach	17,788	18,661
IRB Approach	147,665	151,563
Standardised (STA) Approach	18,956	20,443
Credit risk	166,621	172,006
Counterparty credit risk	8,419	7,981
Contributions to the default fund of a central counterparty	340	488
Credit valuation adjustment risk	864	1,684
Operational risk	25,292	26,123
Market risk	3,147	3,775
Underlying risk-weighted assets	204,683	212,057
Threshold risk-weighted assets[1]	10,851	10,788
Total risk-weighted assets	215,534	222,845
Movement to fully loaded risk-weighted assets[2]	–	(98)
Fully loaded risk-weighted assets	215,534	222,747

1 Threshold risk-weighted assets reflect the element of the significant investments and deferred tax assets that are permitted to be risk-weighted instead of deducted from CET1 capital. Significant investments primarily arise from the investment in the Group's Insurance business.

2 Differences may arise between transitional and fully loaded threshold risk-weighted assets where deferred tax assets reliant on future profitability and arising from temporary timing differences and significant investments exceed the fully loaded threshold limit, resulting in an increase in amounts deducted from CET1 capital rather than being risk-weighted.

Table 1.52: Risk-weighted assets movement by key driver

	Credit risk IRB £m	Credit risk STA £m	Credit risk[1] £m	Counterparty Credit risk[2] £m	Market risk £m	Operational risk £m	Total £m
Fully loaded risk-weighted assets as at 31 December 2015							222,747
Less total threshold risk-weighted assets[3]							(10,690)
Risk-weighted assets at 31 December 2015	151,563	20,443	172,006	10,153	3,775	26,123	212,057
Asset size	(4,453)	(440)	(4,893)	(1,542)	(139)	–	(6,574)
Acquisitions and disposals	(3,406)	(435)	(3,841)	(183)	–	–	(4,024)
Model updates	4,363	–	4,363	99	(951)	–	3,511
Methodology and policy	(1,215)	(1,184)	(2,399)	–	–	–	(2,399)
Asset quality	(2,989)	(75)	(3,064)	729	(200)	–	(2,535)
Movements in risk levels (Market risk only)	–	–	–	–	662	–	662
Foreign exchange	3,802	647	4,449	367	–	–	4,816
Other	–	–	–	–	–	(831)	(831)
Risk-weighted assets as at 31 December 2016	147,665	18,956	166,621	9,623	3,147	25,292	204,683
Threshold risk-weighted assets[3]							10,851
Total risk-weighted assets as at 31 December 2016							215,534

1 Credit risk includes securitisation risk-weighted assets.

2 Counterparty credit risk includes movements in contributions to the default fund of central counterparties and movements in credit valuation adjustment risk.

3 Threshold risk-weighted assets reflect the element of significant investments and deferred tax assets that are permitted to be risk-weighted instead of being deducted from CET1 capital. Significant investments primarily arise from investment in the Group's Insurance business.

The risk-weighted assets movement tables provide analyses of the reduction in risk-weighted assets in the period by risk type and an insight into the key drivers of the movements. The key driver analysis is compiled on a monthly basis through the identification and categorisation of risk-weighted asset movements and is subject to management judgment.

Credit risk-weighted assets reductions of £5.4 billion were driven by the following key movements:

- Asset size movements. Credit risk-weighted assets decreased by £4.9 billion, primarily due to active portfolio management, partially offset by continued growth in targeted customer segments.
- Disposals of the Group's interest in strategic equity investments and other targeted disposals reduced credit risk-weighted assets by £3.8 billion.
- Model update increases of £4.4 billion were mainly related to the Mainstream and buy-to-let UK mortgage portfolios.
- Methodology and policy reductions of £2.4 billion are principally due to securitisation activity.

– Asset quality movements capture movements due to changes in borrower risk, including changes in the economic environment. Net reductions in credit risk-weighted assets of £3.1 billion primarily relate to model calibrations and a net change in credit quality, reflecting improvements in the economic climate, partly offset by increases in the valuation of centrally held strategic equity investments.
– Foreign exchange movements reflect the depreciation of Sterling which has contributed to a £4.4 billion increase in credit risk-weighted assets.

Counterparty credit risk assets decreased by £0.5 billion mainly driven by increased capital relief from CVA related hedges partially offset by increased trading activity, foreign exchange and yield curve movements.

Market risk-weighted assets reduced by £0.6 billion due to a reduction in the Value-at-Risk multiplier, improvements to the VaR model and active portfolio management.

Operational risk-weighted assets reduced by £0.8 billion due to the annual update of the income based TSA operational risk calculation.

Stress testing

The Group undertakes a wide ranging programme of stress testing providing a comprehensive view of the potential impacts arising from the risks to which the Group is exposed. One of the most important uses of stress testing is to assess the resilience of the operational and strategic plans of the Group to adverse economic conditions and other key vulnerabilities. As part of that the Group participates in the UK-wide concurrent stress test run by the Bank of England.

During 2016, the Group was subject to the European Banking Authority's Europe-wide stress test with the Group's results significantly above our minimum capital requirements. The concurrent UK stress test run by the Bank of England was also undertaken in 2016. As announced in November, the Group comfortably exceeded the capital thresholds set by the PRA and was not required to take any action as a result of this test.

Leverage ratio

The table on the next page summarises the component parts of the Group's leverage ratio. Further analysis will be provided in the Group's Pillar 3 Report.

Table 1.53: Leverage ratio

	Fully loaded	
	At 31 Dec 2016 £m	At 31 Dec 2015 £m
Total tier 1 capital for leverage ratio		
Common equity tier 1 capital	**29,284**	28,505
Additional tier 1 capital	**5,320**	5,355
Total tier 1 capital	**34,604**	33,860
Exposure measure		
Statutory balance sheet assets		
Derivative financial instruments	**36,138**	29,467
Securities financing transactions (SFTs)	**42,285**	34,136
Loans and advances and other assets	**739,370**	743,085
Total assets	**817,793**	806,688
Deconsolidation adjustments[1]		
Derivative financial instruments	**(2,403)**	(1,510)
Securities financing transactions (SFTs)	**112**	(441)
Loans and advances and other assets	**(142,955)**	(133,975)
Total deconsolidation adjustments	**(145,246)**	(135,926)
Derivatives adjustments		
Adjustments for regulatory netting	**(20,490)**	(16,419)
Adjustments for cash collateral	**(8,432)**	(6,464)
Net written credit protection	**699**	682
Regulatory potential future exposure	**13,188**	12,966
Total derivatives adjustments	**(15,035)**	(9,235)
SFT adjustments	**39**	3,361
Off-balance sheet items	**58,685**	56,424
Regulatory deductions and other adjustments	**(9,128)**	(9,112)
Total exposure	**707,108**	712,200
Leverage ratio[2]	**4.9%**	4.8%
Average leverage ratio[3]	**4.9%**	
Average leverage ratio exposure measure[4]	**718,926**	

1 Deconsolidation adjustments predominantly reflect the deconsolidation of assets related to Group subsidiaries that fall outside the scope of the Group's regulatory capital consolidation (primarily the Group's Insurance entities).

2 The countercyclical leverage ratio buffer is currently nil.

3 The average leverage ratio is based on the average of the month end tier 1 capital and exposure measures over the quarter (30 September 2016 to 31 December 2016). The average of 4.9 per cent compares to 4.8 per cent at the start and 4.9 per cent at the end of the quarter.

4 The average leverage ratio exposure measure is based on the average of the month end exposure measures over the quarter (30 September 2016 to 31 December 2016).

Risk management continued

Key movements

The Group's fully loaded leverage ratio increased by 0.1 per cent to 4.9 per cent reflecting the impact of both the increase in tier 1 capital and the £5.1 billion reduction in the exposure measure, the latter largely reflecting the reduction in liquid asset holdings.

The derivatives exposure measure, representing derivative financial instruments per the balance sheet net of deconsolidation and derivatives adjustments, reduced marginally with market movements and trading activity broadly offset through netting and cash collateral inflows.

The increase in SFT assets over the period, reflecting increased customer volumes, was offset by the reduction in SFT adjustments reflecting both the recognition of additional eligible netting adjustments and a reduction in the counterparty credit risk add-on.

Off-balance sheet items increased by £2.3 billion, primarily reflecting a change in the profile and subsequent classification of commercial off-balance sheet items and a net increase in securitisation financing facilities, partially offset by a planned drawdown on certain liquidity facilities supporting the Group's conduit programme to provide funding alongside the proceeds of the ABCP issurance.

The average leverage ratio of 4.9 per cent over the quarter reflected a strengthening tier 1 capital position prior to the accrual for the announced full year special dividend and the reduction in balance sheet assets during the quarter, largely reflecting the reduction in liquid asset holdings.

Modified UK leverage ratio

The Group's leverage ratio on a modified basis, excluding qualifying central bank claims from the leverage exposure measure, is 5.2 per cent. This follows the rule modification applied to the UK Leverage Ratio Framework by the PRA in August 2016 as a result of recommendations made by the Financial Policy Committee.

The Financial Policy Committee has indicated that it intends to recalibrate the UK framework in 2017 in order to adjust for the impact of the rule modification, thereby ensuring that levels of capital currently required to meet leverage ratio minimums are maintained. The modified UK leverage ratio should therefore be considered in the context of the proposed recalibration.

G-SIB indicators

Although the Group is not currently classified as a Global Systemically Important Bank (G-SIB), by virtue of the Group's leverage exposure measure exceeding €200 billion the Group is required to report G-SIB indicator metrics to the PRA. The Group's indicator metrics used within the 2016 Basel G-SIBs annual exercise will be disclosed from April 2017, and the results are expected to be made available by the Basel Committee later this year.

Insurance businesses

The business transacted by the insurance companies within the Group comprises both life insurance business and general insurance business. Life insurance business comprises unit-linked business, non-profit business and with-profits business.

Scottish Widows Limited (SW Ltd) holds the only with-profit funds managed by the Group. Each insurance company within the Group is regulated by the PRA.

The Solvency II regime for insurers and insurance groups came into force from 1 January 2016. The insurance businesses are required to calculate solvency capital requirements and available capital on a risk-based approach. The insurance business of the Group calculates regulatory capital on the basis of an internal model, which was approved by the PRA on 5 December 2015.

The minimum required capital must be maintained at all times throughout the year. These capital requirements and the capital available to meet them are regularly estimated in order to ensure that capital maintenance requirements are being met.

All minimum regulatory requirements of the insurance companies have been met during the year.

REGULATORY AND LEGAL RISK

Definition

Regulatory and legal risk is defined as the risk that the Group is exposed to fines, censure, or legal or enforcement action; or to civil or criminal proceedings in the courts (or equivalent) and/or the Group is unable to enforce its rights due to failing to comply with applicable laws (including Codes of Practice which could have legal implications), regulations, codes of conduct or legal obligations.

Exposures

Whilst the Group has a zero risk appetite for material regulatory breaches or material legal incidents, the Group remains exposed to material regulatory breaches and material legal incidents outside of its risk appetite. Exposure is driven by significant ongoing and new legislation, regulation and court proceedings in the UK and overseas which in each case needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group.

Measurement

Regulatory and legal risks are measured against a set of risk appetite metrics, with appropriate thresholds, which are approved annually by the Board and which are regularly reviewed and monitored. Metrics include assessments of control and material regulatory rule breaches.

Mitigation

We have taken a number of steps and have outlined below the following key components:

- The Board establishes a Group-wide risk appetite and metrics for Regulatory and Legal Risk;
- Group policies and procedures set out the principles and key controls that should apply across the business which are aligned to the group risk appetite. Mandated policies and processes require appropriate control frameworks, management information, standards and colleague training to be implemented to identify and manage regulatory and legal risk;
- Business units assess and implement policy and regulatory requirements and establish local control, processes and procedures to ensure governance and compliance;
- Material risks and issues are escalated to divisional and then Group-level bodies which challenge and support the business on its management of them;

- Business units regularly produce management information to assist in the identification of issues and test management controls are working effectively;
- Risk Division and Legal provide oversight and proactive support and constructive challenge to the business in identifying and managing regulatory and legal issues;
- Risk Division will conduct thematic reviews of regulatory compliance across businesses and divisions where appropriate;
- Business units with the support of divisional and Group-Level bodies conduct ongoing horizon scanning to identify and address changes in regulatory and legal requirements.

Monitoring

Business unit risk exposure is reported to Risk Division where it is aggregated at Group level and a report prepared. The report forms the basis of challenge to the business at the monthly Group Conduct, Compliance and Operational Risk Committee. This committee may escalate matters to the Chief Risk Officer, or higher committees. The report also forms the basis of the regulatory and legal sections in the Group's consolidated risk reporting.

State aid commitments

In 2015 we satisfied all material structural and behavioural commitments following the successful carve-out and disposal of TSB with respect to the State Aid commitments agreed with the European Commission under the State Aid regime in 2009. We are therefore no longer subject to restrictive behavioural commitments including the constraint on acquisitions, but continue to be bound by two remaining limited ancillary commitments which means that we remain subject to supervision by the European Commission with respect to these commitments until they cease to have effect on or before June 2017.

INSURANCE RISK

Definition

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

Exposures

The major sources of insurance risk within the Group are the Insurance business and the Group's defined benefit pension schemes.

Longevity and persistency are key risks within the life and pensions business. Longevity risk arises from the annuity portfolios where policyholders' future cashflows are guaranteed at retirement and increases in life expectancy, beyond current assumptions, will increase the cost of annuities. Longevity risk exposures are expected to increase with the Insurance business growth in the bulk annuity market. Persistency assumptions are set to give a best estimate however, customer behaviour may result in increased cancellations or cessation of contributions.

Property insurance risk is a key risk within the general insurance business, through Home Insurance, and exposures can arise, for example, in extreme weather conditions, such as flooding, when property damage claims are higher than expected.

The prime insurance risk of the Group's defined benefit pension schemes is longevity.

Measurement

Insurance risks are measured using a variety of techniques including stress, reverse stress and scenario testing, as well as stochastic modelling. Current and potential future insurance risk exposures are assessed and aggregated on a range of stresses including risk measures based on 1-in-200 year stresses for Insurance's regulatory capital assessments and other supporting measures where appropriate, including those set out in note 33 to the financial statements. For measuring the longevity risk in the Group's defined benefit pension schemes both 1-in-20 year stresses (risk appetite) and 1-in-200 year stresses (regulatory capital) are utilised. For further information on defined benefit schemes please refer to note 36 to the financial statements.

Mitigation

Insurance risk in the Insurance business is mitigated in a number of ways:

- General insurance exposure to accumulations of risk and possible catastrophes is mitigated by reinsurance arrangements broadly spread over different reinsurers. Detailed modelling, including that of the potential losses under various catastrophe scenarios, supports the choice of reinsurance arrangements.
- Insurance processes on underwriting, claims management, pricing and product design.
- Longevity risk transfer and hedging solutions are considered on a regular basis. A team of longevity and bulk pricing experts has been built to support the new bulk annuity proposition.
- Exposure limits by risk type are assessed through the business planning process and used as a control mechanism to ensure risks are taken within risk appetite.

The most significant insurance risk in the defined benefit pension schemes is longevity risk. The merits of longevity risk transfer and hedging solutions are regularly reviewed.

Monitoring

Insurance risks in the Insurance business are monitored by Insurance senior executive Committees and ultimately the Insurance Board. Governance of the Group's defined benefit pension schemes includes two specialist pension committees. Significant risks from the Insurance business and the defined benefit pension schemes are reviewed by the Group Executive and Group Risk Committees and/or Board.

Insurance risk exposures within the Insurance business are monitored against risk appetite. The Insurance business monitors experiences against expectations, for example business volumes and mix, claims and persistency experience. The effectiveness of controls put in place to manage insurance risk is evaluated and significant divergences from experience or movements in risk exposures are investigated and remedial action taken.

Progress against risk appetite metrics in respect of longevity risk in the Group's defined benefit pension schemes is regularly reported and reviewed by the relevant committees.

Risk management continued

PEOPLE RISK

Definition

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver the Group's strategy for customers, shareholders and regulators.

Exposures

The Group's management of material people risks is critical to its capacity to deliver against its strategic objectives and to be the best bank for customers. Over the coming year the Group anticipates the following key people risk exposures:

- Maintaining organisational skills, capability, resilience and capacity levels in response to increasing volumes of organisational, political and external market change;
- Senior Managers and Certification Regime (SM&CR) and additional regulatory constraints on remuneration structures may impact the Group's ability to attract and retain talent;
- The increasing digitisation of the business is changing the capability mix required and may impact our ability to attract and retain talent; and
- Colleague engagement may continue to be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct.

Measurement

People risk is measured through a series of quantitative and qualitative indicators, aligned to key sources of people risk for the Group such as succession, retention, colleague engagement and performance management. In addition to risk appetite measures and limits, people risks and controls are monitored on a monthly basis via the Group's risk governance framework and reporting structures.

Mitigation

The Group takes many mitigating actions with respect to people risk. Key areas of focus include:

- Focusing on leadership and colleague engagement, through delivery of strategies to attract, retain and develop high calibre people together with implementation of rigorous succession planning;
- Continued focus on the Group's culture by developing and delivering initiatives that reinforce the appropriate behaviours which generate the best possible long-term outcomes for customers and colleagues;
- Managing organisational capability and capacity through divisional people strategies to ensure there are the right skills and resources to meet our customers' needs and deliver our strategic plan;
- Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;
- Ensuring compliance with legal and regulatory requirements related to SM&CR, embedding compliant and appropriate colleague behaviours in line with Group policies, values and its people risk priorities; and
- Ongoing consultation with the Group's recognised unions on changes which impact their members.

Monitoring

People risks from across the Group are monitored and reported through Board and Group Governance Committees in accordance with the Group's Risk Management Framework and People Risk sub-framework. Risk exposures are discussed monthly via the Group People Risk Committee with upwards reporting to Group Risk and Executive Committees. In addition oversight, challenge and reporting is completed at Risk Division level and combined with Risk Assurance reviews, assesses the effectiveness of controls, recommending follow up remedial action if relevant. All material People Risk events are escalated in accordance with the formal Group Operational Risk Policy and People Policies to the respective Divisional Managing Directors and the Group Director, Conduct, Compliance and Operational Risk.

FINANCIAL REPORTING RISK

Definition

Financial reporting risk is defined as the risk that the Group suffers reputational damage, loss of investor confidence and/or financial loss arising from the adoption of inappropriate accounting policies, ineffective controls over business or finance processes impacting financial, prudential regulatory, and tax reporting, failure to manage the associated risks of changes in taxation rates, law, corporate ownership or structure and the failure to disclose timely and appropriate information in accordance with regulatory requirements.

Exposures

Exposure represents the sufficiency of the Group's policies and procedures to maintain adequate systems, processes and controls to support statutory, prudential regulatory and tax reporting, to prevent and detect financial reporting fraud, to manage the Group's tax position and to support regulatory disclosures.

Measurement

Financial reporting risk is measured by the adequacy of, and compliance with, a number of key controls. Identification of potential financial reporting risk also forms a part of the Group's Operational Risk management framework.

Mitigation

The Group maintains a system of internal controls, which is designed to:

- ensure that accounting policies are consistently applied, transactions are recorded and undertaken in accordance with delegated authorities, that assets are safeguarded and liabilities are properly recorded;
- enable the calculation, preparation and reporting of financial, prudential regulatory and tax outcomes in accordance with applicable International Financial Reporting Standards, statutory and regulatory requirements; and
- ensure that disclosures are made on a timely basis in accordance with statutory and regulatory requirements and as far as possible are consistent with best practice and in compliance with the British Bankers' Association Code for Financial Reporting Disclosure.

Monitoring

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

- annual assessments of: (i) the effectiveness of internal controls over financial reporting; and (ii) the effectiveness of the Group's disclosure controls and procedures, both in accordance with the requirements of the US Sarbanes Oxley Act; and
- annual certifications by the Senior Accounting Officer with respect to the maintenance of appropriate tax accounting arrangements, in accordance with the requirements of the 2009 Finance Act.

The Group also has in place an assurance process to support its prudential regulatory reporting and monitoring activities designed to identify and review tax exposures on a regular basis. There is ongoing monitoring to assess the impact of emerging regulation and legislation on financial, prudential regulatory and tax reporting.

The Group has a Disclosure Committee which assists the Group Chief Executive and Chief Financial Officer in fulfilling their disclosure responsibilities under relevant listing and other regulatory and legal requirements. In addition, the Audit Committee reviews the quality and acceptability of the Group's financial disclosures. For further information on the Audit Committee's responsibilities relating to financial reporting see pages 72 to 75.

GOVERNANCE RISK

Definition

Governance risk is defined as the risk that the Group's organisational infrastructure fails to provide robust oversight of decision making and the control mechanisms to ensure strategies and management instructions are implemented effectively.

Exposures

The internal and corporate governance arrangements of major financial institutions continue to be subject to a high level of regulatory and public scrutiny. The Group's exposure to governance risk is also reflective of the significant volume of existing and proposed legislation and regulation within the UK and overseas with which it must comply. Risk governance and risk culture are mutually reinforcing.

Measurement

The Group's governance arrangements are assessed against new or proposed legislation and regulation and best practice among peer organisations in order to identify any areas of enhancement required.

Model Risk appetite considers the performance of the Group's most material models.

Mitigation

The Group's Risk Management Framework (RMF) establishes robust arrangements for risk governance, in particular by:

- Defining individual and collective accountabilities for risk management, risk oversight and risk assurance through a Three Lines of Defence model which supports the discharge of responsibilities to customers, shareholders and regulators;
- Outlining governance arrangements which articulate the enterprise-wide approach to risk management; and
- Supporting a consistent approach to Group-wide behaviour and risk decision making through a Group Policy Framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, standards, boundaries and risk appetite measures which can be controlled, enforced and monitored.

Under the banner of the RMF, training modules are in place to support all colleagues in understanding and fulfilling their risk responsibilities.

The Ethics and Responsible Business Policy and supporting Codes of Personal Responsibility and Business Responsibility embody the Group's values and reflect its commitment to operating responsibly and ethically both at a business and an individual level. All colleagues are required to adhere to the Codes in all aspects of their roles.

Driving adherence to the Group's RMF goes 'hand in glove' with its approach to risk culture which is embedded in the Group's approach to recruitment, selection, training, performance management and reward.

Monitoring

A review of the Group's RMF, which includes the status of the Group's Principles and Policy Framework, and the design and operational effectiveness of key governance committees, is undertaken on an annual basis and the findings are reported to the Group Risk Committee, Board Risk Committee and the Board.

This includes a review of the Group's current approach to governance and ongoing initiatives in light of the latest regulatory guidance, including in 2016 the further enhancement of frameworks to address Senior Managers and Certification Regime (SM&CR) requirements and prepare for the requirement to ring-fence retail banking activities with effect from January 2019.

As part of the RMF, the performance of models is regularly monitored to ensure they remain fit-for-purpose.

For further information on Corporate Governance see pages 60 to 80.

For further information on Model Risk see page 78.

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Independent auditors' report to the members of Lloyds Banking Group plc

REPORT ON THE FINANCIAL STATEMENTS

Our opinion

In our opinion:

– Lloyds Banking Group plc's consolidated financial statements and parent company financial statements (the 'financial statements') give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2016 and of the Group's profit and the Group's and the parent company's cash flows for the year then ended;
– the consolidated financial statements have been properly prepared in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the European Union;
– the parent company 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 consolidated financial statements, Article 4 of the IAS Regulation.

What we have audited

The financial statements, included within the Annual Report and Accounts (the 'Annual Report'), comprise:

– the consolidated and parent company balance sheets as at 31 December 2016;
– the consolidated income statement and the consolidated statement of comprehensive income for the year then ended;
– the consolidated and parent company cash flow statements for the year then ended;
– the consolidated and parent company statements of changes in equity for the year then ended; and
– the notes to the financial statements, which include a summary of accounting policies and other explanatory information.

Certain required disclosures have been presented elsewhere in the Annual Report, rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited.

The financial reporting framework that has been applied in the preparation of the financial statements is IFRSs as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006, and applicable law.

Our audit approach

Overview

– Overall Group materiality: £325 million which represents 5 per cent of the 3 year average of adjusted profit before tax. Statutory profits were adjusted to remove the effects of certain items which are exceptional and/or one-off in nature.
– The scope of our audit and the nature, timing and extent of audit procedures performed were determined by our risk assessment, the financial significance of reporting units and other qualitative factors (including history of misstatement through fraud or error).
– We performed audit procedures over reporting units we considered financially significant in the context of the Group (full scope audit) or in the context of individual primary statement account balances (audit of specific account balances). We also performed other procedures including testing entity level controls and analytical review procedures to mitigate the risk of material misstatement in the residual reporting units.

The areas of focus for our audit which involved the greatest allocation of our resources and effort were:

– Loan loss impairment provisions
– Conduct risk and provisions
– Insurance actuarial assumptions
– Defined benefit obligations
– Hedge accounting
– Deferred tax asset
– Uncertain tax positions
– Significant transactions
– Privileged access to IT systems

These items were initially discussed with the Audit Committee as part of our audit plan. There were no modifications to this initial assessment and these were the key matters for discussion at the conclusion of our audit.

Change of Senior Statutory Auditor

Following the mandatory rotation of the previous Engagement Partner, this is my first year as Senior Statutory Auditor to the Group. In order to better understand the Group, its operations, its financial reporting processes and the judgements exercised by the directors I observed a number of Audit Committee meetings, auditor meetings with executive management and auditor process meetings from April 2015 to February 2016. I commenced planning the 2016 audit in March 2016 and presented the audit plan to the Audit Committee in April 2016. This included an assessment of materiality, an identification of the areas of focus of the audit, an overview of planned audit testing strategies, audit team structure and proposed communications with the Audit Committee throughout the audit.

What an audit of financial statements involves

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 the parent company'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.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by

Independent auditors' report to the members of Lloyds Banking Group plc continued

us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report. With respect to the Strategic Report and Directors' Report, we consider whether those reports include the disclosures required by applicable legal requirements.

Materiality

We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement account balances and disclosures and in evaluating the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Overall Group materiality	£325 million (2015: £300 million).
How we determined it	5 per cent of the 3 year average of adjusted statutory profit before tax.
Rationale for benchmark applied	We have used a 3 year average of adjusted profit before tax in order to reduce the potential for volatility and large changes in materiality year-on-year. This is a generally accepted auditing practice. Statutory profits before tax for 2014, 2015 and 2016 were adjusted to remove the disproportionate impact of several items which are considered exceptional and/or one-off in nature. These adjustments included charges related to PPI and other conduct provisions, charges relating to redemption of Enhanced Capital Notes (ECNs) and Additional Tier 1 securities (AT1s), the credit in relation to the disposal of the stake in Visa Europe Ltd., and the credit in relation to pension scheme curtailment.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £20 million (2015: £20 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the Group, the accounting processes and controls, and the industry in which the Group operates.

The Group is structured into four divisions being Retail, Commercial Banking, Insurance and Consumer Finance. Within the Group's main consolidation and financial reporting system, each of the divisions comprises a number of reporting units. The consolidated financial statements are an aggregation of the reporting units.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed over the reporting units by us, as the Group engagement team, or auditors within PwC UK and from other PwC network firms operating under our instruction ('component auditors'). Almost all of our audit work is undertaken by PwC UK component auditors.

Where the work was performed by component auditors, we determined the level of involvement we needed to have in their audit work to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the consolidated financial statements as a whole. This included regular communication with the component auditors throughout the audit, the issuance of instructions, a review of the results of their work on the areas of focus and formal clearance meetings.

Any reporting units which were considered individually financially significant in the context of the Group's consolidated financial statements were considered full scope components. We then considered the individual financial significance of other reporting units in relation to primary statement account balances. In doing this we also considered the presence of any significant audit risks and other qualitative factors (including history of misstatements through fraud or error). Any reporting unit which was not already included as a full scope audit component but was identified as being individually financially significant in respect of one of more primary statement account balances was subject to specific audit procedures over those account balances. Inconsequential components (defined as reporting units which did not represent a reasonable possibility of a risk of material misstatement either individually or in aggregate) were eliminated from further consideration for specific audit procedures although they were subject to Group level analytical review procedures. All remaining reporting units which were neither inconsequential nor individually financially significant were within our audit scope, with the risk of material misstatement mitigated through audit procedures including testing of entity level controls and Group and component level analytical review procedures.

Certain account balances (e.g. cash and balances at central banks) were audited by the Group engagement team.

Reporting units within the scope of our audit contributed 99 per cent of Group total assets. Audit coverage on account balances in the consolidated income statement ranged between 56 per cent and 99 per cent.

Areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ('ISAs (UK & Ireland)').

We designed our audit by applying materiality and assessing the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the directors or management that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as 'areas of focus' in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Area of focus	How our audit addressed the area of focus
Loan loss impairment provisions *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies) and page 210 (Note 21 and Critical Accounting Estimates and Judgements).* The determination of impairment provisions remains a highly subjective and judgemental area. Furthermore, the Group is subject to significant regulatory scrutiny with respect to provisioning levels. Our work covered impairment of loans and advances to customers within Retail, Consumer Finance and Commercial Banking. We assessed the use of historic experience to estimate impairment events which have been incurred but not reported and to derive estimates of future cashflows. We also focused on the calculation of required impairment provisions, including the use of models, and in particular the critical assumptions used in those models and calculations. The models rely upon the accuracy of underlying data including the delinquency status of the borrower. Our work therefore focused on agreed customer treatments such as forbearance, including the presentation of such information in the financial statements, in order to validate the accuracy of such delinquency status markers. Management also applies adjustments, or overlays, where they believe the data driven parameters and calculations are not appropriate, either due to emerging trends or models not capturing the risks in the loan portfolio. An example of this is an overlay for the current low interest rates which management apply on top of the impairment model output in Retail. These overlays require significant judgement and are therefore a main area of focus.	We understood and tested key controls and focused on: – the identification of impairment events and classification of forborne loans; – the governance over the impairment processes, including controls over unauthorised modifications to the models and the re-assessment by management that impairment models are still calibrated in a way which is appropriate for the impairment risks in the Group's loan portfolios; – the transfer of data between underlying source systems and the impairment models that the Group operates; and – the review and approval process that management have in place for the outputs of the Group's impairment models, and the adjustments and overlays that are applied to modelled outputs. We found these key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these key controls for the purposes of our audit. In addition we have performed the following substantive procedures: *Retail and Consumer Finance* We understood management's basis for determining whether a loan is impaired and assessed the reasonableness using our understanding of the Group's lending portfolios and our broader industry knowledge. We tested the completeness and accuracy of relevant data from underlying systems and data warehouses that is used in those models. We understood and critically assessed the models used. Modelling assumptions and parameters, such as probability of default, are based on historic data. We challenged whether historic experience was representative of current circumstances and of the recent losses incurred in the portfolios. Where changes had been made in model parameters and assumptions, we understood the reasons why changes had taken place and used our industry knowledge and experience to evaluate the appropriateness of such changes. We performed sensitivity analysis, and for certain portfolios, re-performed the provision calculation using our own independent models. We understood and corroborated any material differences identified. We also performed testing to obtain evidence over the existence and valuation of collateral. In considering the appropriateness of provisions, we have assessed whether higher risk concentrations (e.g. past term interest only loans, forborne loans) have been appropriately considered and captured in the modelled provision, and where not, whether overlays to modelled calculations appropriately reflected those risks. We challenged management over the completeness of overlays and to provide objective evidence to support the adjustments made to the modelled provision and performed substantive testing over certain overlays. Based on the evidence obtained we found that the impairment model assumptions, data used within the models and overlays to modelled outputs are reasonable and therefore concluded that provisions are appropriate. *Commercial Banking* We understood and evaluated the processes for identifying impairment events within the loan portfolios, as well as the impairment assessment processes for loans within the Business Support Unit and run-off portfolio. We critically assessed the criteria for determining whether an impairment event had occurred and therefore whether there was a requirement to calculate an impairment provision. We tested a sample of performing loans with characteristics that might imply an impairment indicator existed (e.g. a customer experiencing financial difficulty or in breach of covenant) as well as an additional sample of haphazardly selected performing loans to assess whether these loans had any impairment indicators that management had not identified. For a sample of individually impaired loans we understood the latest developments at the borrower and the basis of measuring the impairment provisions and considered whether key judgements were appropriate given the borrowers' circumstances. We also re-performed management's impairment calculation, testing key inputs including the expected future cash flows, discount rates and the valuation of collateral held. Our testing of collateral valuation specifically considered whether valuations were up to date, consistent with the strategy being followed in respect of the particular borrower and assessed the appropriateness and sensitivities of key assumptions. We back-tested previous provisions by comparing the gains or losses crystallised when impaired loans were sold or exited. For the collective unidentified impaired provision, which reflects losses incurred but not yet identified, we tested the completeness and accuracy of the underlying loan information used in the impairment models by agreeing details to the Group's source systems as well as re-performing the calculation of the modelled provision. For the key inputs and assumptions in the model, we obtained and tested objective evidence that supported their appropriateness. For overlays to the modelled output, we challenged management to provide objective evidence that the overlays were appropriate. We also considered whether certain recent events and macro-economic factors (e.g. continued volatility and uncertainty around commodity prices, sterling exchange rate movements and further reduction in interest rates) had been appropriately considered and captured. Based on the procedures performed and evidence obtained, we found management's assumptions to be reasonable and therefore consider provisions to be appropriate.

Independent auditors' report to the members of Lloyds Banking Group plc continued

Area of focus	How our audit addressed the area of focus
Conduct risk and provisions *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies) and page 230 (Note 38 and Critical Accounting Estimates and Judgements).* Significant provisions have been made in respect of conduct matters in recent years, reflecting customer redress payments, operational costs and regulatory fines. The most significant provisions have related to past sales of payment protection insurance policies, arrears handling activities, packaged bank accounts and insurance products of the German branch of Clerical Medical Investment Group Ltd (now Scottish Widows Ltd). Given the number and volume of products sold by the Group historically, and the continued regulatory and public focus on the banking industry, there is a continuing risk that new conduct issues will emerge. Therefore, there is a financial reporting risk that such emerging risks and exposures are not appropriately identified and provided for. In relation to known issues, the measurement of provisions is highly judgemental and involves the use of several management assumptions including volume of future complaints and related redress costs. Furthermore, there is a risk that these known and emerging issues are not appropriately disclosed in the financial statements.	We understood and tested the key controls and management's processes for: – identifying emerging conduct risk exposures and assessing whether provisions or disclosures were necessary; and – the calculation and review of conduct provisions including governance processes and approvals of model assumptions and outputs. We found these key controls were designed, implemented and operated effectively and therefore we determined that we could place reliance on these key controls for the purposes of our audit. In addition we have performed the following substantive procedures: We met with Divisional and Group management to understand the emerging and potential issues that they had identified. We independently assessed emerging and potential areas where exposures might have arisen based upon our knowledge and experience of emerging industry issues and the regulatory environment. We used this to challenge the completeness of the issues identified by management and whether a provision was required. We understood customer complaints received, and assessed the trends. We used this analysis to understand whether there were indicators of more systemic issues being present for which provisions or disclosures may have needed to be made in the financial statements. We read the Group's correspondence with the Financial Conduct Authority and Prudential Regulation Authority and discussed the output of any meetings held. We met on a trilateral basis with the Financial Conduct Authority, Prudential Regulation Authority and the Chair of the Audit Committee. We also met on a bilateral basis with each regulator. We read the minutes of key governance meetings including those of the Board, and of various management committees, as well as attending Audit Committee and Board Risk Committee meetings. We also understood the key activities of the Conduct and Compliance function. The majority of our detailed audit work was on the significant conduct provisions in relation to past sales of payment protection insurance policies, arrears handling activities, packaged bank accounts and insurance products in the German branch of Clerical Medical Investment Group Ltd (now Scottish Widows Ltd). We also examined other areas of compensation payments made to customers. For significant provisions made, we understood and challenged the provisioning methodologies and underlying assumptions used by management. For example, we challenged the basis that management used for forecasting the number of PPI complaints that will be received in the future. We also considered regulatory developments and management's interactions with regulators. For those assumptions based on historic information, we challenged whether this was appropriate for future experience and challenged the appropriateness of any adjustments made by management. We also independently performed sensitivity analysis on the key assumptions. Given the inherent uncertainty in the calculation of conduct provisions and their judgemental nature, we evaluated the disclosures made in the financial statements. In particular, we focused on challenging management that the disclosures were sufficiently clear in highlighting the exposures that remain, significant uncertainties that exist in respect of the provisions and the sensitivity of the provisions to changes in the underlying assumptions. No additional material conduct issues that would require either provision or disclosure in the financial statements were identified as a result of the audit work performed.
Insurance actuarial assumptions *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies) and pages 213, 217 and 221 (Notes 24, 32, 33 and Critical Accounting Estimates and Judgements).* The valuation of the Group's insurance contracts is dependent on a number of subjective assumptions about future experience. Some of the economic and non-economic actuarial assumptions used in valuing insurance contracts are highly judgemental, in particular persistency (the retention of policies over time), longevity (the expectation of how long an annuity policyholder will live and how that might change over time), expenses (future expenses incurred to maintain existing policies to maturity), credit risk and illiquidity premium (adjustments made to the discount rate). The Group's accounting policy is that the discount rate applied to cash flows is consistent with that applied to such cash flows in the capital markets. Management currently use the actual asset mix as a proxy for deriving a market consistent view of the illiquidity adjustment to the discount rate. Small changes in each of these assumptions can result in material impacts to the valuation of insurance contract liabilities, the value of in-force assets and the related movements in the income statement.	We understood and tested key controls and governance around the processes for analysing economic and noneconomic assumptions. We found the key controls for the setting of assumptions, including the experience analysis data, were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We engaged our actuarial specialists to assess the actuarial assumptions, including the consideration and challenge of management's rationale for the judgements applied and any reliance placed on industry information. The assessment included reference to our independent benchmarking data which considers each of these principal areas. For persistency, longevity and expenses we considered recent experience and the appropriateness of the judgements applied by management on how future experience will evolve. For persistency, we also considered the appropriateness of assumptions set by management in light of regulatory changes. In particular, we considered how the assumptions reflect expected persistency improvements from the removal of commission for qualifying pension schemes and greater outflows of funds expected as a result of increased options available to pension policyholders (Finance Act 2014). For longevity and expenses we assessed the appropriateness of the assumptions by comparing them to experience and latest industry data. For credit risk and illiquidity premium we assessed the appropriateness of the methodology, including modifications made, against our knowledge and experience of the regulatory requirements and of the industry. We assessed the assumptions with reference to wider market practice and prevailing economic conditions. We challenged whether the actual asset mix remained an appropriate proxy to a market consistent portfolio by comparing the proportion of illiquid assets held to those held by other similar companies; this comparison was based on our understanding of the market and the most recent public information for other similar companies. We performed testing to confirm that the assumptions approved were those applied. Based on the results of our audit work we concluded that the data and assumptions used by management were reasonable.

Area of focus	How our audit addressed the area of focus
Defined benefit obligations *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies) and page 226 (Note 36 and Critical Accounting Estimates and Judgements).* The valuations of the retirement benefit schemes are calculated with reference to a number of actuarial assumptions including discount rate, rate of inflation and mortality rates. Because of the size of the schemes, small changes in these assumptions can have a significant impact on the financial statements.	We understood and tested key controls over the completeness and accuracy of data extracted and supplied to the Group's actuary, which is used in the valuation of the Group's defined benefit obligations. We also tested the controls for determining the actuarial assumptions and the approval of those assumptions by senior management. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We engaged our actuarial specialists and met with management and their actuary to understand the judgements made in determining key economic assumptions used in the calculation of the liability. We assessed the reasonableness of those assumptions by comparing to our own independently determined benchmarks and concluded that the assumptions used by management were appropriate. We tested the consensus and employee data used in calculating the obligation. Where material, we also considered the treatment of curtailments, settlements, past service costs and measurements, and any other amendments made to obligations during the year. Based on the evidence obtained, we found that the data and assumptions used by management in the actuarial valuations for pension obligations are within a range we consider to be reasonable. We also read and assessed the disclosures made in the financial statements, including disclosures of the assumptions, and found them to be appropriate.
Hedge accounting *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies), and page 261 (Note 52).* The Group enters into derivative contracts in order to manage and hedge risks such as interest rate and foreign exchange rate risk. These arrangements create accounting mismatches which are addressed through hedge accounting, predominantly fair value hedges or cash flow hedges. The application of hedge accounting and ensuring hedge effectiveness can be highly judgemental and operationally cumbersome, and requires close monitoring from management. .	We understood and tested key controls over the designation and ongoing management of hedge accounting relationships, including testing of hedge effectiveness as well as the controls around the preparation and review of hedging strategy and related documentation prior to the implementation of new hedges. We found the key controls were designed, implemented and operated effectively, and therefore we determined that we could place reliance on these controls for the purposes of our audit. We examined hedge documentation to assess whether the documentation complied with all IAS 39 requirements. We tested key year-end reconciliations between underlying source systems and spreadsheets used to manage hedging models, including testing of hedging capacity after considering the impact of structural reform, designation of hedges and the measurement and recording of hedge effectiveness adjustments. In monitoring hedging effectiveness against stresses, we noted that despite significant market uncertainty and volatility during the year, all significant hedge accounting relationships continued to be effective. We also tested a sample of manual adjustments posted to hedge reserves relating to hedge ineffectiveness arising in cash flow hedging models. We specifically considered the re-designations that were required as a result of the reclassification of gilts from held-to-maturity to available-for-sale. We found that hedge accounting methodology was appropriately applied.
Deferred tax asset *Refer to page 72 (Audit Committee Report), page 186 (Accounting Policies), and page 228 (Note 37 and Critical Accounting Estimates and Judgements).* 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. When considering the availability of future taxable profits, judgement is required when assessing projections of future taxable income which are based on approved business plans/forecasts. The allocation of forecast profits is also judgemental when considering the utilisation of the deferred tax assets in the separate legal entities where the assets reside. Furthermore, there have recently been changes to legislation in relation to the level of profits which banking entities may offset with brought forward tax losses.	We understood and tested key controls over the production and approval of the forecast taxable profits used to support the recognition of various deferred tax assets. We found the key controls were designed, implemented and operated effectively, and therefore we were able to place reliance on these controls for the purposes of our audit. We assessed whether the forecast profits were appropriate by challenging both the underlying and economic assumptions, focusing on those directly impacting the adjusted profit figures, for example interest rates and gross domestic product. We used our independent benchmarking data to benchmark a number of the economic assumptions to external data sources where possible, and also assessed previous forecasts for evidence of bias. We also reviewed management's basis for allocating forecast profits between legal entities, challenging significant assumptions and using our experience of the Group's activities. We have evaluated the impact of recent tax law changes on the calculation of the Group's deferred tax balances, including confirming that the loss restriction rules, the banking surcharge and the restriction of deductions for certain customer compensation payments have been correctly applied. In addition, we ensured that management's forecasts considered the impacts of structural reform. We found that the both the utilisation period and the carrying value of the deferred tax asset together with the related disclosures are reasonable.
Uncertain tax positions *Refer to page 72 (Audit Committee Report), and page 242 (Note 48).* The Group has a number of open tax matters, for which management is required to make certain judgements as to the likely outturn for the purposes of calculating the Group's tax liabilities. The most significant uncertainties at present relate to a claim for group relief of group losses incurred in its former Irish banking subsidiary and the tax treatment of certain costs arising from the divestment of TSB Banking Group plc.	We understood and tested key controls surrounding the governance procedures in evaluating such uncertain exposures as well as performed an assessment over the experience of management in evaluating these exposures. We found the key controls were designed, implemented and operated effectively, and therefore we were able to place reliance on these controls for the purposes of our audit. We examined and challenged the analyses performed by management which set out the basis for their judgements in respect of the material tax exposures identified, together with relevant supporting evidence such as correspondence with tax authorities and legal opinions obtained. We used our understanding of the business and also read correspondence with tax authorities to challenge the completeness of identified exposures and the need for provisions. We made our own assessment of the likelihood of the tax exposures occurring based on our knowledge of tax legislation and applicable precedent. In making our assessment we considered the range of interpretation of the applicable tax legislation in the relevant jurisdictions. We also evaluated the calculation of the exposures and agreed these to the financial statements. We assessed whether the extent of the disclosures made, in particular, in relation to contingent liabilities and judgements was appropriate. We found management's judgements in respect of the Group's positions on uncertain tax items to be reasonable.

Independent auditors' report to the members of Lloyds Banking Group plc continued

Area of focus	How our audit addressed the area of focus
Significant transactions *Refer to page 72 (Audit Committee Report).* The Group has entered into a number of significant one-off transactions where a high level of complexity and/or judgement is involved in determining the accounting treatment resulting in an increased risk of management bias. (e.g. the redemption of ECN's and the reclassification of gilts from held-to-maturity to available-for-sale). Due to the nature of these transactions, the accounting falls outside of the business as usual process level controls and requires manual calculations to be performed. The design of the initial accounting treatment may form the basis for subsequent periods for long dated transactions.	We understood and tested key controls which require that one-off transactions are referred to Group Financial Reporting and an accounting paper prepared. We found the key controls were designed, implemented and operated effectively. We reviewed the accounting papers produced for each significant transaction in the year including any transaction documents or contracts to evaluate and assess the impact of the transaction on the Group. We made our own assessment as to the most appropriate accounting treatment for each individual significant transaction, using this as a basis to challenge the key judgements made by management, including the assessment of any potential management bias. We assessed whether the extent of the disclosures made, in relation to significant transactions was appropriate. Based on the results of our audit work we concluded that the accounting treatment applied to significant transactions entered into in the year is reasonable.
Privileged access to IT systems The Group's financial reporting processes are heavily reliant on automated processes and controls performed by IT systems. As part of the audit, we validate the design and operating effectiveness of in-scope automated and IT dependent controls at a point in time as well as review the supporting IT General Computer Controls (ITGCs) that provide assurance over the continued integrity of these controls for the full financial reporting period. In our 2015 audit, we identified control matters in relation to the management of IT privileged access to IT systems and therefore relied on compensating controls and performed additional procedures. While there is an ongoing programme of activities to address such control matters, their exercise during 2016 meant there was an increased risk that the data and reports from the affected systems were not reliable.	We understood and tested key controls surrounding Group IT's central process for the periodic recertification of user access entitlements across in-scope systems as well as reviewed the processes for managing privileged access to IT systems. We have observed significant progress in terms of remediating the control matters, however several of the controls did not operate effectively for the full financial reporting period. Where these control matters affected applications and supporting IT systems within the scope of our audit, we performed a combination of additional controls testing, including compensating controls where relevant and substantive audit procedures. On the basis of our additional audit testing we were able to place reliance on the data and reports from in-scope applications.

Going concern

Under the Listing Rules we are required to review the directors' statement, set out on page 82, in relation to going concern. We have nothing to report having performed our review.

Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the directors' statement about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements. We have nothing material to add or to draw attention to.

As noted in the directors' statement, the directors have concluded that it is appropriate to adopt the going concern basis in preparing the financial statements. The going concern basis presumes that the Group and parent company have adequate resources to remain in operation, and that the directors intend them to do so, for at least one year from the date the financial statements were signed. In drawing this conclusion the directors have considered:

– the regulatory capital position of the Group which is critical to the market maintaining confidence in the Group's ability to absorb losses that it may incur in a market stress; and
– the funding and liquidity position of the Group to be able to meet its liabilities as they fall due, including in a market stress.

As part of our audit we have concluded that the directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and parent company's ability to continue as a going concern.

In drawing our conclusion, we critically assessed the going concern assessment undertaken by management and approved by the Board or directors. As part of our assessment we have:

– assessed and challenged the appropriateness of the stress scenarios used and their impact on the Group's and parent company's capital and liquidity positions;
– understood and challenged key economic and other assumptions used in both the capital and liquidity plan and the Group's operating plan; and
– substantiated the Group's and parent company's unencumbered collateral position and potential to access central bank liquidity facilities.

OTHER REQUIRED REPORTING

Consistency of other information and compliance with applicable requirements

Companies Act 2006 reporting

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' Report. We have nothing to report in this respect.

ISAs (UK & Ireland) reporting

Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

– information in the Annual Report is: – materially inconsistent with the information in the audited financial statements; or – apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group and parent company acquired in the course of performing our audit; or – otherwise misleading.	We have no exceptions to report arising from this responsibility.
– the statement given by the directors on page 83, in accordance with provision C.1.1 of the UK Corporate Governance Code (the 'Code'), that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the Group's and parent company's position and performance, business model and strategy is materially inconsistent with our knowledge of the Group and parent company acquired in the course of performing our audit.	We have no exceptions to report arising from this responsibility.
– the section of the Annual Report on page 72, as required by provision C.3.8 of the Code, describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.	We have no exceptions to report arising from this responsibility.

The directors' assessment of the prospects of the Group and of the principal risks that would threaten the solvency or liquidity of the Group

Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to:

– the directors' confirmation on page 83 of the Annual Report, in accordance with provision C.2.1 of the Code, that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity.	We have nothing material to add or draw attention to.
– the disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.	We have nothing material to add or draw attention to.
– the directors' explanation on page 82 of the Annual Report, in accordance with provision C.2.2 of the Code, as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.	We have nothing material to add or draw attention to.

Under the Listing Rules we are required to review the directors' statement that they have carried out a robust assessment of the principal risks facing the Group and the directors' statement in relation to the longer-term viability of the Group. Our review was substantially less in scope than an audit and only consisted of making inquiries and considering the directors' process supporting their statements; checking that the statements are in alignment with the relevant provisions of the Code; and considering whether the statements are consistent with the knowledge acquired by us in the course of performing our audit. We have nothing to report having performed our review.

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Independent auditors' report to the members of Lloyds Banking Group plc continued

Directors' remuneration

Directors' remuneration report - Companies Act 2006 opinion

In our opinion, the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

Other Companies Act 2006 reporting

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Corporate governance statement

Under the Companies Act 2006 we are required to report to you if, in our opinion, a corporate governance statement has not been prepared by the parent company. We have no exceptions to report arising from this responsibility.

Under the Listing Rules we are required to review the part of the corporate governance statement relating to ten further provisions of the Code. We have nothing to report having performed our review.

RESPONSIBILITIES FOR THE FINANCIAL STATEMENTS AND THE AUDIT

Our responsibilities and those of the directors

As explained more fully in the Statement of directors' responsibilities set out on page 83, 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 ISAs (UK & 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 parent company'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.

Mark Hannam (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
21 February 2017

(a) The maintenance and integrity of the Lloyds Banking Group plc website is the responsibility of the 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

	Note	2016 £ million	2015 £ million	2014 £ million
Interest and similar income		16,620	17,615	19,211
Interest and similar expense		(7,346)	(6,297)	(8,551)
Net interest income	5	9,274	11,318	10,660
Fee and commission income		3,045	3,252	3,659
Fee and commission expense		(1,356)	(1,442)	(1,402)
Net fee and commission income	6	1,689	1,810	2,257
Net trading income	7	18,545	3,714	10,159
Insurance premium income	8	8,068	4,792	7,125
Other operating income	9	2,035	1,516	(309)
Other income		30,337	11,832	19,232
Total income		39,611	23,150	29,892
Insurance claims	10	(22,344)	(5,729)	(13,493)
Total income, net of insurance claims		17,267	17,421	16,399
Regulatory provisions		(2,024)	(4,837)	(3,125)
Other operating expenses		(10,253)	(10,550)	(10,760)
Total operating expenses	11	(12,277)	(15,387)	(13,885)
Trading surplus		4,990	2,034	2,514
Impairment	12	(752)	(390)	(752)
Profit before tax		4,238	1,644	1,762
Taxation	13	(1,724)	(688)	(263)
Profit for the year		2,514	956	1,499
Profit attributable to ordinary shareholders		2,001	466	1,125
Profit attributable to other equity holders[1]		412	394	287
Profit attributable to equity holders		2,413	860	1,412
Profit attributable to non-controlling interests		101	96	87
Profit for the year		2,514	956	1,499
Basic earnings per share	14	2.9p	0.8p	1.7p
Diluted earnings per share	14	2.9p	0.8p	1.6p

1 The profit after tax attributable to other equity holders of £412 million (2015: £394 million; 2014: £287 million) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £91 million (2015: £80 million; 2014: £62 million).

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

Consolidated statement of comprehensive income

for the year ended 31 December

	2016 £ million	2015 £ million	2014 £ million
Profit for the year	**2,514**	956	1,499
Other comprehensive income			
Items that will not subsequently be reclassified to profit or loss:			
Post-retirement defined benefit scheme remeasurements:			
Remeasurements before taxation	**(1,348)**	(274)	674
Taxation	**320**	59	(135)
	(1,028)	(215)	539
Items that may subsequently be reclassified to profit or loss:			
Movements in revaluation reserve in respect of available-for-sale financial assets:			
Adjustment on transfer from held-to-maturity portfolio	**1,544**	–	–
Change in fair value	**356**	(318)	690
Income statement transfers in respect of disposals	**(575)**	(51)	(131)
Income statement transfers in respect of impairment	**173**	4	2
Taxation	**(301)**	(6)	(13)
	1,197	(371)	548
Movement in cash flow hedging reserve:			
Effective portion of changes in fair value taken to other comprehensive income	**2,432**	537	3,896
Net income statement transfers	**(557)**	(956)	(1,153)
Taxation	**(466)**	7	(549)
	1,409	(412)	2,194
Currency translation differences (tax: nil)	**(4)**	(42)	(3)
Other comprehensive income for the year, net of tax	**1,574**	(1,040)	3,278
Total comprehensive income for the year	**4,088**	(84)	4,777
Total comprehensive income attributable to ordinary shareholders	**3,575**	(574)	4,403
Total comprehensive income attributable to other equity holders	**412**	394	287
Total comprehensive income attributable to equity holders	**3,987**	(180)	4,690
Total comprehensive income attributable to non-controlling interests	**101**	96	87
Total comprehensive income for the year	**4,088**	(84)	4,777

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

Consolidated balance sheet

at 31 December

	Note	2016 £ million	2015 £ million
Assets			
Cash and balances at central banks		**47,452**	58,417
Items in the course of collection from banks		**706**	697
Trading and other financial assets at fair value through profit or loss	15	**151,174**	140,536
Derivative financial instruments	16	**36,138**	29,467
Loans and receivables:			
Loans and advances to banks	17	**26,902**	25,117
Loans and advances to customers	18	**457,958**	455,175
Debt securities		**3,397**	4,191
		488,257	484,483
Available-for-sale financial assets	22	**56,524**	33,032
Held-to-maturity investments		**–**	19,808
Goodwill	23	**2,016**	2,016
Value of in-force business	24	**5,042**	4,596
Other intangible assets	25	**1,681**	1,838
Property, plant and equipment	26	**12,972**	12,979
Current tax recoverable		**28**	44
Deferred tax assets	37	**2,706**	4,010
Retirement benefit assets	36	**342**	901
Other assets	27	**12,755**	13,864
Total assets		**817,793**	806,688

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

Consolidated balance sheet continued

at 31 December

Equity and liabilities	Note	2016 £ million	2015 £ million
Liabilities			
Deposits from banks	28	**16,384**	16,925
Customer deposits	29	**415,460**	418,326
Items in course of transmission to banks		**548**	717
Trading and other financial liabilities at fair value through profit or loss	30	**54,504**	51,863
Derivative financial instruments	16	**34,924**	26,301
Notes in circulation		**1,402**	1,112
Debt securities in issue	31	**76,314**	82,056
Liabilities arising from insurance contracts and participating investment contracts	32	**94,390**	80,294
Liabilities arising from non-participating investment contracts	34	**20,112**	22,777
Other liabilities	35	**29,193**	29,661
Retirement benefit obligations	36	**822**	365
Current tax liabilities		**226**	279
Deferred tax liabilities	37	**–**	33
Other provisions	38	**4,868**	5,687
Subordinated liabilities	39	**19,831**	23,312
Total liabilities		**768,978**	759,708
Equity			
Share capital	40	**7,146**	7,146
Share premium account	41	**17,622**	17,412
Other reserves	42	**14,652**	12,260
Retained profits	43	**3,600**	4,416
Shareholders' equity		**43,020**	41,234
Other equity instruments	44	**5,355**	5,355
Total equity excluding non-controlling interests		**48,375**	46,589
Non-controlling interests		**440**	391
Total equity		**48,815**	46,980
Total equity and liabilities		**817,793**	806,688

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

The directors approved the consolidated financial statements on 21 February 2017.

Lord Blackwell
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Chief Financial Officer

Consolidated statement of changes in equity

for the year ended 31 December

	Attributable to equity shareholders						
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2016	**24,558**	**12,260**	**4,416**	**41,234**	**5,355**	**391**	**46,980**
Comprehensive income							
Profit for the year	–	–	2,413	2,413	–	101	2,514
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(1,028)	(1,028)	–	–	(1,028)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	1,197	–	1,197	–	–	1,197
Movements in cash flow hedging reserve, net of tax	–	1,409	–	1,409	–	–	1,409
Currency translation differences (tax: £nil)	–	(4)	–	(4)	–	–	(4)
Total other comprehensive income	–	2,602	(1,028)	1,574	–	–	1,574
Total comprehensive income	–	2,602	1,385	3,987	–	101	4,088
Transactions with owners							
Dividends	–	–	(2,014)	(2,014)	–	(29)	(2,043)
Distributions on other equity instruments, net of tax	–	–	(321)	(321)	–	–	(321)
Redemption of preference shares	210	(210)	–	–	–	–	–
Movement in treasury shares	–	–	(175)	(175)	–	–	(175)
Value of employee services:							
Share option schemes	–	–	141	141	–	–	141
Other employee award schemes	–	–	168	168	–	–	168
Changes in non-controlling interests	–	–	–	–	–	(23)	(23)
Total transactions with owners	210	(210)	(2,201)	(2,201)	–	(52)	(2,253)
Balance at 31 December 2016	24,768	14,652	3,600	43,020	5,355	440	48,815

Further details of movements in the Group's share capital, reserves and other equity instruments are provided in notes 40, 41, 42, 43 and 44.

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

Consolidated statement of changes in equity continued

for the year ended 31 December

	Attributable to equity shareholders						
	Share capital and premium £ million	Other reserves £ million	Retained profits £ million	Total £ million	Other equity instruments £ million	Non-controlling interests £ million	Total £ million
Balance at 1 January 2014	24,424	10,477	4,088	38,989	–	347	39,336
Comprehensive income							
Profit for the year	–	–	1,412	1,412	–	87	1,499
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	539	539	–	–	539
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	548	–	548	–	–	548
Movements in cash flow hedging reserve, net of tax	–	2,194	–	2,194	–	–	2,194
Currency translation differences (tax: £nil)	–	(3)	–	(3)	–	–	(3)
Total other comprehensive income	–	2,739	539	3,278	–	–	3,278
Total comprehensive income	–	2,739	1,951	4,690	–	87	4,777
Transactions with owners							
Dividends	–	–	–	–	–	(27)	(27)
Distributions on other equity instruments, net of tax	–	–	(225)	(225)	–	–	(225)
Issue of ordinary shares	3	–	–	3	–	–	3
Issue of other equity instruments	–	–	(21)	(21)	5,355	–	5,334
Movement in treasury shares	–	–	(286)	(286)	–	–	(286)
Value of employee services:							
Share option schemes	–	–	123	123	–	–	123
Other employee award schemes	–	–	233	233	–	–	233
Adjustment on sale of non-controlling interest in TSB Banking Group plc	–	–	(171)	(171)	–	805	634
Other changes in non-controlling interests	–	–	–	–	–	1	1
Total transactions with owners	3	–	(347)	(344)	5,355	779	5,790
Balance at 31 December 2014	24,427	13,216	5,692	43,335	5,355	1,213	49,903
Comprehensive income							
Profit for the year	–	–	860	860	–	96	956
Other comprehensive income							
Post-retirement defined benefit scheme remeasurements, net of tax	–	–	(215)	(215)	–	–	(215)
Movements in revaluation reserve in respect of available-for-sale financial assets, net of tax	–	(371)	–	(371)	–	–	(371)
Movements in cash flow hedging reserve, net of tax	–	(412)	–	(412)	–	–	(412)
Currency translation differences (tax: £nil)	–	(42)	–	(42)	–	–	(42)
Total other comprehensive income	–	(825)	(215)	(1,040)	–	–	(1,040)
Total comprehensive income	–	(825)	645	(180)	–	96	(84)
Transactions with owners							
Dividends	–	–	(1,070)	(1,070)	–	(52)	(1,122)
Distributions on other equity instruments, net of tax	–	–	(314)	(314)	–	–	(314)
Redemption of preference shares	131	(131)	–	–	–	–	–
Movement in treasury shares	–	–	(816)	(816)	–	–	(816)
Value of employee services:							
Share option schemes	–	–	107	107	–	–	107
Other employee award schemes	–	–	172	172	–	–	172
Adjustment on sale of interest in TSB Banking Group plc	–	–	–	–	–	(825)	(825)
Other changes in non-controlling interests	–	–	–	–	–	(41)	(41)
Total transactions with owners	131	(131)	(1,921)	(1,921)	–	(918)	(2,839)
Balance at 31 December 2015	24,558	12,260	4,416	41,234	5,355	391	46,980

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

Consolidated cash flow statement

for the year ended 31 December

	Note	2016 £ million	2015 £ million	2014 £ million
Profit before tax		**4,238**	1,644	1,762
Adjustments for:				
Change in operating assets	53(A)	**(12,218)**	34,700	(872)
Change in operating liabilities	53(B)	**(2,659)**	(11,985)	11,992
Non-cash and other items	53(C)	**13,535**	(7,808)	(2,496)
Tax paid		**(822)**	(179)	(33)
Net cash provided by (used in) operating activities		**2,074**	16,372	10,353
Cash flows from investing activities				
Purchase of financial assets		**(4,930)**	(19,354)	(11,533)
Proceeds from sale and maturity of financial assets		**6,335**	22,000	4,668
Purchase of fixed assets		**(3,760)**	(3,417)	(3,442)
Proceeds from sale of fixed assets		**1,684**	1,537	2,043
Acquisition of businesses, net of cash acquired		**(20)**	(5)	(1)
Disposal of businesses, net of cash disposed	53(E)	**5**	(4,071)	543
Net cash used in investing activities		**(686)**	(3,310)	(7,722)
Cash flows from financing activities				
Dividends paid to ordinary shareholders		**(2,014)**	(1,070)	–
Distributions on other equity instruments		**(412)**	(394)	(287)
Dividends paid to non-controlling interests		**(29)**	(52)	(27)
Interest paid on subordinated liabilities		**(1,687)**	(1,840)	(2,205)
Proceeds from issue of subordinated liabilities		**1,061**	338	629
Proceeds from issue of ordinary shares		**–**	–	3
Repayment of subordinated liabilities		**(7,885)**	(3,199)	(3,023)
Changes in non-controlling interests		**(8)**	(41)	635
Net cash used in financing activities		**(10,974)**	(6,258)	(4,275)
Effects of exchange rate changes on cash and cash equivalents		**21**	2	(6)
Change in cash and cash equivalents		**(9,565)**	6,806	(1,650)
Cash and cash equivalents at beginning of year		**71,953**	65,147	66,797
Cash and cash equivalents at end of year	53(D)	**62,388**	71,953	65,147

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

Notes to the consolidated financial statements

NOTE 1: BASIS OF PREPARATION

The consolidated financial statements of Lloyds Banking Group plc have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board (IASB) and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee (IFRS IC) 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. As stated on page 82, the directors consider that it is appropriate to continue to adopt the going concern basis in preparing the financial statements.

During the year the Group has reviewed its holding of government securities classified as held-to-maturity in light of the current low interest rate environment and they have been reclassified as available-for-sale; this has resulted in a credit of £1,544 million to the available-for-sale revaluation reserve (£1,127 million after tax).

Details of those IFRS pronouncements which will be relevant to the Group but which were not effective at 31 December 2016 and which have not been applied in preparing these financial statements are given in note 55.

NOTE 2: ACCOUNTING POLICIES

The Group's accounting policies are set out below. These accounting policies have been applied consistently.

(A) Consolidation

The assets, liabilities and results of Group undertakings (including structured entities) are included in the financial statements on the basis of accounts made up to the reporting date. Group undertakings include subsidiaries, associates and joint ventures. Details of the Group's subsidiaries and related undertakings are given on pages 293 to 300.

(1) Subsidiaries

Subsidiaries are entities controlled by the Group. The Group controls an entity when it has power over the entity, is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through the exercise of its power. This generally accompanies a shareholding of more than one half of the voting rights although in certain circumstances a holding of less than one half of the voting rights may still result in the ability of the Group to exercise control. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to any of the above elements. Subsidiaries are fully consolidated from the date on which control is transferred to the Group; they are de-consolidated from the date that control ceases.

The Group consolidates collective investment vehicles if its beneficial ownership interests give it substantive rights to remove the external fund manager over the investment activities of the fund. Where a subsidiary of the Group is the fund manager of a collective investment vehicle, the Group considers a number of factors in determining whether it acts as principal, and therefore controls the collective investment vehicle, including: an assessment of the scope of the Group's decision making authority over the investment vehicle; the rights held by other parties including substantive removal rights without cause over the Group acting as fund manager; the remuneration to which the Group is entitled in its capacity as decision maker; and the Group's exposure to variable returns from the beneficial interest it holds in the investment vehicle. Consolidation may be appropriate in circumstances where the Group has less than a majority beneficial interest. Where a collective investment vehicle is consolidated the interests of parties other than the Group are reported in other liabilities and the movement in these interests in interest expense.

Structured entities are entities that are designed so that their activities are not governed by way of voting rights. In assessing whether the Group has power over such entities in which it has an interest, the Group considers factors such as the purpose and design of the entity; its practical ability to direct the relevant activities of the entity; the nature of the relationship with the entity; and the size of its exposure to the variability of returns of the entity.

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

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

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

(2) Joint ventures and associates

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

The Group utilises the venture capital exemption for investments where significant influence or joint control is present and the business unit operates as a venture capital business. These investments are designated at initial recognition at fair value through profit or loss. Otherwise, the Group's investments in joint ventures and associates are accounted for by the equity method of accounting.

NOTE 2: ACCOUNTING POLICIES continued

(B) Goodwill

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

Goodwill is recognised as an asset at cost and is tested at least annually for impairment. If an impairment is identified the carrying value of the goodwill is written down immediately through the income statement and is not subsequently reversed. At the date of disposal of a subsidiary, the carrying value of attributable goodwill is included in the calculation of the profit or loss on disposal.

(C) Other intangible assets

Intangible assets which have been determined to have a finite useful life are amortised on a straight line basis over their estimated useful life as follows: up to 7 years for capitalised software; 10 to 15 years for brands and other intangibles.

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

(D) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments using the effective interest method, except for those classified at fair value through profit or loss. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense over the expected life of the financial instrument. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability, including early redemption fees, and related penalties; and premiums and discounts that are an integral part of the overall return. Direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument are also taken into account.

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan once drawn. Where it is unlikely that loan commitments will be drawn, loan commitment fees are recognised over the life of the facility.

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

Revenue recognition policies specific to life insurance and general insurance business are detailed below (see (M) below); those relating to leases are set out in (J)(2) below.

(E) Financial assets and liabilities

On initial recognition, financial assets are classified into fair value through profit or loss, available-for-sale financial assets, held-to-maturity investments or loans and receivables. Financial liabilities are measured at amortised cost, except for trading liabilities and other financial liabilities designated at fair value through profit or loss on initial recognition which are held at fair value. The Group initially recognises loans and receivables, deposits, debt securities in issue and subordinated liabilities when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of securities and other financial assets and trading liabilities are recognised on trade date, being the date that the Group is committed to purchase or sell an asset.

Financial assets are derecognised when the contractual right to receive cash flows from those assets has expired or when the Group has transferred its contractual right to receive the cash flows from the assets and either: substantially all of the risks and rewards of ownership have been transferred; or the Group has neither retained nor transferred substantially all of the risks and rewards, but has transferred control.

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

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

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

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

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

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

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES continued

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using valuation techniques. Refer to note 49(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

(2) Available-for-sale financial assets

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

The Group is permitted to transfer a financial asset from the available-for-sale category to the loans and receivables category where that asset would otherwise have met the definition of loans and receivables at the time of reclassification and where there is both the intention and ability to hold that financial asset for the foreseeable future. Reclassification of a financial asset from the available-for-sale category to the held-to-maturity category is permitted when the Group has the ability and intent to hold that financial asset to maturity. Reclassifications are made at fair value as of the reclassification date. Fair value becomes the new cost or amortised cost as applicable. Effective interest rates for financial assets reclassified to the loans and receivables and held-to-maturity categories are determined at the reclassification date. Any previous gain or loss on a transferred asset that has been recognised in equity is amortised to profit or loss over the remaining life of the investment using the effective interest method or until the asset becomes impaired. Any difference between the new amortised cost and the expected cash flows is also amortised over the remaining life of the asset using the effective interest method.

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

(3) Loans and receivables

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

The Group has entered into securitisation and similar transactions to finance certain loans and advances to customers. In cases where the securitisation vehicles are funded by the issue of debt, on terms whereby the majority of the risks and rewards of the portfolio of securitised lending are retained by the Group, these loans and advances continue to be recognised by the Group, together with a corresponding liability for the funding.

(4) 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: those that the Group designates upon initial recognition as at fair value through profit or loss; those that the Group designates as available-for-sale; and 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.

A sale or reclassification of a more than insignificant amount of held-to-maturity investments would result in the reclassification of all held-to-maturity investments to available-for-sale financial assets.

(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. Securities which carry a discretionary coupon and have no fixed maturity or redemption date are classified as other equity instruments. Interest payments on these securities are recognised, net of tax, as distributions from equity in the period in which they are paid. An exchange of financial liabilities on substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability extinguished and the new financial liability is recognised in profit or loss together with any related costs or fees incurred.

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

(6) Sale and repurchase agreements (including securities lending and borrowing)

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

Securities borrowing and lending transactions are typically secured; collateral takes the form of securities or cash advanced or received. Securities lent to counterparties are retained on the balance sheet. Securities borrowed are not recognised on the balance sheet, unless these are sold to third parties, in which case the obligation to return them is recorded at fair value as a trading liability. Cash collateral given or received is treated as a loan and receivable or customer deposit.

NOTE 2: ACCOUNTING POLICIES continued

(F) Derivative financial instruments and hedge accounting

Derivatives are classified as trading except those designated as effective hedging instruments which meet the criteria under IAS 39. All derivatives are recognised at their fair value. Derivatives are carried in the balance sheet as assets when their fair value is positive and as liabilities when their fair value is negative. Refer to note 49(3) (Financial instruments: Financial assets and liabilities carried at fair value) for details of valuation techniques and significant inputs to valuation models.

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

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

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

(1) Fair value hedges

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

(2) Cash flow hedges

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

(3) Net investment hedges

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

(G) Offset

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

(H) Impairment of financial assets

(1) Assets accounted for at amortised cost

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

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

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

Impairment allowances are assessed individually for financial assets that are individually significant. Impairment allowances for portfolios of smaller balance homogenous loans such as most residential mortgages, personal loans and credit card balances that are below the individual assessment thresholds, and for loan losses that have been incurred but not separately identified at the balance sheet date, are determined on a collective basis.

In certain circumstances, the Group will renegotiate the original terms of a customer's loan, either as part of an ongoing customer relationship or in response to adverse changes in the circumstances of the borrower. Where the renegotiated payments of interest and principal will not recover the original carrying value of the asset, the asset continues to be reported as past due and is considered impaired. Where the renegotiated payments of interest and principal will recover the original carrying value of the asset, the loan is no longer reported as past due or impaired provided that payments are made in accordance with the revised terms. Renegotiation may lead to the loan and associated provision being derecognised and a new loan being recognised initially at fair value.

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES continued

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. For both secured and unsecured retail balances, the write-off takes place only once an extensive set of collections processes has been completed, or the status of the account reaches a point where policy dictates that forbearance is no longer appropriate. For commercial lending, a write-off occurs if the loan facility with the customer is restructured, the asset is under administration and the only monies that can be received are the amounts estimated by the administrator, the underlying assets are disposed and a decision is made that no further settlement monies will be received, or external evidence (for example, third party valuations) is available that there has been an irreversible decline in expected cash flows.

(2) Available-for-sale financial assets

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

(I) Property, plant and equipment

Property, plant and equipment (other than investment property) is included at cost less accumulated depreciation. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows: the shorter of 50 years and the remaining period of the lease for freehold/long and short leasehold premises; the shorter of 10 years and, if lease renewal is not likely, the remaining period of the lease for leasehold improvements; 10 to 20 years for fixtures and furnishings; and 2 to 8 years for other equipment and motor vehicles.

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

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

Investment property comprises freehold and long leasehold land and buildings that are held either to earn rental income or for capital accretion or both, primarily within the life insurance funds. In accordance with the guidance published by the Royal Institution of Chartered Surveyors, investment property is carried at fair value based on current prices for similar properties, adjusted for the specific characteristics of the property (such as location or condition). If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets. These valuations are reviewed at least annually by independent professionally qualified valuers. Investment property being redeveloped for continuing use as investment property, or for which the market has become less active, continues to be valued at fair value.

(J) Leases

(1) As lessee

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

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

(2) As lessor

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

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

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

(K) Employee benefits

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services.

(1) Pension schemes

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

NOTE 2: ACCOUNTING POLICIES continued

Scheme assets are included at their fair value and scheme liabilities are measured on an actuarial basis using the projected unit credit method. The defined benefit scheme liabilities are discounted using rates equivalent to the market yields at the balance sheet date on high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. The Group's income statement charge includes the current service cost of providing pension benefits, past service costs, net interest expense (income), and plan administration costs that are not deducted from the return on plan assets. Past service costs, which represents the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment, are recognised when the plan amendment or curtailment occurs. Net interest expense (income) is calculated by applying the discount rate at the beginning of the period to the net defined benefit liability or asset.

Remeasurements, comprising actuarial gains and losses, the return on plan assets (excluding amounts included in net interest expense (income) and net of the cost of managing the plan assets), and the effect of changes to the asset ceiling (if applicable) are reflected immediately in the balance sheet with a charge or credit recognised in other comprehensive income in the period in which they occur. Remeasurements recognised in other comprehensive income are reflected immediately in retained profits and will not subsequently be reclassified to profit or loss.

The Group's balance sheet includes the net surplus or deficit, being the difference between the fair value of scheme assets and the discounted value of scheme liabilities at the balance sheet date. Surpluses are only recognised to the extent that they are recoverable through reduced contributions in the future or through refunds from the schemes. In assessing whether a surplus is recoverable, the Group considers its current right to obtain a refund or a reduction in future contributions and does not anticipate any future acts by other parties that could change the amount of the surplus that may ultimately be recovered.

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

(2) Share-based compensation

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

(L) Taxation

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

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. Dependent on their complexity, provisions are based on management's interpretation of the relevant tax legislation, precedents and guidance as well as external tax advice. The provision is the best estimate of the consideration expected to be required to settle the particular obligation taking into account management's judgement of the relevant risks and uncertainties.

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 shareholders' 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 substantively 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.

(M) Insurance

The Group undertakes both life insurance and general insurance business. Insurance and participating investment contracts are accounted for under IFRS 4 *Insurance Contracts*, which permits (with certain exceptions) the continuation of accounting practices for measuring insurance and participating investment contracts that applied prior to the adoption of IFRS. The Group, therefore, continues to account for these products using UK GAAP and UK established practice.

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

- Insurance contracts – these contracts transfer significant insurance risk and may also transfer financial risk. The Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event which are significantly more than the benefits payable if the insured event were not to occur. These contracts may or may not include discretionary participation features.
- Investment contracts containing a discretionary participation feature (participating investment contracts) – these contracts do not transfer significant insurance risk, but contain a contractual right which gives the holder the right to receive, in addition to the guaranteed benefits, further additional

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Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES continued

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.

(1) Life insurance business

(i) Accounting for insurance and participating investment contracts

Premiums and claims

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

Liabilities

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

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

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

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

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

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

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

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

Unallocated surplus

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

(ii) Accounting for non-participating investment contracts

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

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

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

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

(iii) Value of in-force business

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

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

NOTE 2: ACCOUNTING POLICIES continued

(2) General insurance business

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

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

(3) Liability adequacy test

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

(4) Reinsurance

Contracts entered into by the Group with reinsurers under which the Group is compensated for benefits payable on one or more contracts issued by the Group are recognised as assets arising from reinsurance contracts held. Where the underlying contracts issued by the Group are classified as insurance contracts and the reinsurance contract transfers significant insurance risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as insurance contracts. Where the underlying contracts issued by the Group are classified as non-participating investment contracts and the reinsurance contract transfers financial risk on those contracts to the reinsurer, the assets arising from reinsurance contracts held are classified as non-participating investment contracts.

Assets arising from reinsurance contracts held – Classified as insurance contracts

Amounts recoverable from or due to reinsurers are measured consistently with the amounts associated with the reinsured contracts and in accordance with the terms of each reinsurance contract and are regularly reviewed for impairment. Premiums payable for reinsurance contracts are recognised as an expense when due within insurance premium income. Changes in the reinsurance recoverable assets are recognised in the income statement through insurance claims.

Assets arising from reinsurance contracts held – Classified as non-participating investment contracts

These contracts are accounted for as financial assets whose value is contractually linked to the fair values of financial assets within the reinsurers' investment funds. Investment returns (including movements in fair value and investment income) allocated to these contracts are recognised in insurance claims. Deposits and withdrawals are not accounted for through the income statement but are accounted for directly in the balance sheet as adjustments to the assets arising from reinsurance contracts held.

(N) Foreign currency translation

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

The results and financial position of all group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows: the assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on the acquisition of a foreign entity, are translated into sterling at foreign exchange rates ruling at the balance sheet date; and the income and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions in which case income and expenses are translated at the dates of the transactions.

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

(O) Provisions and contingent liabilities

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

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

Provision is made for irrevocable undrawn loan commitments if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

Notes to the consolidated financial statements continued

NOTE 2: ACCOUNTING POLICIES continued

(P) Share capital

Incremental costs directly attributable to the issue of new shares or options or to the acquisition of a business are shown in equity as a deduction, net of tax, from the proceeds. Dividends paid on the Group's ordinary shares are recognised as a reduction in equity in the period in which they are paid.

Where the Company or any member of the Group purchases the Company's share capital, the consideration paid is deducted from shareholders' equity as treasury shares until they are cancelled; if these shares are subsequently sold or reissued, any consideration received is included in shareholders' equity.

(Q) Cash and cash equivalents

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

NOTE 3: CRITICAL ACCOUNTING ESTIMATES

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

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

- Allowance for impairment losses on loans and receivables (note 21);
- Valuation of assets and liabilities arising from insurance business (notes 24 and 32);
- Defined benefit pension scheme obligations (note 36);
- Recoverability of deferred tax assets (note 37);
- Payment protection insurance and other regulatory provisions (note 38); and
- Fair value of financial instruments (note 49).

NOTE 4: SEGMENTAL ANALYSIS

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

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

The segmental results and comparatives are presented on an underlying basis, the basis reviewed by the chief operating decision maker. The effects of the following are excluded in arriving at underlying profit:

- losses on redemption of the Enhanced Capital Notes and the volatility in the value of the embedded equity conversion feature;
- market volatility and other items, which includes the effects of certain asset sales, the volatility relating to the Group's own debt and hedging arrangements as well as that arising in the insurance businesses, insurance gross up, the unwind of acquisition-related fair value adjustments and the amortisation of purchased intangible assets;
- restructuring costs, (which in 2015 and 2016 comprised severance related costs relating to the Simplification programme announced in October 2014 and in 2014 included severance, IT and business costs relating to the programme started in 2011) and the costs of implementing regulatory reform and ring-fencing;
- TSB build and dual running costs and the loss relating to the TSB sale in 2015;
- payment protection insurance and other conduct provisions; and
- certain past service pension credits or charges.

The Group's activities are organised into four financial reporting segments: Retail; Commercial Banking; Consumer Finance and Insurance. The Group's unsecured personal lending portfolio, previously part of Retail, is now managed by Consumer Finance and elements of the Group's business in the Channel Islands and Isle of Man were transferred from Retail to Commercial Banking; comparatives have been restated accordingly.

Retail offers a broad range of financial service products, including current accounts, savings and mortgages, to UK personal customers, including wealth and small business customers. It is also a distributor of insurance and a range of long-term savings and investment products.

Commercial Banking is client-led, helping UK-based clients and international clients with a link to the UK. Through its four client facing divisions – SME, Mid Markets, Global Corporates and Financial Institutions – it provides clients with a range of products and services such as lending, transactional banking, working capital management, risk management, debt capital markets services, as well as access to private equity through Lloyds Development Capital.

Consumer Finance comprises all the Group's consumer lending products including motor finance, credit cards, and unsecured personal loans along with its European business.

Insurance provides a range of protection, pension and investment products to meet the needs of its customers.

Other includes certain assets previously reported as outside of the Group's risk appetite and the results of businesses disposed. Other also includes income and expenditure not recharged to divisions, including the costs of certain central and head office functions and the costs of managing the Group's technology platforms, branch and head office property estate, operations (including payments, banking operations and collections) and sourcing, the costs of which are predominantly recharged to the other divisions. It also reflects other items not recharged to the divisions.

NOTE 4: SEGMENTAL ANALYSIS continued

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 the majority of those derivative contracts entered into by business units for risk management purposes, the business unit recognises the net interest income or expense on an accrual accounting basis and transfers the remainder of the movement in the fair value of the derivative to the central group segment where the resulting accounting volatility is managed where possible through the establishment of hedge accounting relationships. Any change in fair value of the hedged instrument attributable to the hedged risk is also recorded within the central group segment. This allocation of the fair value of the derivative and change in fair value of the hedged instrument attributable to the hedged risk avoids accounting asymmetry in segmental results and leads to accounting volatility, which is managed centrally and reported within Other.

	Retail £m	Commercial Banking £m	Consumer Finance £m	Insurance £m	Other £m	Underlying basis total £m
Year ended 31 December 2016						
Net interest income	6,497	2,735	1,941	(146)	408	11,435
Other income, net of insurance claims	1,053	1,987	1,338	1,755	(68)	6,065
Total underlying income, net of insurance claims	7,550	4,722	3,279	1,609	340	17,500
Operating lease depreciation[1]	–	(105)	(775)	–	(15)	(895)
Net income	7,550	4,617	2,504	1,609	325	16,605
Operating costs	(4,174)	(2,133)	(939)	(772)	(75)	(8,093)
Impairment	(373)	(16)	(282)	–	26	(645)
Underlying profit (loss)	3,003	2,468	1,283	837	276	7,867
External income	8,460	3,668	3,885	1,311	176	17,500
Inter-segment income	(910)	1,054	(606)	298	164	–
Segment underlying income, net of insurance claims	7,550	4,722	3,279	1,609	340	17,500
Segment external assets	300,085	188,296	40,992	153,936	134,484	817,793
Segment customer deposits	271,005	132,628	7,920	–	3,907	415,460
Segment external liabilities	275,006	221,395	12,494	146,836	113,247	768,978
Other segment items reflected in income statement above:						
Depreciation and amortisation	459	286	888	168	579	2,380
Increase in value of in-force business	–	–	–	472	–	472
Defined benefit scheme charges	134	45	10	13	85	287
Other segment items:						
Additions to fixed assets	278	126	2,086	481	789	3,760
Investments in joint ventures and associates at end of year	1	–	5	–	53	59

1 Net of profits on disposal of operating lease assets of £58 million.

Notes to the consolidated financial statements continued

NOTE 4: SEGMENTAL ANALYSIS continued

	Retail[1] £m	Commercial Banking[1] £m	Consumer Finance[1] £m	Insurance £m	Other £m	Underlying basis total £m
Year ended 31 December 2015						
Net interest income	6,664	2,576	1,954	(163)	451	11,482
Other income, net of insurance claims	1,115	2,072	1,359	1,827	(218)	6,155
Total underlying income, net of insurance claims	7,779	4,648	3,313	1,664	233	17,637
Operating lease depreciation[2]	–	(30)	(720)	–	(14)	(764)
Net income	7,779	4,618	2,593	1,664	219	16,873
Operating costs	(4,339)	(2,162)	(977)	(702)	(131)	(8,311)
Impairment	(349)	22	(235)	–	(6)	(568)
TSB	–	–	–	–	118	118
Underlying profit	3,091	2,478	1,381	962	200	8,112
External income	8,545	3,636	3,772	2,065	(381)	17,637
Inter-segment income	(766)	1,012	(459)	(401)	614	–
Segment underlying income, net of insurance claims	7,779	4,648	3,313	1,664	233	17,637
Segment external assets	307,887	178,838	36,501	143,217	140,245	806,688
Segment customer deposits	273,719	131,998	11,082	–	1,527	418,326
Segment external liabilities	278,933	226,106	15,462	137,233	101,974	759,708
Other segment items reflected in income statement above:						
Depreciation and amortisation	408	204	839	124	537	2,112
Decrease in value of in-force business	–	–	–	(162)	–	(162)
Defined benefit scheme charges	123	30	9	11	142	315
Other segment items:						
Additions to fixed assets	383	153	1,752	343	786	3,417
Investments in joint ventures and associates at end of year	1	–	4	–	42	47

1 Restated – see page 194.
2 Net of profits on disposal of operating lease assets of £66 million.

	Retail[1] £m	Commercial Banking[1] £m	Consumer Finance[1] £m	Insurance £m	Other £m	Underlying basis total £m
Year ended 31 December 2014						
Net interest income	6,270	2,542	2,037	(131)	257	10,975
Other income, net of insurance claims	1,202	1,962	1,368	1,725	210	6,467
Total underlying income, net of insurance claims	7,472	4,504	3,405	1,594	467	17,442
Operating lease depreciation[2]	–	(24)	(667)	–	(29)	(720)
Net income	7,472	4,480	2,738	1,594	438	16,722
Operating costs	(4,239)	(2,139)	(971)	(672)	(301)	(8,322)
Impairment	(494)	(85)	(318)	–	(205)	(1,102)
TSB	–	–	–	–	458	458
Underlying profit	2,739	2,256	1,449	922	390	7,756
External income	8,083	3,810	3,744	1,206	599	17,442
Inter-segment income	(611)	694	(339)	388	(132)	–
Segment underlying income, net of insurance claims	7,472	4,504	3,405	1,594	467	17,442
Segment external assets	308,414	242,452	33,781	150,615	119,634	854,896
Segment customer deposits	279,148	126,273	14,955	–	26,691	447,067
Segment external liabilities	289,442	237,764	18,629	144,921	114,237	804,993
Other segment items reflected in income statement above:						
Depreciation and amortisation	335	158	778	130	194	1,595
Decrease in value of in-force business	–	–	–	(428)	–	(428)
Defined benefit scheme charges	121	37	9	9	168	344
Other segment items:						
Additions to fixed assets	368	245	1,642	449	738	3,442
Investments in joint ventures and associates at end of year	1	–	9	–	64	74

1 Restated – see page 194.
2 Net of profits on disposal of operating lease assets of £67 million.

NOTE 4: SEGMENTAL ANALYSIS continued

Reconciliation of underlying basis to statutory results

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

	Lloyds Banking Group statutory £m	Removal of: Volatility and other items[1] £m	Insurance gross up[2] £m	PPI £m	Other conduct provisions £m	Underlying basis £m
Year ended 31 December 2016						
Net interest income	9,274	263	1,898	–	–	11,435
Other income, net of insurance claims	7,993	121	(2,110)	–	61	6,065
Total income, net of insurance claims	17,267	384	(212)	–	61	17,500
Operating lease depreciation[3]		(895)	–	–	–	(895)
Net income	17,267	(511)	(212)	–	61	16,605
Operating expenses	(12,277)	1,948	212	1,000	1,024	(8,093)
Impairment	(752)	107	–	–	–	(645)
Profit before tax	4,238	1,544	–	1,000	1,085	7,867

	Lloyds Banking Group statutory £m	Removal of: Volatility and other items[4] £m	TSB[5] £m	Insurance gross up[2] £m	PPI £m	Other conduct provisions £m	Underlying basis £m
Year ended 31 December 2015							
Net interest income	11,318	318	(192)	38	–	–	11,482
Other income, net of insurance claims	6,103	209	(31)	(126)	–	–	6,155
Total income, net of insurance claims	17,421	527	(223)	(88)	–	–	17,637
Operating lease depreciation[3]		(764)	–	–	–	–	(764)
Net income	17,421	(237)	(223)	(88)	–	–	16,873
Operating expenses	(15,387)	2,065	86	88	4,000	837	(8,311)
Impairment	(390)	(197)	19	–	–	–	(568)
TSB	–	–	118	–	–	–	118
Profit	1,644	1,631	–	–	4,000	837	8,112

	Lloyds Banking Group statutory £m	Removal of: Volatility and other items[6] £m	TSB[4] £m	Insurance gross up[2] £m	PPI £m	Other conduct provisions £m	Underlying basis £m
Year ended 31 December 2014							
Net interest income	10,660	619	(786)	482	–	–	10,975
Other income, net of insurance claims	5,739	1,482	(140)	(614)	–	–	6,467
Total income, net of insurance claims	16,399	2,101	(926)	(132)	–	–	17,442
Operating lease depreciation[3]		(720)	–	–	–	–	(720)
Net income	16,399	1,381	(926)	(132)	–	–	16,722
Operating expenses	(13,885)	1,936	370	132	2,200	925	(8,322)
Impairment	(752)	(448)	98	–	–	–	(1,102)
TSB	–	–	458	–	–	–	458
Profit	1,762	2,869	–	–	2,200	925	7,756

1 Comprises the write-off of the ECN embedded derivative and premium paid on redemption of the remaining notes in the first quarter (loss of £790 million); the effects of asset sales (gain of £217 million); volatile items (gain of £99 million); liability management (gain of £123 million); the amortisation of purchased intangibles (£340 million); restructuring costs (£622 million, principally comprising the severance related costs related to phase II of the Simplification programme); and the fair value unwind and other items (loss of £231 million).

2 The Group's insurance businesses' income statements include income and expenditure which are attributable to the policyholders of the Group's long-term assurance funds. These items have no impact in total upon the profit attributable to equity shareholders and, in order to provide a clearer representation of the underlying trends within the business, these items are shown net within the underlying results.

3 Net of profits on disposal of operating lease assets of £58 million (2015: £66 million; 2014: £67 million).

4 Comprises market movements on the ECN embedded derivative (loss of £101 million); the effects of asset sales (gain of £54 million); volatile items (loss of £107 million); liability management (loss of £28 million); the amortisation of purchased intangibles (£342 million); restructuring costs (£170 million); TSB costs (£745 million); and the fair value unwind and other items (loss of £192 million).

5 Comprises the underlying results of TSB.

6 Comprises the loss arising on the Group's exchange and tender offers in respect of its ECNs in April 2014 (£1,362 million); market movements on the ECN embedded derivative (gain of £401 million); the effects of asset sales (gain of £138 million); volatile items (loss of £343 million); liability management (loss of £24 million); the past service pension credit of £710 million (which represented the curtailment credit of £843 million following the group's decision to reduce the cap on pensionable pay partly offset by the cost of other changes to the pay, benefits and reward offered to employees); the amortisation of purchased intangibles (£336 million); restructuring costs (£966 million); and TSB costs (£558 million); and the fair value unwind and other items (loss of £529 million).

Notes to the consolidated financial statements continued

Geographical areas

Following the reduction in the Group's non-UK activities, an analysis between UK and non-UK activities is no longer provided.

NOTE 5: NET INTEREST INCOME

	Weighted average effective interest rate					
	2016 %	2015 %	2014 %	**2016 £m**	2015 £m	2014 £m
Interest and similar income:						
Loans and advances to customers	**3.32**	3.50	3.53	**15,190**	16,256	17,806
Loans and advances to banks	**0.46**	0.42	0.52	**381**	397	406
Debt securities held as loans and receivables	**1.47**	1.87	2.57	**56**	40	42
Interest receivable on loans and receivables	**2.87**	2.98	3.12	**15,627**	16,693	18,254
Available-for-sale financial assets	**1.88**	1.77	1.90	**762**	725	957
Held-to-maturity investments	**1.44**	1.49	–	**231**	197	–
Total interest and similar income	**2.77**	2.86	3.03	**16,620**	17,615	19,211
Interest and similar expense:						
Deposits from banks, excluding liabilities under sale and repurchase transactions[1]	**0.65**	0.41	0.74	**(68)**	(43)	(86)
Customer deposits, excluding liabilities under sale and repurchase transactions	**0.69**	0.87	1.15	**(2,520)**	(3,299)	(4,781)
Debt securities in issue[2]	**0.94**	0.69	0.63	**(799)**	(586)	(552)
Subordinated liabilities	**8.35**	8.37	8.44	**(1,864)**	(2,091)	(2,475)
Liabilities under sale and repurchase agreements	**0.46**	0.57	2.61	**(38)**	(34)	(55)
Interest payable on liabilities held at amortised cost	**1.07**	1.19	1.45	**(5,289)**	(6,053)	(7,949)
Amounts payable to unitholders in consolidated open-ended investment vehicles	**10.85**	1.16	3.23	**(2,057)**	(244)	(602)
Total interest and similar expense	**1.44**	1.19	1.51	**(7,346)**	(6,297)	(8,551)
Net interest income				**9,274**	11,318	10,660

1 Includes £51 million (2015: £nil; 2014: £nil) of interest expense on assets with negative interest rates.

2 The impact of the Group's hedging arrangements is included on this line; excluding this impact the weighted average effective interest rate in respect of debt securities in issue would be 2.70 per cent (2015: 2.76 per cent; 2014: 3.06 per cent).

Included within interest and similar income is £205 million (2015: £248 million; 2014: £407 million) in respect of impaired financial assets. Net interest income also includes a credit of £557 million (2015: credit of £956 million; 2014: credit of £1,153 million) transferred from the cash flow hedging reserve (see note 42).

NOTE 6: NET FEE AND COMMISSION INCOME

	2016 £m	2015 £m	2014 £m
Fee and commission income:			
Current accounts	**752**	804	918
Credit and debit card fees	**875**	918	1,050
Other	**1,418**	1,530	1,691
Total fee and commission income	**3,045**	3,252	3,659
Fee and commission expense	**(1,356)**	(1,442)	(1,402)
Net fee and commission income	**1,689**	1,810	2,257

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.

NOTE 7: NET TRADING INCOME

	2016 £m	2015 £m	2014 £m
Foreign exchange translation (losses) gains	1,363	(80)	(95)
Gains on foreign exchange trading transactions	542	335	344
Total foreign exchange	1,905	255	249
Investment property (losses) gains (note 26)	(83)	416	513
Securities and other gains (see below)	16,723	3,043	9,397
Net trading income	18,545	3,714	10,159

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

	2016 £m	2015 £m	2014 £m
Net income arising on assets held at fair value through profit or loss:			
Debt securities, loans and advances	4,771	451	4,805
Equity shares	12,534	2,384	3,816
Total net income arising on assets held at fair value through profit or loss	17,305	2,835	8,621
Net income (expense) arising on liabilities held at fair value through profit or loss – debt securities in issue	(154)	14	(75)
Total net gains arising on assets and liabilities held at fair value through profit or loss	17,151	2,849	8,546
Net (losses) gains on financial instruments held for trading	(428)	194	851
Securities and other gains	16,723	3,043	9,397

NOTE 8: INSURANCE PREMIUM INCOME

	2016 £m	2015 £m	2014 £m
Life insurance			
Gross premiums:			
Life and pensions	5,613	3,613	6,070
Annuities	1,685	430	327
	7,298	4,043	6,397
Ceded reinsurance premiums	(88)	(122)	(142)
Net earned premiums	7,210	3,921	6,255
Non-life insurance			
Net earned premiums	858	871	870
Total net earned premiums	8,068	4,792	7,125

Premium income in 2015 was reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group.

Notes to the consolidated financial statements continued

NOTE 9: OTHER OPERATING INCOME

	2016 £m	2015 £m	2014 £m
Operating lease rental income	**1,225**	1,165	1,126
Rental income from investment properties (note 26)	**229**	268	269
Gains less losses on disposal of available-for-sale financial assets (note 42)	**575**	51	131
Movement in value of in-force business (note 24)	**472**	(162)	(428)
Liability management	**(598)**	(28)	(1,386)
Share of results of joint ventures and associates	**(1)**	(3)	32
Other	**133**	225	(53)
Total other operating income	**2,035**	1,516	(309)

Liability management

In April 2014, the Group completed exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) and a tender offer to eligible retail holders outside the United States. A loss of £1,362 million was recognised in relation to these exchange and tender transactions in the year ended 31 December 2014. The Group completed tender offers and redemptions in respect of the remaining ECNs in March 2016, resulting in a net loss to the Group of £721 million, principally comprising the write-off of the embedded equity conversion feature and premiums paid under the terms of the transaction.

Profits of £123 million arose in the year ended 31 December 2016 (2015: losses of £28 million; 2014: losses of £24 million) on other transactions undertaken as part of the Group's management of its wholesale funding and subordinated debt.

NOTE 10: INSURANCE CLAIMS

Insurance claims comprise:	2016 £m	2015 £m	2014 £m
Life insurance and participating investment contracts			
Claims and surrenders	**(8,617)**	(7,983)	(7,506)
Change in insurance and participating investment contracts (note 32)	**(14,160)**	2,898	(4,392)
Change in non-participating investment contracts	**679**	(438)	(1,448)
	(22,098)	(5,523)	(13,346)
Reinsurers' share	**106**	101	109
	(21,992)	(5,422)	(13,237)
Change in unallocated surplus	**14**	63	74
Total life insurance and participating investment contracts	**(21,978)**	(5,359)	(13,163)
Non-life insurance			
Total non-life insurance claims, net of reinsurance	**(366)**	(370)	(330)
Total insurance claims	**(22,344)**	(5,729)	(13,493)
Life insurance and participating investment contracts gross claims and surrenders can also be analysed as follows:			
Deaths	**(635)**	(631)	(549)
Maturities	**(1,347)**	(1,348)	(1,656)
Surrenders	**(5,444)**	(4,811)	(4,102)
Annuities	**(949)**	(902)	(884)
Other	**(242)**	(291)	(315)
Total life insurance gross claims and surrenders	**(8,617)**	(7,983)	(7,506)

NOTE 11: OPERATING EXPENSES

	2016 £m	2015 £m	2014 £m
Staff costs:			
Salaries	**2,750**	2,808	3,178
Performance-based compensation	**475**	409	390
Social security costs	**363**	349	398
Pensions and other post-retirement benefit schemes (note 36):			
Past service (credits) charges[1]	**–**	–	(822)
Other	**555**	548	596
	555	548	(226)
Restructuring costs	**241**	104	264
Other staff costs	**433**	459	741
	4,817	4,677	4,745
Premises and equipment:			
Rent and rates	**365**	368	424
Repairs and maintenance	**187**	173	221
Other	**120**	174	246
	672	715	891
Other expenses:			
Communications and data processing	**848**	893	1,118
Advertising and promotion	**198**	253	336
Professional fees	**265**	262	481
UK bank levy	**200**	270	237
TSB disposal	**–**	665	–
Other	**873**	703	1,017
	2,384	3,046	3,189
Depreciation and amortisation:			
Depreciation of property, plant and equipment (note 26)	**1,761**	1,534	1,391
Amortisation of acquired value of in-force non-participating investment contracts (note 24)	**37**	41	43
Amortisation of other intangible assets (note 25)	**582**	537	501
	2,380	2,112	1,935
Total operating expenses, excluding regulatory provisions	**10,253**	10,550	10,760
Regulatory provisions:			
Payment protection insurance provision (note 38)	**1,000**	4,000	2,200
Other regulatory provisions[2] (note 38)	**1,024**	837	925
	2,024	4,837	3,125
Total operating expenses	**12,277**	15,387	13,885

1 On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £843 million with a corresponding curtailment gain recognised in the income statement. This has been partly offset by a charge of £21 million following changes to pension arrangements for staff within the TSB business.

2 In addition, regulatory provisions of £61 million (2015: £nil; 2014: £nil) have been charged against income.

Notes to the consolidated financial statements continued

NOTE 11: OPERATING EXPENSES continued

Performance-based compensation

The table below analyses the Group's performance-based compensation costs between those relating to the current performance year and those relating to earlier years.

	2016 £m	2015 £m	2014 £m
Performance-based compensation expense comprises:			
Awards made in respect of the year ended 31 December	**312**	280	324
Awards made in respect of earlier years	**163**	129	66
	475	409	390

	2016 £m	2015 £m	2014 £m
Performance-based compensation expense deferred until later years comprises:			
Awards made in respect of the year ended 31 December	**123**	114	152
Awards made in respect of earlier years	**41**	56	32
	164	170	184

Performance-based awards expensed in 2016 include cash awards amounting to £116 million (2015: £96 million; 2014: £104 million).

Average headcount

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

	2016	2015	2014
UK	**79,606**	84,922	94,241
Overseas	**812**	781	847
Total	**80,418**	85,703	95,088

Fees payable to the auditors

Fees payable to the Company's auditors by the Group are as follows:

	2016 £m	2015 £m	2014 £m
Fees payable for the audit of the Company's current year annual report	**1.5**	1.2	1.4
Fees payable for other services:			
Audit of the Company's subsidiaries pursuant to legislation	**14.7**	14.9	15.5
Other services supplied pursuant to legislation	**3.1**	2.2	2.1
Total audit fees	**19.3**	18.3	19.0
Other services – audit related fees	**3.1**	3.2	9.1
Total audit and audit related fees	**22.4**	21.5	28.1
Services relating to taxation:			
Taxation compliance services	**0.2**	0.2	0.2
All other taxation advisory services	**0.1**	0.1	0.3
	0.3	0.3	0.5
Other non-audit fees:			
Services relating to corporate finance transactions	**0.1**	0.2	0.3
Other services	**1.5**	2.3	3.2
Total other non-audit fees	**1.6**	2.5	3.5
Total fees payable to the Company's auditors by the Group	**24.3**	24.3	32.1

NOTE 11: OPERATING EXPENSES continued

The following types of services are included in the categories listed above:

Audit fees: This category includes fees in respect of the audit of the Group's annual financial statements and other services in connection with regulatory filings. Other services supplied pursuant to legislation relate primarily to the costs associated with the Sarbanes-Oxley Act audit requirements together with the cost of the audit of the Group's Form 20-F filing.

Audit related fees: This category includes fees in respect of services for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements, for example acting as reporting accountants in respect of prospectuses and circulars required by the UKLA listing rules.

Services relating to taxation: This category includes tax compliance and tax advisory services.

Other non-audit fees: This category includes due diligence relating to corporate finance, including venture capital transactions and other assurance and advisory services.

It is the Group's policy to use the auditors on assignments in cases where their knowledge of the Group means that it is neither efficient nor cost effective to employ another firm of accountants. Such assignments typically relate to the provision of advice on tax issues, assistance in transactions involving the acquisition and disposal of businesses and accounting advice.

The Group has procedures that are designed to ensure auditor independence, including that fees for audit and non-audit services are approved in advance. This approval can be obtained either on an individual engagement basis or, for certain types of non-audit services, particularly those of a recurring nature, through the approval of a fee cap covering all engagements of that type provided the fee is below that cap.

All statutory audit work as well as non-audit assignments where the fee is expected to exceed the relevant fee cap must be pre-approved by the Audit Committee on an individual engagement basis. On a quarterly basis, the Audit Committee receives and reviews a report detailing all pre-approved services and amounts paid to the auditors for such pre-approved services.

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

	2016 £m	2015 £m	2014 £m
Audits of Group pension schemes	0.3	0.3	0.3
Audits of the unconsolidated Open Ended Investment Companies managed by the Group	0.4	0.4	0.4
Reviews of the financial position of corporate and other borrowers	1.2	3.1	5.0
Acquisition due diligence and other work performed in respect of potential venture capital investments	1.0	1.2	1.0

NOTE 12: IMPAIRMENT

	2016 £m	2015 £m	2014 £m
Impairment losses on loans and receivables:			
Loans and advances to customers	592	443	735
Debt securities classified as loans and receivables	–	(2)	2
Total impairment losses on loans and receivables (note 21)	592	441	737
Impairment of available-for-sale financial assets	173	4	5
Other credit risk provisions	(13)	(55)	10
Total impairment charged to the income statement	**752**	**390**	**752**

Notes to the consolidated financial statements continued

NOTE 13: TAXATION

(A) Analysis of tax charge for the year

	2016 £m	2015 £m	2014 £m
UK corporation tax:			
Current tax on profit for the year	**(1,010)**	(485)	(162)
Adjustments in respect of prior years	**156**	(90)	213
	(854)	(575)	51
Foreign tax:			
Current tax on profit for the year	**(20)**	(24)	(39)
Adjustments in respect of prior years	**2**	27	3
	(18)	3	(36)
Current tax (charge) credit	**(872)**	(572)	15
Deferred tax (note 37):			
Origination and reversal of temporary differences	**(557)**	(185)	(72)
Due to change in UK corporation tax rate	**(201)**	(27)	(24)
Adjustments in respect of prior years	**(94)**	96	(182)
	(852)	(116)	(278)
Tax charge	**(1,724)**	(688)	(263)

The charge for tax on the profit for 2016 is based on a UK corporation tax rate of 20 per cent (2015: 20.25 per cent; 2014: 21.5 per cent).

The income tax charge is made up as follows:

	2016 £m	2015 £m	2014 £m
Tax (charge) credit attributable to policyholders	**(301)**	3	(18)
Shareholder tax charge	**(1,423)**	(691)	(245)
Tax charge	**(1,724)**	(688)	(263)

(B) Factors affecting the tax charge for the year

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

	2016 £m	2015 £m	2014 £m
Profit before tax	**4,238**	1,644	1,762
Tax charge thereon at UK corporation tax rate of 20 per cent (2015: 20.25 per cent; 2014: 21.5 per cent)	**(848)**	(333)	(379)
Factors affecting charge:			
Impact of bank surcharge	**(266)**	–	–
Impact of changes in UK corporation tax rates	**(201)**	(27)	(24)
Disallowed items[1]	**(394)**	(630)	(195)
Non-taxable items	**75**	162	153
Overseas tax rate differences	**10**	(4)	(24)
Gains exempted	**19**	67	181
Policyholder tax[2]	**(241)**	3	(14)
Tax losses not previously recognised	**59**	42	–
Adjustments in respect of previous years	**64**	33	34
Effect of results of joint ventures and associates	**(1)**	(1)	7
Other items	**–**	–	(2)
Tax charge on profit on ordinary activities	**(1,724)**	(688)	(263)

1 The Finance (No. 2) Act 2015 introduced restrictions on the tax deductibility of provisions for conduct charges arising on or after 8 July 2015. This has resulted in an additional income statement tax charge of £219 million (2015: £459 million).

2 In 2016 this includes a £231 million write down of the deferred tax asset held within the life business, reflecting the Group's utilisation estimate which has been restricted by the current economic environment.

The Finance (No. 2) Act 2015 introduced an additional surcharge of 8 per cent on banking profits from 1 January 2016.

The Finance Act 2016 was enacted on 15 September 2016. The Act further reduced the corporation tax rate applicable from 1 April 2020 to 17 per cent and further restricts the amount of banks' profits that can be offset by carried forward losses for the purposes of calculating corporation tax liabilities from 50 per cent to 25 per cent with effect from 1 April 2016.

The corporation tax changes enacted have resulted in a reduction in the Group's net deferred tax asset at 31 December 2016 of £158 million, comprising a £201 million charge included in the income statement and a £43 million credit included in equity.

NOTE 14: EARNINGS PER SHARE

	2016 £m	2015 £m	2014 £m
Profit attributable to equity shareholders – basic and diluted	2,001	466	1,125
Tax credit on distributions to other equity holders	91	80	62
	2,092	546	1,187

	2016 million	2015 million	2014 million
Weighted average number of ordinary shares in issue – basic	71,234	71,272	71,350
Adjustment for share options and awards	790	1,068	1,097
Weighted average number of ordinary shares in issue – diluted	72,024	72,340	72,447
Basic earnings per share	2.9p	0.8p	1.7p
Diluted earnings per share	2.9p	0.8p	1.6p

Basic earnings per share are calculated by dividing the net profit attributable to equity shareholders by the weighted average number of ordinary shares in issue during the year, which has been calculated after deducting 140 million (2015: 101 million; 2014: 22 million) ordinary shares representing the Group's holdings of own shares in respect of employee share schemes.

For the calculation of diluted earnings per share the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares that arise in respect of share options and awards granted to employees. The number of shares that could have been acquired at the average annual share price of the Company's shares based on the monetary value of the subscription rights attached to outstanding share options and awards is determined. This is deducted from the number of shares issuable under such options and awards to leave a residual bonus amount of shares which are added to the weighted-average number of ordinary shares in issue, but no adjustment is made to the profit attributable to equity shareholders.

The weighted-average number of anti-dilutive share options and awards excluded from the calculation of diluted earnings per share was 0.3 million at 31 December 2016 (2015: 1 million; 2014: 7 million).

NOTE 15: TRADING AND OTHER FINANCIAL ASSETS AT FAIR VALUE THROUGH PROFIT OR LOSS

These assets are comprised as follows:

	2016			2015		
	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m	Trading assets £m	Other financial assets at fair value through profit or loss £m	Total £m
Loans and advances to customers	30,473	–	30,473	30,109	–	30,109
Loans and advances to banks	2,606	–	2,606	3,065	–	3,065
Debt securities:						
Government securities	11,828	14,904	26,732	8,269	13,848	22,117
Other public sector securities	–	1,325	1,325	–	2,039	2,039
Bank and building society certificates of deposit	–	244	244	–	135	135
Asset-backed securities:						
Mortgage-backed securities	47	660	707	516	842	1,358
Other asset-backed securities	69	1,469	1,538	85	762	847
Corporate and other debt securities	224	19,608	19,832	612	19,704	20,316
	12,168	38,210	50,378	9,482	37,330	46,812
Equity shares	6	67,691	67,697	5	60,471	60,476
Treasury and other bills	–	20	20	–	74	74
Total	45,253	105,921	151,174	42,661	97,875	140,536

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

(i) financial assets backing insurance contracts and investment contracts of £101,888 million (2015: £90,492 million) which are so designated because the related liabilities either have cash flows that are contractually based on the performance of the assets or are contracts whose measurement takes account of current market conditions and where significant measurement inconsistencies would otherwise arise. Included within these assets are investments in unconsolidated structured entities of £15,611 million (2015: £13,282 million), see note 20; and

(ii) private equity investments of £2,245 million (2015: £2,415 million) that are managed, and evaluated, on a fair value basis in accordance with a documented risk management or investment strategy and reported to key management personnel on that basis.

For amounts included above which are subject to repurchase and reverse repurchase agreements see note 52.

Notes to the consolidated financial statements continued

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS

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

	31 December 2016			31 December 2015		
	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contract/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Trading and other						
Exchange rate contracts:						
Spot, forwards and futures	38,072	1,149	1,383	39,817	852	774
Currency swaps	288,441	6,903	6,382	293,536	5,585	4,323
Options purchased	15,192	808	–	20,352	751	–
Options written	18,342	–	1,016	22,708	–	984
	360,047	8,860	8,781	376,413	7,188	6,081
Interest rate contracts:						
Interest rate swaps	2,160,535	19,780	18,862	2,316,071	14,442	13,050
Forward rate agreements	628,962	13	87	1,159,099	6	57
Options purchased	39,509	3,251	–	55,962	3,003	–
Options written	39,847	–	3,400	52,202	–	3,116
Futures	114,284	6	3	105,475	7	8
	2,983,137	23,050	22,352	3,688,809	17,458	16,231
Credit derivatives	8,098	381	659	4,566	295	407
Embedded equity conversion feature (note 9)	–	–	–	–	545	–
Equity and other contracts	43,218	1,135	1,168	14,174	1,295	1,145
Total derivative assets/liabilities – trading and other	3,394,500	33,426	32,960	4,083,962	26,781	23,864
Hedging						
Derivatives designated as fair value hedges:						
Currency swaps	1,454	19	22	2,649	52	107
Interest rate swaps	194,416	1,462	737	121,063	1,572	724
Options purchased	–	–	–	–	–	–
	195,870	1,481	759	123,712	1,624	831
Derivatives designated as cash flow hedges:						
Interest rate swaps	384,182	814	1,166	460,829	816	1,534
Futures	53,115	–	3	150,085	3	–
Currency swaps	8,121	417	36	11,228	243	72
	445,418	1,231	1,205	622,142	1,062	1,606
Total derivative assets/liabilities – hedging	641,288	2,712	1,964	745,854	2,686	2,437
Total recognised derivative assets/liabilities	4,035,788	36,138	34,924	4,829,816	29,467	26,301

The notional amount of the contract does not represent the Group's real exposure to credit risk which is limited to the current cost of replacing contracts with a positive value to the Group should the counterparty default. To reduce credit risk the Group uses a variety of credit enhancement techniques such as netting and collateralisation, where security is provided against the exposure. Further details are provided in note 52 Credit risk.

The Group holds derivatives as part of the following strategies:

– Customer driven, where derivatives are held as part of the provision of risk management products to Group customers;

– To manage and hedge the Group's interest rate and foreign exchange risk arising from normal banking business. The hedge accounting strategy adopted by the Group is to utilise a combination of fair value and cash flow hedge approaches as described in note 52; and

– Derivatives held in policyholder funds as permitted by the investment strategies of those funds.

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.

NOTE 16: DERIVATIVE FINANCIAL INSTRUMENTS continued

- 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 used credit default swaps to securitise, in combination with external funding, £455 million of corporate and commercial banking loans at 31 December 2015; these arrangements were wound up during 2016.
- Equity derivatives are also used by the Group as part of its equity-based retail product activity to eliminate the Group's exposure to fluctuations in various international stock exchange indices. Index-linked equity options are purchased which give the Group the right, but not the obligation, to buy or sell a specified amount of equities, or basket of equities, in the form of published indices on or before a specified future date.

Hedged cash flows

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

2016	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	**172**	**198**	**415**	**372**	**391**	**1,215**	**102**	**45**	**2,910**
Forecast payable cash flows	**(565)**	**(722)**	**(692)**	**(599)**	**(429)**	**(1,541)**	**(806)**	**(262)**	**(5,616)**
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	**211**	**223**	**418**	**363**	**472**	**1,070**	**99**	**54**	**2,910**
Forecast payable cash flows	**(777)**	**(713)**	**(671)**	**(521)**	**(415)**	**(1,477)**	**(787)**	**(255)**	**(5,616)**

2015	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Hedged forecast cash flows expected to occur:									
Forecast receivable cash flows	363	298	499	500	376	1,876	137	75	4,124
Forecast payable cash flows	(1,235)	(758)	(714)	(667)	(440)	(1,116)	(532)	(145)	(5,607)
Hedged forecast cash flows affect profit or loss:									
Forecast receivable cash flows	381	439	515	453	345	1,777	136	78	4,124
Forecast payable cash flows	(1,261)	(741)	(715)	(671)	(440)	(1,115)	(523)	(141)	(5,607)

There were no transactions for which cash flow hedge accounting had to be ceased in 2015 or 2016 as a result of the highly probable cash flows no longer being expected to occur.

NOTE 17: LOANS AND ADVANCES TO BANKS

	2016 £m	2015 £m
Lending to banks	**2,903**	2,273
Money market placements with banks	**23,999**	22,844
Total loans and advances to banks	**26,902**	25,117

For amounts included above which are subject to reverse repurchase agreements see note 52.

Notes to the consolidated financial statements continued

NOTE 18: LOANS AND ADVANCES TO CUSTOMERS

	2016 £m	2015 £m
Agriculture, forestry and fishing	**7,269**	6,924
Energy and water supply	**2,320**	3,247
Manufacturing	**7,285**	5,953
Construction	**4,535**	4,952
Transport, distribution and hotels	**13,320**	13,526
Postal and telecommunications	**2,564**	2,563
Property companies	**32,192**	32,228
Financial, business and other services	**49,197**	43,072
Personal:		
Mortgages	**306,682**	312,877
Other	**20,761**	20,579
Lease financing	**2,628**	2,751
Hire purchase	**11,617**	9,536
Total loans and advances to customers before allowance for impairment losses	**460,370**	458,208
Allowance for impairment losses (note 21)	**(2,412)**	(3,033)
Total loans and advances to customers	**457,958**	455,175

For amounts included above which are subject to reverse repurchase agreements see note 52.

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

	2016 £m	2015 £m
Gross investment in finance leases, receivable:		
Not later than 1 year	**551**	497
Later than 1 year and not later than 5 years	**1,618**	1,225
Later than 5 years	**1,561**	2,407
	3,730	4,129
Unearned future finance income on finance leases	**(1,038)**	(1,316)
Rentals received in advance	**(64)**	(62)
Net investment in finance leases	**2,628**	2,751

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

	2016 £m	2015 £m
Not later than 1 year	**361**	319
Later than 1 year and not later than 5 years	**1,282**	859
Later than 5 years	**985**	1,573
Net investment in finance leases	**2,628**	2,751

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 2015 and 2016 no contingent rentals in respect of finance leases were recognised in the income statement. There was no allowance for uncollectable finance lease receivables included in the allowance for impairment losses (2015: £nil).

NOTE 19: SECURITISATIONS AND COVERED BONDS

Securitisation programmes

Loans and advances to customers and debt securities classified as loans and receivables include loans securitised under the Group's securitisation programmes, the majority of which have been sold by subsidiary companies to bankruptcy remote structured entities. As the structured entities are funded by the issue of debt on terms whereby the majority of the risks and rewards of the portfolio are retained by the subsidiary, the structured entities are consolidated fully and all of these loans are retained on the Group's balance sheet, with the related notes in issue included within debt securities in issue.

Covered bond programmes

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

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

	2016		2015	
	Loans and advances securitised £m	Notes in issue £m	Loans and advances securitised £m	Notes in issue £m
Securitisation programmes[1]				
UK residential mortgages	35,146	17,705	39,154	20,931
Commercial loans	7,395	8,179	9,345	8,720
Credit card receivables	7,610	5,723	7,305	5,277
Dutch residential mortgages	2,033	2,081	1,981	2,044
PFI/PPP and project finance loans	–	–	305	94
	52,184	33,688	58,090	37,066
Less held by the Group		(26,435)		(29,303)
Total securitisation programmes (note 31)		7,253		7,763
Covered bond programmes				
Residential mortgage-backed	33,881	30,021	43,323	29,697
Social housing loan-backed	2,087	1,200	2,544	1,700
	35,968	31,221	45,867	31,397
Less held by the Group		(700)		(4,197)
Total covered bond programmes (note 31)		30,521		27,200
Total securitisation and covered bond programmes		37,774		34,963

1 Includes securitisations utilising a combination of external funding and credit default swaps.

Cash deposits of £9,018 million (2015: £8,383 million) which support the debt securities issued by the structured entities, the term advances related to covered bonds and other legal obligations are held by the Group. Additionally, the Group had certain contractual arrangements to provide liquidity facilities to some of these structured entities. At 31 December 2016 these obligations had not been triggered; the maximum exposure under these facilities was £373 million (2015: £381 million).

The Group has a number of covered bond programmes, for which Limited Liability Partnerships have been established to ring-fence asset pools and guarantee the covered bonds issued by the Group. At the reporting date the Group had over-collateralised these programmes as set out in the table above to meet the terms of the programmes, to secure the rating of the covered bonds and to provide operational flexibility. From time-to-time, the obligations of the Group to provide collateral may increase due to the formal requirements of the programmes. The Group may also voluntarily contribute collateral to support the ratings of the covered bonds.

The Group recognises the full liabilities associated with its securitisation and covered bond programmes within debt securities in issue, although the obligations of the Group are limited to the cash flows generated from the underlying assets. The Group could be required to provide additional support to a number of the securitisation programmes to support the credit ratings of the debt securities issued, in the form of increased cash reserves and the holding of subordinated notes. Further, certain programmes contain contractual obligations that require the Group to repurchase assets should they become credit impaired.

The Group has not voluntarily offered to repurchase assets from any of its public securitisation programmes during 2016 (2015: none). Such repurchases are made in order to ensure that the expected maturity dates of the notes issued from these programmes are met.

Notes to the consolidated financial statements continued

NOTE 20: STRUCTURED ENTITIES

The Group's interests in structured entities are both consolidated and unconsolidated. Detail of the Group's interests in consolidated structured entities are set out in: note 19 for securitisations and covered bond vehicles, note 36 for structured entities associated with the Group's pension schemes, and below in part (A) and (B). Details of the Group's interests in unconsolidated structured entities are included below in part (C).

(A) Asset-backed conduits

In addition to the structured entities discussed in note 19, which are used for securitisation and covered bond programmes, the Group sponsors an active asset-backed conduit, Cancara, which invests in client receivables and debt securities. The total consolidated exposure of Cancara at 31 December 2016 was £6,840 million (2015: £7,295 million), comprising £6,684 million of loans and advances (2015: £6,440 million) and £156 million of debt securities (2015: £855 million).

All lending assets and debt securities held by the Group in Cancara are restricted in use, as they are held by the collateral agent for the benefit of the commercial paper investors and the liquidity providers only. The Group provides liquidity facilities to Cancara under terms that are usual and customary for standard lending activities in the normal course of the Group's banking activities. During 2016 there has been a planned drawdown on certain liquidity facilities for balance sheet management purposes, supporting the programme to provide funding alongside the proceeds of the asset-backed commercial paper issuance. The Group could be asked to provide further support under the contractual terms of these arrangements including, for example, if Cancara experienced a shortfall in external funding, which may occur in the event of market disruption. As at 31 December 2015 there had been no drawdowns on these liquidity facilities.

The external assets in Cancara are consolidated in the Group's financial statements.

(B) Consolidated collective investment vehicles and limited partnerships

The assets and liabilities of the Insurance business held in consolidated collective investment vehicles, such as Open-Ended Investment Companies and limited partnerships, are not directly available for use by the Group. However, the Group's investment in the majority of these collective investment vehicles is readily realisable. As at 31 December 2016, the total carrying value of these consolidated collective investment vehicle assets and liabilities held by the Group was £75,669 million (2015: £67,122 million).

The Group has no contractual arrangements (such as liquidity facilities) that would require it to provide financial or other support to the consolidated collective investment vehicles; the Group has not previously provided such support and has no current intentions to provide such support.

(C) Unconsolidated collective investment vehicles and limited partnerships

The Group's direct interests in unconsolidated structured entities comprise investments in collective investment vehicles, such as Open-Ended Investment Companies, and limited partnerships with a total carrying value of £15,611 million at 31 December 2016 (2015: £13,282 million), included within financial assets designated at fair value through profit and loss (see note 15). These investments include both those entities managed by third parties and those managed by the Group. At 31 December 2016, the total asset value of these unconsolidated structured entities, including the portion in which the Group has no interest, was £1,849 billion (2015: £603 billion).

The Group's maximum exposure to loss is equal to the carrying value of the investment. However, the Group's investments in these entities are primarily held to match policyholder liabilities in the Insurance division and the majority of the risk from a change in the value of the Group's investment is matched by a change in policyholder liabilities. The collective investment vehicles are primarily financed by investments from investors in the vehicles.

During the year the Group has not provided any non-contractual financial or other support to these entities and has no current intention of providing any financial or other support. There were no transfers from/to these unconsolidated collective investment vehicles and limited partnerships.

The Group considers itself the sponsor of a structured entity where it is primarily involved in the design and establishment of the structured entity; and further where the Group transfers assets to the structured entity; market products associated with the structured entity in its own name and/or provide guarantees regarding the structured entity's performance.

The Group sponsors a range of diverse investment funds and limited partnerships where it acts as the fund manager or equivalent decision maker and markets the funds under one of the Group's brands.

The Group earns fees from managing the investments of these funds. The investment management fees that the Group earned from these entities, including those in which the Group held no ownership interest at 31 December 2016, are reported in note 6.

NOTE 21: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

Critical accounting estimates and judgements

The allowance for impairment losses on loans and receivables is management's best estimate of losses incurred in the portfolio at the balance sheet date. In determining the required level of impairment provisions, the Group uses the output from various statistical models. Management judgement is required to assess the robustness of the outputs from these models and, where necessary, make appropriate adjustments. Impairment allowances are made up of two components, those determined individually and those determined collectively.

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

For such individually identified financial assets, a review is undertaken of the expected future cash flows which requires significant management judgement as to the amount and timing of such cash flows. Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of costs to realise, whether or not foreclosure or realisation of the collateral is probable. The determination of individual impairment allowances requires the exercise of considerable judgement by management involving matters such as local economic conditions and the resulting trading performance of the customer, and the value of the security held, for which there may not be a readily accessible market. The actual amount of the future cash flows and their timing may differ significantly from the assumptions made for the purposes of determining the impairment allowances and consequently these allowances can be subject to variation as time progresses and the circumstances of the customer become clearer.

NOTE 21: ALLOWANCE FOR IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES continued

Collective impairment allowances are generally established for smaller balance homogenous portfolios such as the retail portfolios. For these portfolios the asset is included in a group of financial assets with similar risk characteristics and collectively assessed for impairment. Segmentation takes into account factors such as the type of asset, industry sector, geographical location, collateral type, past-due status and other relevant factors. These characteristics are relevant to the estimation of future cash flows for groups of such assets as they are indicative of the borrower's ability to pay all amounts due according to the contractual terms of the assets being evaluated.

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

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

For unsecured personal lending portfolios, the impairment trigger is generally when the balance is two or more instalments in arrears or where the customer has exhibited one or more of the impairment characteristics set out above. While the trigger is based on the payment performance or circumstances of each individual asset, the assessment of future cash flows uses historical experience of cohorts of similar portfolios such that the assessment is considered to be collective. Future cash flows are estimated on the basis of the contractual cash flows of the assets in the cohort and historical loss experience for similar assets. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Group to reduce any differences between loss estimates and actual loss experience. The collective impairment allowance is also subject to estimation uncertainty and in particular is sensitive to changes in economic and credit conditions, including the interdependency of house prices, unemployment rates, interest rates, borrowers' behaviour, and consumer bankruptcy trends. It is, however, inherently difficult to estimate how changes in one or more of these factors might impact the collective impairment allowance.

The value of collateral supporting the Group's UK mortgage portfolio is estimated by applying changes in the house price indices to the original assessed value of the property. Given the relative size of the portfolio, this is a key variable in determining the Group's impairment charge for loans and receivables. If average house prices were ten per cent lower than those estimated at 31 December 2016, the impairment charge would increase by approximately £190 million in respect of UK mortgages.

In addition, the collective provision also includes provision for inherent losses, that is losses that have been incurred but have not been separately identified at the balance sheet date. The loans that are not currently recognised as impaired are grouped into homogenous portfolios by key risk drivers. Risk drivers for secured retail lending include the current indexed loan-to-value, previous mortgage arrears, internal cross-product delinquency data and external credit bureau data; for unsecured retail lending they include whether the account is up-to-date and, if not, the number of payments that have been missed; and for commercial lending they include factors such as observed default rates and loss given default. An assessment is made of the likelihood of assets being impaired at the balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. The loss emergence period is determined by local management for each portfolio and the Group has a range of loss emergence periods which are dependent upon the characteristics of the portfolios. Loss emergence periods are reviewed regularly and updated when appropriate. In general the periods used across the Group vary between one month and 12 months based on historical experience. Unsecured portfolios tend to have shorter loss emergence periods than secured portfolios. This provision is sensitive to changes in the loss emergence period. Management use a significant level of judgement when determining the collective unidentified impairment provision, including the assessment of the level of overall risk existing within particular sectors and the impact of the low interest rate environment on loss emergence periods. In the Commercial Banking division, an increase of one month in the loss emergence period in respect of the loan portfolio assessed for collective unidentified impairment provisions would result in an increase in the collective unidentified impairment provision of approximately £33 million (2015: £36 million).

	2016			2015		
	Loans and advances to customers £m	Debt securities £m	Total £m	Loans and advances to customers £m	Debt securities £m	Total £m
At 1 January	3,033	97	3,130	6,414	126	6,540
Exchange and other adjustments	69	–	69	(246)	–	(246)
Disposal of businesses	–	–	–	(82)	–	(82)
Advances written off	(2,111)	(22)	(2,133)	(4,204)	(31)	(4,235)
Recoveries of advances written off in previous years	861	1	862	764	4	768
Unwinding of discount	(32)	–	(32)	(56)	–	(56)
Charge (release) to the income statement (note 12)	592	–	592	443	(2)	441
At 31 December	2,412	76	2,488	3,033	97	3,130

Of the total allowance in respect of loans and advances to customers, £1,876 million (2015: £2,425 million) related to lending that had been determined to be impaired (either individually or on a collective basis) at the reporting date.

Of the total allowance in respect of loans and advances to customers, £1,208 million (2015: £1,170 million) was assessed on a collective basis.

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NOTE 22: AVAILABLE-FOR-SALE FINANCIAL ASSETS

	2016 £m	2015 £m
Debt securities:		
Government securities	48,714	25,329
Bank and building society certificates of deposit	142	186
Asset-backed securities:		
Mortgage-backed securities	108	197
Other asset-backed securities	317	319
Corporate and other debt securities	6,030	5,808
	55,311	31,839
Equity shares	1,213	1,193
Total available-for-sale financial assets	56,524	33,032

All assets have been individually assessed for impairment. The criteria used to determine whether an impairment loss has been incurred are disclosed in note 2(H).

During 2016 government securities with a fair value at the point of transfer of £22,830 million were reclassified from held-to-maturity investments, (see note 1).

NOTE 23: GOODWILL

	2016 £m	2015 £m
At 1 January and 31 December	2,016	2,016
Cost[1]	2,362	2,362
Accumulated impairment losses	(346)	(346)
At 31 December	2,016	2,016

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

The goodwill held in the Group's balance sheet is tested at least annually for impairment. For the purposes of impairment testing the goodwill is allocated to the appropriate cash generating unit; of the total balance of £2,016 million (2015: £2,016 million), £1,836 million, or 91 per cent of the total (2015: £1,836 million, 91 per cent of the total) has been allocated to Scottish Widows in the Group's Insurance division and £170 million, or 8 per cent of the total (2015: £170 million, 8 per cent of the total) to Motor Finance in the Group's Consumer Finance division.

The recoverable amount of the goodwill relating to Scottish Widows has been based on a value-in-use calculation. The calculation uses pre-tax projections of future cash flows based upon budgets and plans approved by management covering a five-year period, the related run-off of existing business in force and a discount rate of 10 per cent. The budgets and plans are based upon past experience adjusted to take into account anticipated changes in sales volumes, product mix and margins having regard to expected market conditions and competitor activity. The discount rate is determined with reference to internal measures and available industry information. New business cash flows beyond the five-year period have been extrapolated using a steady 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 above would not cause the recoverable amount of Scottish Widows to fall below its balance sheet carrying value.

The recoverable amount of the goodwill relating to Motor Finance has also been based on a value-in-use calculation using pre-tax cash flow projections based on financial budgets and plans approved by management covering a five-year period and a discount rate of 14 per cent. The cash flows beyond the five-year period are extrapolated using a growth rate of 0.5 per cent which does not exceed the long-term average growth rates for the markets in which Motor Finance participates. Management believes that any reasonably possible change in the key assumptions above would not cause the recoverable amount of Motor Finance to fall below the balance sheet carrying value.

NOTE 24: VALUE OF IN-FORCE BUSINESS

Critical accounting estimates and judgements

The value of in-force business asset (2016: £4,702 million; 2015: £4,219 million) represents the present value of future profits expected to arise from the portfolio of in-force life insurance and participating investment contracts. The valuation of this asset requires assumptions to be made about future economic and operating conditions which are inherently uncertain and changes could significantly affect the value attributed to this asset. The methodology used to value this asset and the key assumptions that have been made in determining the carrying value of the value of in-force business asset at 31 December 2016 are set out below.

Key assumptions

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

Economic assumptions

Each cash flow is valued using the discount rate consistent with that applied to such a cash flow in the capital markets. In practice, to achieve the same result, where the cash flows are either independent of or move linearly with market movements, a method has been applied known as the 'certainty equivalent' approach whereby it is assumed that all assets earn a risk-free rate and all cash flows are discounted at a risk-free rate. The certainty equivalent approach covers all investment assets relating to insurance and participating investment contracts, other than the annuity business (where an illiquidity premium is included, see below).

A market-consistent approach has been adopted for the valuation of financial options and guarantees, using a stochastic option pricing technique calibrated to be consistent with the market price of relevant options at each valuation date. Further information on options and guarantees can be found in note 32.

The liabilities in respect of the Group's UK annuity business are matched by a portfolio of fixed interest securities, including a large proportion of corporate bonds and illiquid loan assets. The value of the in-force business asset for UK annuity business has been calculated after taking into account an estimate of the market premium for illiquidity in respect of corporate bond holdings and relevant illiquid loan assets. In determining the market premium for illiquidity, we consider a range of inputs which reflect actual asset allocation and relevant observable market data. The illiquidity premium is estimated to be 138 basis points at 31 December 2016 (2015: range of 85 to 144 basis points).

The risk-free rate is derived from the relevant swap curve with a deduction for credit risk.

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

	2016 %	2015 %
Risk-free rate (value of in-force non-annuity business)[1]	**0.00 to 4.20**	0.00 to 4.20
Risk-free rate (value of in-force annuity business)[1]	**1.38 to 5.58**	0.85 to 5.64
Risk-free rate (financial options and guarantees)[1]	**0.00 to 4.20**	0.00 to 2.54
Retail price inflation	**3.50**	3.27
Expense inflation	**3.73**	3.65

1 All risk-free rates are quoted as the range of rates implied by the relevant swap curve.

Non-market risk

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

Non-economic assumptions

Future mortality, morbidity, expenses, lapse and paid-up rate assumptions are reviewed each year and are based on an analysis of past experience and on management's view of future experience. Further information on these assumptions is given in note 32 and the effect of changes in key assumptions is given in note 33.

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

	2016 £m	2015 £m
Acquired value of in-force non-participating investment contracts	**340**	377
Value of in-force insurance and participating investment contracts	**4,702**	4,219
Total value of in-force business	**5,042**	4,596

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

	2016 £m	2015 £m
At 1 January	**377**	418
Amortisation taken to income statement (note 11)	**(37)**	(41)
At 31 December	**340**	377

The acquired value of in-force non-participating investment contracts includes £206 million (2015: £228 million) in relation to OEIC business.

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NOTE 24: VALUE OF IN-FORCE BUSINESS continued

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

	2016 £m	2015 £m
At 1 January	**4,219**	4,446
Exchange and other adjustments	**11**	(5)
Movements in the year:		
New business	**428**	454
Existing business:		
Expected return	**(210)**	(365)
Experience variances	**(137)**	(130)
Assumption changes	**127**	(209)
Economic variance	**264**	88
Movement in the value of in-force business taken to income statement (note 9)	**472**	(162)
Disposal of businesses	**–**	(60)
At 31 December	**4,702**	4,219

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. This will also contain changes in the other assets and liabilities, including the effects of changes in assumptions used to value the liabilities, of the relevant businesses. The presentation of economic variance includes the impact of financial market conditions being different at the end of the reporting period from those included in assumptions used to calculate new and existing business returns.

NOTE 25: OTHER INTANGIBLE ASSETS

	Brands £m	Core deposit intangible £m	Purchased credit card relationships £m	Customer-related intangibles £m	Capitalised software enhancements £m	Total £m
Cost:						
At 1 January 2015	596	2,770	315	538	1,509	5,728
Additions	–	–	–	–	306	306
Disposals	–	–	–	–	(1)	(1)
At 31 December 2015	596	2,770	315	538	1,814	6,033
Additions	**–**	**–**	**–**	**–**	**463**	**463**
Disposals	**–**	**–**	**–**	**–**	**(110)**	**(110)**
At 31 December 2016	**596**	**2,770**	**315**	**538**	**2,167**	**6,386**
Accumulated amortisation:						
At 1 January 2015	128	2,160	305	456	609	3,658
Charge for the year	21	300	4	16	196	537
Disposals	–	–	–	–	–	–
At 31 December 2015	149	2,460	309	472	805	4,195
Charge for the year	**22**	**297**	**2**	**27**	**234**	**582**
Disposals	**–**	**–**	**–**	**–**	**(72)**	**(72)**
At 31 December 2016	**171**	**2,757**	**311**	**499**	**967**	**4,705**
Balance sheet amount at 31 December 2016	**425**	**13**	**4**	**39**	**1,200**	**1,681**
Balance sheet amount at 31 December 2015	447	310	6	66	1,009	1,838

Included within brands above are assets of £380 million (31 December 2015: £380 million) that have been determined to have indefinite useful lives and are not amortised. These brands use the Bank of Scotland name which has been in existence for over 300 years. These brands are well established financial services brands and there are no indications that they should not have an indefinite useful life.

The core deposit intangible is the benefit derived from a large stable deposit base that has low interest rates, and the balance sheet amount at 31 December 2016 shown above will become fully amortised during 2017.

The purchased credit card relationships represent the benefit of recurring income generated from the portfolio of credit cards purchased.

The customer-related intangibles include customer lists and the benefits of customer relationships that generate recurring income.

Capitalised software enhancements principally comprise identifiable and directly associated internal staff and other costs.

NOTE 26: PROPERTY, PLANT AND EQUIPMENT

	Investment properties £m	Premises £m	Equipment £m	Operating lease assets £m	Total £m
Cost or valuation:					
At 1 January 2015	4,492	2,893	4,643	4,605	16,633
Exchange and other adjustments	(5)	–	–	23	18
Additions	–	141	1,071	1,702	2,914
Expenditure on investment properties (see below)	272	–	–	–	272
Change in fair value of investment properties (note 7)	416	–	–	–	416
Disposals	(814)	(172)	(281)	(1,307)	(2,574)
Disposal of businesses	–	(273)	(167)	–	(440)
At 31 December 2015	4,361	2,589	5,266	5,023	17,239
Exchange and other adjustments	**13**	**2**	**6**	**112**	**133**
Additions	**–**	**59**	**806**	**2,088**	**2,953**
Expenditure on investment properties (see below)	**344**	**–**	**–**	**–**	**344**
Change in fair value of investment properties (note 7)	**(83)**	**–**	**–**	**–**	**(83)**
Disposals	**(871)**	**(100)**	**(113)**	**(1,017)**	**(2,101)**
At 31 December 2016	**3,764**	**2,550**	**5,965**	**6,206**	**18,485**
Accumulated depreciation and impairment:					
At 1 January 2015	–	1,374	1,883	832	4,089
Exchange and other adjustments	–	9	(2)	7	14
Depreciation charge for the year	–	116	588	830	1,534
Disposals	–	(90)	(245)	(752)	(1,087)
Disposal of businesses	–	(162)	(128)	–	(290)
At 31 December 2015	–	1,247	2,096	917	4,260
Exchange and other adjustments	**–**	**(1)**	**(8)**	**49**	**40**
Depreciation charge for the year	**–**	**136**	**672**	**953**	**1,761**
Disposals	**–**	**(49)**	**(89)**	**(410)**	**(548)**
At 31 December 2016	**–**	**1,333**	**2,671**	**1,509**	**5,513**
Balance sheet amount at 31 December 2016	**3,764**	**1,217**	**3,294**	**4,697**	**12,972**
Balance sheet amount at 31 December 2015	4,361	1,342	3,170	4,106	12,979

Expenditure on investment properties is comprised as follows:

	2016 £m	2015 £m
Acquisitions of new properties	**251**	165
Additional expenditure on existing properties	**93**	107
	344	272

Rental income of £229 million (2015: £268 million) and direct operating expenses arising from properties that generate rental income of £26 million (2015: £27 million) have been recognised in the income statement.

Capital expenditure in respect of investment properties which had been contracted for but not recognised in the financial statements was £65 million (2015: £37 million).

The table above analyses movements in investment properties, all of which are categorised as level 3. See note 49 for details of levels in the fair value hierarchy.

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

	2016 £m	2015 £m
Receivable within 1 year	**1,120**	1,003
1 to 5 years	**1,373**	1,163
Over 5 years	**347**	172
Total future minimum rentals receivable	**2,840**	2,338

Equipment leased to customers under operating leases primarily relates to vehicle contract hire arrangements. During 2015 and 2016 no contingent rentals in respect of operating leases were recognised in the income statement.

In addition, total future minimum sub-lease income of £109 million at 31 December 2016 (£72 million at 31 December 2015) is expected to be received under non-cancellable sub-leases of the Group's premises.

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NOTE 27: OTHER ASSETS

	2016 £m	2015 £m
Assets arising from reinsurance contracts held (notes 32 and 34)	**714**	675
Deferred acquisition and origination costs	**81**	106
Settlement balances	**700**	264
Corporate pension asset	**6,645**	7,725
Investments in joint ventures and associates	**59**	47
Other assets and prepayments	**4,556**	5,047
Total other assets	**12,755**	13,864

NOTE 28: DEPOSITS FROM BANKS

	2016 £m	2015 £m
Liabilities in respect of securities sold under repurchase agreements	**7,279**	7,061
Other deposits from banks	**9,105**	9,864
Deposits from banks	**16,384**	16,925

For amounts included above which are subject to repurchase agreements see note 52.

NOTE 29: CUSTOMER DEPOSITS

	2016 £m	2015 £m
Non-interest bearing current accounts	**61,804**	48,518
Interest bearing current accounts	**90,978**	85,491
Savings and investment accounts	**208,227**	224,137
Liabilities in respect of securities sold under repurchase agreements	**2,462**	–
Other customer deposits	**51,989**	60,180
Customer deposits	**415,460**	418,326

For amounts included above which are subject to repurchase agreements, see note 52.

Included in the amounts reported above are deposits of £219,106 million (2015: £230,110 million) which are protected under the UK Financial Services Compensation Scheme.

NOTE 30: TRADING AND OTHER FINANCIAL LIABILITIES AT FAIR VALUE THROUGH PROFIT OR LOSS

	2016 £m	2015 £m
Liabilities held at fair value through profit or loss	**9,425**	7,879
Trading liabilities:		
Liabilities in respect of securities sold under repurchase agreements	**42,067**	38,431
Other deposits	**530**	1,113
Short positions in securities	**2,482**	4,440
	45,079	43,984
Trading and other financial liabilities at fair value through profit or loss	**54,504**	51,863

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

The amount contractually payable on maturity of the debt securities held at fair value through profit or loss at 31 December 2016 was £16,079 million, which was £6,656 million higher than the balance sheet carrying value (2015: £12,034 million, which was £4,156 million higher than the balance sheet carrying value). At 31 December 2016 there was a cumulative £95 million increase in the fair value of these liabilities attributable to changes in credit spread risk; this is determined by reference to the quoted credit spreads of Lloyds Bank plc, the issuing entity within the Group. Of the cumulative amount an increase of £28 million arose in 2016 and a decrease of £114 million arose in 2015.

For the fair value of collateral pledged in respect of repurchase agreements see note 52.

NOTE 31: DEBT SECURITIES IN ISSUE

	2016 £m	2015 £m
Medium-term notes issued	**27,182**	29,329
Covered bonds (note 19)	**30,521**	27,200
Certificates of deposit issued	**8,077**	11,101
Securitisation notes (note 19)	**7,253**	7,763
Commercial paper	**3,281**	6,663
Total debt securities in issue	**76,314**	82,056

NOTE 32: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS

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

	2016			2015		
	Gross £m	Reinsurance[1] £m	Net £m	Gross £m	Reinsurance[1] £m	Net £m
Life insurance (see (1) below):						
Insurance contracts	**79,793**	**(671)**	**79,122**	66,122	(629)	65,493
Participating investment contracts	**13,984**	**–**	**13,984**	13,460	–	13,460
	93,777	**(671)**	**93,106**	79,582	(629)	78,953
Non-life insurance contracts (see (2) below):						
Unearned premiums	**404**	**(14)**	**390**	461	(12)	449
Claims outstanding	**209**	**–**	**209**	251	–	251
	613	**(14)**	**599**	712	(12)	700
Total	**94,390**	**(685)**	**93,705**	80,294	(641)	79,653

1 Reinsurance balances are reported within other assets (note 27).

(1) Life insurance

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

	Insurance contracts £m	Participating investment contracts £m	Gross £m	Reinsurance £m	Net £m
At 1 January 2015	72,168	14,102	86,270	(636)	85,634
New business	2,422	28	2,450	(4)	2,446
Changes in existing business	(4,681)	(667)	(5,348)	11	(5,337)
Change in liabilities charged to the income statement (note 10)	(2,259)	(639)	(2,898)	7	(2,891)
Exchange and other adjustments	39	(1)	38	–	38
Disposal of businesses	(3,826)	(2)	(3,828)	–	(3,828)
At 31 December 2015	66,122	13,460	79,582	(629)	78,953
New business	**4,422**	**28**	**4,450**	**(5)**	**4,445**
Changes in existing business	**9,214**	**496**	**9,710**	**(37)**	**9,673**
Change in liabilities charged to the income statement (note 10)	**13,636**	**524**	**14,160**	**(42)**	**14,118**
Exchange and other adjustments	**35**	**–**	**35**	**–**	**35**
At 31 December 2016	**79,793**	**13,984**	**93,777**	**(671)**	**93,106**

Notes to the consolidated financial statements continued

NOTE 32: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS continued

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

	2016			2015		
	With-profit fund £m	Non-profit fund £m	Total £m	With-profit fund £m	Non-profit fund £m	Total £m
Insurance contracts	**9,147**	**70,646**	**79,793**	9,023	57,099	66,122
Participating investment contracts	**8,860**	**5,124**	**13,984**	9,341	4,119	13,460
Total	**18,007**	**75,770**	**93,777**	18,364	61,218	79,582

With-profit fund realistic liabilities

(i) Business description

Scottish Widows Limited has the only with-profit funds within the Group. The primary purpose of the conventional and unitised business written in the with-profit funds is to provide a smoothed investment vehicle to policyholders, protecting them against short-term market fluctuations. Payouts may be subject to a guaranteed minimum payout if certain policy conditions are met. With-profit policyholders are entitled to at least 90 per cent of the distributed profits, with the shareholders receiving the balance. The policyholders are also usually insured against death and the policy may carry a guaranteed annuity option at retirement.

(ii) Method of calculation of liabilities

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

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

(iii) Assumptions

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

Investment returns and discount rates

With-profit fund liabilities are valued on a market-consistent basis, achieved by the use of a valuation model which values liabilities on a basis calibrated to tradable market option contracts and other observable market data. The with-profit fund financial options and guarantees are valued using a stochastic simulation model where all assets are assumed to earn, on average, the risk-free yield and all cash flows are discounted using the risk-free yield. The risk-free yield is defined as the spot yield derived from the relevant swap curve, adjusted for credit risk. Further information on significant options and guarantees is given below.

Guaranteed annuity option take-up rates

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

Investment volatility

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

Mortality

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

Lapse rates (persistency)

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

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

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

NOTE 32: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS continued

(iv) Options and guarantees within the With-Profit Funds

The most significant options and guarantees provided from within the With-Profit Funds are in respect of guaranteed minimum cash benefits on death, maturity, retirement or certain policy anniversaries, and guaranteed annuity options on retirement for certain pension policies.

For those policies written in Scottish Widows pre-demutualisation containing potentially valuable options and guarantees, under the terms of the Scheme a separate memorandum account was set up, within the With-Profit Fund originally held in Scottish Widows plc and subsequently transferred into Scottish Widows Limited, called the Additional Account which is available, inter alia, to meet any additional costs of providing guaranteed benefits in respect of those policies. The Additional Account had a value at 31 December 2016 of £2.7 billion (2015: £2.5 billion). The eventual cost of providing benefits on policies written both pre and post demutualisation is dependent upon a large number of variables, including future interest rates and equity values, demographic factors, such as mortality, and the proportion of policyholders who seek to exercise their options. The ultimate cost will therefore not be known for many years.

As noted above, the liabilities of the With-Profit Funds are valued using a market-consistent stochastic simulation model which places a value on the options and guarantees which captures both their intrinsic value and their time value.

The most significant economic assumptions included in the model are risk-free yield and investment volatility.

Non-profit fund liabilities

(i) Business description

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

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

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

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

(ii) Method of calculation of liabilities

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

(iii) Assumptions

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

Interest rates

The rates of interest used are determined by reference to a number of factors including the redemption yields on fixed interest assets at the valuation date.

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

Mortality and morbidity

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

Lapse rates (persistency)

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

Maintenance expenses

Allowance is made for future policy costs explicitly. Expenses are determined by reference to an internal analysis of current and expected future costs plus a margin for adverse deviation. Explicit allowance is made for future expense inflation.

Key changes in assumptions

A detailed review of the Group's assumptions in 2016 resulted in the following key impacts on profit before tax:

- Change in persistency assumptions (£48 million decrease).
- Change in the assumption in respect of current and future mortality and morbidity rates (£194 million increase).
- Change in expenses assumptions (£109 million decrease).

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

(iv) Options and guarantees outside the With-Profit Funds

A number of typical guarantees are provided outside the With-Profit Funds such as guaranteed payments on death (e.g. term assurance) or guaranteed income for life (e.g. annuities). In addition, certain personal pension policyholders in Scottish Widows, for whom reinstatement to their occupational pension scheme was not an option, have been given a guarantee that their pension and other benefits will correspond in value to the benefits of the relevant occupational pension scheme. The key assumptions affecting the ultimate value of the guarantee are future salary growth, gilt yields at retirement, annuitant mortality at retirement, marital status at retirement and future investment returns. There is currently a provision, calculated on a deterministic basis, of £82 million (2015: £68 million) in respect of those guarantees.

Notes to the consolidated financial statements continued

NOTE 32: LIABILITIES ARISING FROM INSURANCE CONTRACTS AND PARTICIPATING INVESTMENT CONTRACTS continued

(2) Non-life insurance

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

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

	2016 £m	2015 £m
Provisions for unearned premiums		
Gross provision at 1 January	461	424
Increase in the year	827	934
Release in the year	(884)	(897)
Change in provision for unearned premiums charged to income statement	(57)	37
Gross provision at 31 December	404	461
Reinsurers' share	(14)	(12)
Net provision at 31 December	390	449

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

	2016 £m	2015 £m
Claims outstanding		
Gross claims outstanding at 1 January	251	224
Cash paid for claims settled in the year	(408)	(343)
Increase/(decrease) in liabilities[1]	366	370
Change in liabilities charged to the income statement	(42)	27
Gross claims outstanding at 31 December	209	251
Reinsurers' share	–	–
Net claims outstanding at 31 December	209	251
Notified claims	122	117
Incurred but not reported	87	134
Net claims outstanding at 31 December	209	251

1 Of which an increase of £363 million (2015: £393 million) was in respect of current year claims and an increase of £3 million (2015: decrease of £23 million) was in respect of prior year claims.

NOTE 33: LIFE INSURANCE SENSITIVITY ANALYSIS

Critical accounting estimates and judgements

Elements of the valuations of liabilities arising from insurance contracts and participating investment contracts require assumptions to be made about future investment returns, future mortality rates and future policyholder behaviour and are subject to significant management judgement and estimation uncertainty. The methodology used to value these liabilities and the key assumptions that have been made in determining their carrying value are set out in note 32.

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

		2016		2015	
	Change in variable	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m	Increase (reduction) in profit before tax £m	Increase (reduction) in equity £m
Non-annuitant mortality and morbidity[1]	5% reduction	25	21	32	26
Annuitant mortality[2]	5% reduction	(287)	(238)	(190)	(156)
Lapse rates[3]	10% reduction	48	40	85	70
Future maintenance and investment expenses[4]	10% reduction	318	264	231	190
Risk-free rate[5]	0.25% reduction	(74)	(62)	(44)	(37)
Guaranteed annuity option take up[6]	5% addition	(12)	(10)	2	2
Equity investment volatility[7]	1% addition	(10)	(8)	(7)	(5)
Widening of credit default spreads on corporate bonds[8]	0.25% addition	(200)	(166)	(183)	(151)
Increase in illiquidity premia[9]	0.10% addition	152	126	120	98

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

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

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

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

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

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

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

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

8 This sensitivity shows the impact of a 25 basis point increase in credit default spreads on corporate bonds and the corresponding reduction in market values. Swap curves, the risk-free rate and illiquidity premia are all assumed to be unchanged.

9 This sensitivity shows the impact of a 10 basis point increase in the allowance for illiquidity premia. It assumes the overall spreads on assets are unchanged and hence market values are unchanged. Swap curves and the non-annuity risk-free rate are both assumed to be unchanged. The increased illiquidity premium increases the annuity risk-free rate.

NOTE 34: LIABILITIES ARISING FROM NON-PARTICIPATING INVESTMENT CONTRACTS

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

	2016 £m	2015 £m
At 1 January	22,777	27,248
New business	560	539
Changes in existing business	(3,225)	(4,461)
Disposal of businesses	–	(549)
At 31 December	**20,112**	22,777

The balances above are shown gross of reinsurance. As at 31 December 2016, related reinsurance balances were £29 million (2015: £34 million); reinsurance balances are reported within other assets (note 27). Liabilities arising from non-participating investment contracts are categorised as level 2. See note 49 for details of levels in the fair value hierarchy.

Notes to the consolidated financial statements continued

NOTE 35: OTHER LIABILITIES

	2016 £m	2015 £m
Settlement balances	**706**	467
Unitholders' interest in Open Ended Investment Companies	**22,947**	22,621
Unallocated surplus within insurance businesses	**243**	257
Other creditors and accruals	**5,297**	6,316
Total other liabilities	**29,193**	29,661

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS

	2016 £m	2015 £m	2014 £m
Charge to the income statement			
Past service (credits) charges [1]	**–**	–	(822)
Other	**279**	307	334
Defined benefit pension schemes	**279**	307	(488)
Other post-retirement benefit schemes	**8**	8	10
Total defined benefit schemes	**287**	315	(478)
Defined contribution pension schemes	**268**	233	252
Total charge (credit) to the income statement (note 11)	**555**	548	(226)

1 On 11 March 2014 the Group announced a change to its defined benefit pension schemes, revising the existing cap on the increases in pensionable pay used in calculating the pension benefit, from 2 per cent to nil with effect from 2 April 2014. The effect of this change was to reduce the Group's retirement benefit obligations recognised on the balance sheet by £843 million with a corresponding curtailment gain recognised in the income statement. This was partly offset by a charge of £21 million following changes to pension arrangements for staff within the TSB business.

	2016 £m	2015 £m
Amounts recognised in the balance sheet		
Retirement benefit assets	**342**	901
Retirement benefit obligations	**(822)**	(365)
Total amounts recognised in the balance sheet	**(480)**	536

The total amount recognised in the balance sheet relates to:

	2016 £m	2015 £m
Defined benefit pension schemes	**(244)**	736
Other post-retirement benefit schemes	**(236)**	(200)
Total amounts recognised in the balance sheet	**(480)**	536

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

Pension schemes

Defined benefit schemes

Critical accounting estimates and judgements

The value of the Group's defined benefit pension schemes' liabilities requires management to make a number of assumptions. The key areas of estimation uncertainty are the discount rate applied to future cash flows and the expected lifetime of the schemes' members. The discount rate is required to be set with reference to market yields at the end of the reporting period on high quality corporate bonds in the currency and with a term consistent with the defined benefit pension schemes' obligations. The average duration of the schemes' obligations is approximately 20 years. The market for bonds with a similar duration is illiquid and, as a result, significant management judgement is required to determine an appropriate yield curve on which to base the discount rate. The cost of the benefits payable by the schemes will also depend upon the life expectancy of the members. The Group considers latest market practice and actual experience in determining the appropriate assumptions for both current mortality expectations and the rate of future mortality improvement. Given the advances in medical science in recent years, it is uncertain whether this rate of improvement will be sustained going forward and, as a result, actual experience may differ from current expectations. The effect on the net accounting surplus or deficit and on the pension charge in the Group's income statement of changes to the principal actuarial assumptions is set out in (iii) below.

(i) Characteristics of and risks associated with the Group's schemes

The Group has established a number of defined benefit pension schemes in the UK and overseas. All significant schemes are based in the UK, with the three most significant being the defined benefit sections of the Lloyds Bank Pension Schemes No's 1 and 2 and the HBOS Final Salary Pension Scheme. These schemes provide retirement benefits calculated as a percentage of final pensionable salary depending upon the length of service; the minimum retirement age under the rules of the schemes at 31 December 2016 is generally 55 although certain categories of member are deemed to have a contractual right to retire at 50.

The Group operates a number of funded and unfunded pension arrangements, the majority, including the three most significant schemes, are funded schemes in the UK. All these schemes are operated as separate legal entities under trust law by the trustees and are in compliance with the Pensions Act 2004. A valuation exercise is carried out for each scheme at least every three years, whereby scheme assets are measured at market value and liabilities (technical provisions) are measured using prudent assumptions. If a deficit is identified a recovery plan is agreed between the Group and the scheme Trustee and sent to the Pensions Regulator for review. The Group has not provided for these deficit contributions as the future economic benefits arising from these contributions are expected to be available to the Group. The Group's overseas defined benefit pension schemes are subject to local regulatory arrangements.

The latest full valuations of the three main schemes were carried out as at 30 June 2014; the results have been updated to 31 December 2016 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 2016 by qualified independent actuaries.

During 2009, the Group made one-off contributions to the Lloyds Bank Pension Scheme No 1 and Lloyds Bank Pension Scheme No 2 in the form of interests in limited liability partnerships for each of the two schemes which hold assets to provide security for the Group's obligations to the two schemes. At 31 December 2016, the limited liability partnerships held assets of approximately £5.4 billion. The limited liability partnerships are consolidated fully in the Group's balance sheet.

The Group has also established three private limited companies which hold assets to provide security for the Group's obligations to the HBOS Final Salary Pension Scheme, a section of the Lloyds Bank Pension Scheme No 1 and the Lloyds Bank Offshore Pension Scheme. At 31 December 2016 these held assets of approximately £4.8 billion in aggregate. The private limited companies are consolidated fully in the Group's balance sheet. The terms of these arrangements require the Group to maintain assets in these vehicles to agreed minimum values in order to secure obligations owed to the relevant Group pension schemes. The Group has satisfied this requirement during 2016.

The Group currently expects to pay contributions of approximately £575 million to its defined benefit schemes in 2017.

The responsibility for the governance of the Group's funded defined benefit pension schemes lies with the Pension Trustees. Each of the Group's funded UK defined benefit pension schemes are managed by a Trustee Board (the Trustee) whose role is to ensure that their Scheme is administered in accordance with the Scheme rules and relevant legislation, and to safeguard the assets in the best interests of all members and beneficiaries. The Trustee is solely responsible for setting investment policy and for agreeing funding requirements with the employer through the triennial valuation process. The Board of Trustees must be composed of representatives of the Company and plan participants in accordance with the Scheme's regulations.

Notes to the consolidated financial statements continued

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

(ii) Amounts in the financial statements

	2016 £m	2015 £m
Amount included in the balance sheet		
Present value of funded obligations	(45,822)	(36,903)
Fair value of scheme assets	45,578	37,639
Net amount recognised in the balance sheet	(244)	736

	2016 £m	2015 £m
Net amount recognised in the balance sheet		
At 1 January	736	890
Net defined benefit pension charge	(279)	(307)
Actuarial (losses) gains on defined benefit obligation	(8,770)	607
Return on plan assets	7,455	(879)
Employer contributions	623	427
Exchange and other adjustments	(9)	(2)
At 31 December	(244)	736

	2016 £m	2015 £m
Movements in the defined benefit obligation		
At 1 January	(36,903)	(37,243)
Current service cost	(257)	(302)
Interest expense	(1,401)	(1,340)
Remeasurements:		
Actuarial gains – experience	535	195
Actuarial gains (losses) – demographic assumptions	195	(747)
Actuarial (losses) gains – financial assumptions	(9,500)	1,159
Benefits paid	1,580	1,371
Past service cost	(20)	(12)
Employee contributions	–	(1)
Settlements	12	8
Exchange and other adjustments	(63)	9
At 31 December	(45,822)	(36,903)

	2016 £m	2015 £m
Analysis of the defined benefit obligation:		
Active members	(9,903)	(7,530)
Deferred members	(16,934)	(12,723)
Pensioners	(17,476)	(15,312)
Dependants	(1,509)	(1,338)
	(45,822)	(36,903)

	2016 £m	2015 £m
Changes in the fair value of scheme assets		
At 1 January	37,639	38,133
Return on plan assets excluding amounts included in interest income	7,455	(879)
Interest income	1,441	1,383
Employer contributions	623	427
Employee contributions	–	1
Benefits paid	(1,580)	(1,371)
Settlements	(18)	(14)
Administrative costs paid	(36)	(30)
Exchange and other adjustments	54	(11)
At 31 December	45,578	37,639

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

Composition of scheme assets:

	2016			2015		
	Quoted £m	Unquoted £m	Total £m	Quoted £m	Unquoted £m	Total £m
Equity instruments	**1,114**	**–**	**1,114**	947	–	947
Debt instruments[1]:						
Fixed interest government bonds	**5,797**	**–**	**5,797**	4,841	–	4,841
Index-linked government bonds	**14,359**	**–**	**14,359**	9,944	–	9,944
Corporate and other debt securities	**7,464**	**–**	**7,464**	7,243	–	7,243
Asset-backed securities	**99**	**–**	**99**	74	–	74
	27,719	**–**	**27,719**	22,102	–	22,102
Property	**–**	**497**	**497**	–	440	440
Pooled investment vehicles	**3,577**	**12,845**	**16,422**	3,464	10,619	14,083
Money market instruments, cash, derivatives and other assets and liabilities	**1,462**	**(1,636)**	**(174)**	525	(458)	67
At 31 December	**33,872**	**11,706**	**45,578**	27,038	10,601	37,639

1 Of the total debt instruments, £25,219 million (31 December 2015: £18,428 million) were investment grade (credit ratings equal to or better than 'BBB').

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

The pension schemes' pooled investment vehicles comprise:

	2016 £m	2015 £m
Equity funds	**2,883**	2,412
Hedge and mutual funds	**2,350**	2,078
Liquidity funds	**484**	918
Bond and debt funds	**3,383**	2,807
Other	**7,322**	5,868
At 31 December	**16,422**	14,083

The expense (credit) recognised in the income statement for the year ended 31 December comprises:

	2016 £m	2015 £m	2014 £m
Current service cost	**257**	302	277
Net interest amount	**(40)**	(43)	(6)
Past service credits and curtailments (see page 222)	**–**	–	(822)
Settlements	**6**	6	7
Past service cost – plan amendments	**20**	12	20
Plan administration costs incurred during the year	**36**	30	36
Total defined benefit pension expense (credit)	**279**	307	(488)

Notes to the consolidated financial statements continued

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

Assumptions

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

	2016 %	2015 %
Discount rate	**2.76**	3.87
Rate of inflation:		
Retail Prices Index	**3.23**	2.99
Consumer Price Index	**2.18**	1.99
Rate of salary increases	**0.00**	0.00
Weighted-average rate of increase for pensions in payment	**2.74**	2.58

	2016 Years	2015 Years
Life expectancy for member aged 60, on the valuation date:		
Men	**28.1**	28.1
Women	**30.3**	30.4
Life expectancy for member aged 60, 15 years after the valuation date:		
Men	**29.3**	29.5
Women	**31.7**	31.9

The mortality assumptions used in the scheme valuations are based on standard tables published by the Institute and Faculty of Actuaries which were adjusted in line with the actual experience of the relevant schemes. The table shows that a member retiring at age 60 at 31 December 2016 is assumed to live for, on average, 28.1 years for a male and 30.3 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.

(iii) Amount timing and uncertainty of future cash flows

Risk exposure of the defined benefit schemes

Whilst the Group is not exposed to any unusual, entity specific or scheme specific risks in its defined benefit pension schemes, it is exposed to a number of significant risks, detailed below:

Inflation rate risk: the majority of the plans' benefit obligations are linked to inflation both in deferment and once in payment. Higher inflation will lead to higher liabilities although this will be partially offset by holdings of inflation-linked gilts and, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation.

Interest rate risk: The defined benefit obligation is determined using a discount rate derived from yields on AA-rated corporate bonds. A decrease in corporate bond yields will increase plan liabilities although this will be partially offset by an increase in the value of bond holdings.

Longevity risk: The majority of the schemes obligations are to provide benefits for the life of the members so increases in life expectancy will result in an increase in the plans' liabilities.

Investment risk: Scheme assets are invested in a diversified portfolio of debt securities, equities and other return-seeking assets. If the assets underperform the discount rate used to calculate the defined benefit obligation, it will reduce the surplus or increase the deficit. Volatility in asset values and the discount rate will lead to volatility in the net pension liability on the Group's balance sheet and in other comprehensive income. To a lesser extent this will also lead to volatility in the pension expense in the Group's income statement.

The ultimate cost of the defined benefit obligations to the Group will depend upon actual future events rather than the assumptions made. The assumptions made are unlikely to be borne out in practice and as such the cost may be higher or lower than expected.

Sensitivity analysis

The effect of reasonably possible changes in key assumptions on the value of scheme liabilities and the resulting pension charge in the Group's income statement and on the net defined benefit pension scheme liability, for the Group's three most significant schemes, is set out below. The sensitivities provided assume that all other assumptions and the value of the schemes' assets remain unchanged, and are not intended to represent changes that are at the extremes of possibility. The calculations are approximate in nature and full detailed calculations could lead to a different result. It is unlikely that isolated changes to individual assumptions will be experienced in practice. Due to the correlation of assumptions, aggregating the effects of these isolated changes may not be a reasonable estimate of the actual effect of simultaneous changes in multiple assumptions.

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

	Effect of reasonably possible alternative assumptions			
	Increase (decrease) in the income statement charge		Increase (decrease) in the net defined benefit pension scheme liability	
	2016 £m	2015 £m	2016 £m	2015 £m
Inflation (including pension increases):[1]				
Increase of 0.1 per cent	**19**	17	**491**	363
Decrease of 0.1 per cent	**(14)**	(16)	**(458)**	(346)
Discount rate:[2]				
Increase of 0.1 per cent	**(30)**	(29)	**(821)**	(605)
Decrease of 0.1 per cent	**30**	30	**847**	621
Expected life expectancy of members:				
Increase of one year	**42**	43	**1,213**	952
Decrease of one year	**(37)**	(41)	**(1,178)**	(927)

1 At 31 December 2016, the assumed rate of RPI inflation is 3.23 per cent and CPI inflation 2.18 per cent (2015: RPI 2.99 per cent and CPI 1.99 per cent).

2 At 31 December 2016, the assumed discount rate is 2.76 per cent (2015: 3.87 per cent).

Sensitivity analysis method and assumptions

The sensitivity analysis above reflects the impact on the Group's three most significant schemes which account for over 90 per cent of the Group's defined benefit obligations. Whilst differences in the underlying liability profiles for the remainder of the Group's pension arrangements mean they may exhibit slightly different sensitivities to variations in these assumptions, the sensitivities provided above are indicative of the impact across the Group as a whole.

The inflation assumption sensitivity applies to both the assumed rate of increase in the Consumer Prices Index (CPI) and the Retail Prices Index (RPI), and include the impact on the rate of increases to pensions, both before and after retirement. These pension increases are linked to inflation (either CPI or RPI) subject to certain minimum and maximum limits.

The sensitivity analysis (including the inflation sensitivity) does not include the impact of any change in the rate of salary increases as pensionable salaries have been frozen since 2 April 2014.

The life expectancy assumption has been applied by allowing for an increase/decrease in life expectation from age 60 of one year, based upon the approximate weighted average age for each scheme. Whilst this is an approximate approach and will not give the same result as a one year increase in life expectancy at every age, it provides an appropriate indication of the potential impact on the schemes from changes in life expectancy.

There was no change in the methods and assumptions used in preparing the sensitivity analysis from the prior year.

Asset-liability matching strategies

The main schemes' assets are invested in a diversified portfolio, consisting primarily of debt securities. The investment strategy is not static and will evolve to reflect the structure of liabilities within the schemes. Specific asset-liability matching strategies for each pension plan are independently determined by the responsible governance body for each scheme and in consultation with the employer.

A significant goal of the asset-liability matching strategies adopted by Group schemes is to reduce volatility caused by changes in market expectations of interest rates and inflation. In the main schemes, this is achieved by investing scheme assets in bonds, primarily fixed interest gilts and index linked gilts, and by entering into interest rate and inflation swap arrangements. These investments are structured to take into account the profile of scheme liabilities, and actively managed to reflect both changing market conditions and changes to the liability profile.

At 31 December 2016 the asset-liability matching strategy mitigated 89 per cent of the liability sensitivity to interest rate movements and 102 per cent of the liability sensitivity to inflation movements. Much of the residual interest rate sensitivity is mitigated through holdings of corporate and other debt securities.

Maturity profile of defined benefit obligation

The following table provides information on the weighted average duration of the defined benefit pension obligations and the distribution and timing of benefit payments:

	2016 Years	2015 Years
Duration of the defined benefit obligation	**20**	19

	2016 £m	2015 £m
Maturity analysis of benefits expected to be paid		
Benefits expected to be paid within 12 months	**1,639**	1,370
Benefits expected to be paid between 1 and 2 years	**1,180**	1,121
Benefits expected to be paid between 2 and 5 years	**3,971**	3,759
Benefits expected to be paid between 5 and 10 years	**8,030**	7,710
Benefits expected to be paid between 10 and 15 years	**9,453**	9,102
Benefits expected to be paid between 15 and 25 years	**20,268**	19,882
Benefits expected to be paid between 25 and 35 years	**18,831**	18,631
Benefits expected to be paid between 35 and 45 years	**13,589**	13,878
Benefits expected to be paid in more than 45 years	**7,809**	8,857

Notes to the consolidated financial statements continued

NOTE 36: RETIREMENT BENEFIT OBLIGATIONS continued

Maturity analysis method and assumptions

The projected benefit payments are based on the assumptions underlying the assessment of the obligations, including allowance for expected future inflation. They are shown in their undiscounted form and therefore appear large relative to the discounted assessment of the defined benefit obligations recognised in the Group's balance sheet. They are in respect of benefits that have been accrued prior to the respective year-end date only and make no allowance for any benefits that may have been accrued subsequently.

Defined contribution schemes

The Group operates a number of defined contribution pension schemes in the UK and overseas, principally Your Tomorrow and the defined contribution sections of the Lloyds Bank Pension Scheme No. 1.

During the year ended 31 December 2016 the charge to the income statement in respect of defined contribution schemes was £268 million (2015: £233 million; 2014: £252 million), representing the contributions payable by the employer in accordance with each scheme's rules.

Other post-retirement benefit schemes

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

For the principal post-retirement healthcare scheme, the latest actuarial valuation of the liability was carried out at 31 December 2014 by qualified independent actuaries. The principal assumptions used were as set out above, except that the rate of increase in healthcare premiums has been assumed at 6.84 per cent (2015: 6.59 per cent).

Movements in the other post-retirement benefits obligation:

	2016 £m	2015 £m
At 1 January	(200)	(196)
Actuarial (loss) gain	(33)	(2)
Insurance premiums paid	7	6
Charge for the year	(8)	(8)
Exchange and other adjustments	(2)	–
At 31 December	**(236)**	(200)

NOTE 37: DEFERRED TAX

Critical accounting estimates and judgements

The largest category of deferred tax asset relates to tax losses carried forward. The recoverability of the Group's deferred tax assets in respect of carry forward losses is based on an assessment of future levels of taxable profit expected to arise that can be offset against these losses. The Group's expectations as to the level of future taxable profits take into account the Group's long-term financial and strategic plans, and anticipated future tax adjusting items.

In making this assessment account is taken of business plans, the board approved operating plan and the expected future economic outlook as set out in the Group Chief Executive's Review and Market Overview, as well as the risks associated with future regulatory change.

The Group's total deferred tax asset includes £4,298 million (2015: £4,890 million) in respect of trading losses carried forward. The tax losses have arisen in individual legal entities and will be used as future taxable profits arise in those legal entities, though substantially all of the unused tax losses for which a deferred tax asset has been recognised arise in Bank of Scotland plc and Lloyds Bank plc.

The deferred tax asset is expected to be utilised over different time periods in each of the entities in which the losses arise. Under current UK tax law there is no expiry date for unused tax losses. Following the enactment of the Finance Acts in 2015 and 2016, there is a restriction imposed on the amount of banks' profits that can be offset by certain carried forward tax losses for the purposes of calculating corporation tax liabilities. The additional restriction in 2016 has increased the period over which the Group expects to fully utilise its tax losses from 2025 to 2031.

NOTE 37: DEFERRED TAX continued

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

	2016 £m	2015 £m
Asset at 1 January	**3,977**	4,091
Exchange and other adjustments	**(14)**	5
Disposals	**–**	(59)
Income statement charge (note 13):		
Due to change in UK corporation tax rate and related impacts	**(201)**	(27)
Origination and reversal of temporary differences	**(651)**	(89)
	(852)	(116)
Amount credited (charged) to equity:		
Post-retirement defined benefit scheme remeasurements	**320**	59
Available-for-sale financial assets (note 42)	**(246)**	(7)
Cash flow hedges (note 42)	**(466)**	7
Share-based compensation	**(13)**	(3)
	(405)	56
Asset at 31 December	**2,706**	3,977

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.

Statutory position	2016 £m	2015 £m	Tax disclosure	2016 £m	2015 £m
Deferred tax assets	**2,706**	4,010	Deferred tax assets	**5,549**	6,400
Deferred tax liabilities	**–**	(33)	Deferred tax liabilities	**(2,843)**	(2,423)
Asset at 31 December	**2,706**	3,977	**Asset at 31 December**	**2,706**	3,977

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

	2016 £m	2015 £m	2014 £m
Accelerated capital allowances	**(120)**	377	34
Pensions and other post-retirement benefits	**(105)**	(40)	(243)
Long-term assurance business	**(273)**	303	312
Allowances for impairment losses	**–**	(5)	(24)
Tax losses carried forward	**(625)**	(855)	(565)
Tax on fair value of acquired assets	**93**	178	159
Other temporary differences	**178**	(74)	49
Deferred tax charge in the income statement	**(852)**	(116)	(278)

Deferred tax assets and liabilities are comprised as follows:

	2016 £m	2015 £m
Deferred tax assets:		
Accelerated capital allowances	**969**	1,089
Pensions and other post-retirement benefits	**143**	–
Other provisions	**40**	28
Tax losses carried forward	**4,298**	4,890
Other temporary differences	**99**	393
Total deferred tax assets	**5,549**	6,400

	2016 £m	2015 £m
Deferred tax liabilities:		
Pensions and other post-retirement benefits	**–**	(72)
Long-term assurance business	**(914)**	(641)
Available-for-sale asset revaluation	**(233)**	(11)
Tax on fair value of acquired assets	**(798)**	(891)
Derivatives	**(643)**	(395)
Other temporary differences	**(255)**	(413)
Total deferred tax liabilities	**(2,843)**	(2,423)

Notes to the consolidated financial statements continued

NOTE 37: DEFERRED TAX continued

The Finance (No. 2) Act 2015 introduced an additional surcharge of 8 per cent on banking profits from 1 January 2016.

The Finance Act 2016 was enacted on 15 September 2016. The Act further reduced the corporation tax rate applicable from 1 April 2020 to 17 per cent and further restricts the amount of banks' profits that can be offset by carried forward losses for the purposes of calculating corporation tax liabilities from 50 per cent to 25 per cent with effect from 1 April 2016.

The corporation tax changes enacted have resulted in a reduction in the Group's net deferred tax asset at 31 December 2016 of £158 million, comprising a £201 million charge included in the income statement and a £43 million credit included in equity.

Deferred tax assets not recognised

Deferred tax assets of £92 million (2015: £140 million) 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.

Deferred tax assets of £723 million (2015: £893 million) have not been recognised in respect of trading losses carried forward, mainly in respect of temporary differences in the insurance businesses and in certain overseas companies. Trading losses can be carried forward indefinitely, except for losses in the USA which expire after 20 years.

In addition, deferred tax assets have not been recognised in respect of unrelieved foreign tax carried forward at 31 December 2016 of £46 million (2015: £76 million), 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.

NOTE 38: OTHER PROVISIONS

Critical accounting estimates and judgements

At 31 December 2016, the Group carried provisions of £3,597 million (2015: £4,463 million) against the cost of making redress payments to customers and the related administration costs in connection with historical regulatory breaches, principally the mis-selling of payment protection insurance (2016: £2,258 million; 2015: £3,458 million).

Determining the amount of the provisions, which represent management's best estimate of the cost of settling these issues, requires the exercise of significant judgement. It will often be necessary to form a view on matters which are inherently uncertain, such as the scope of reviews required by regulators, the number of future complaints, the extent to which they will be upheld, the average cost of redress and the impact of legal decisions that may be relevant to claims received. Consequently the continued appropriateness of the underlying assumptions is reviewed on a regular basis against actual experience and other relevant evidence and adjustments made to the provisions where appropriate.

More detail on the nature of the assumptions that have been made and key sensitivities is set out below.

	Provisions for commitments £m	Payment protection insurance £m	Other regulatory provisions £m	Vacant leasehold property £m	Other £m	Total £m
At 1 January 2016	50	3,458	1,005	37	1,137	5,687
Exchange and other adjustments	19	–	10	4	64	97
Provisions applied	–	(2,200)	(761)	(14)	(282)	(3,257)
Charge for the year	(13)	1,000	1,085	24	245	2,341
At 31 December 2016	**56**	**2,258**	**1,339**	**51**	**1,164**	**4,868**

Provisions for commitments

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

Payment protection insurance

The Group increased the provision for PPI costs by a further £1,000 million in 2016, bringing the total amount provided to £17,025 million.

The charge to the provision in 2016 was largely driven by a higher total volume of complaints expected as a result of the Financial Conduct Authority's (FCA) proposed industry deadline being extended to the end of June 2019 in its consultation paper published on 2 August 2016 (CP16/20: Rules and guidance on payment protection insurance complaints: feedback on CP15/39 and further consultation). The paper also consulted on some changes to the proposed rules and guidance that should apply when firms handle PPI complaints in light of the Supreme Court's decision in Plevin v Paragon Personal Finance Limited [2014] UKSC 61 (Plevin). In December 2016, the FCA stated that a further announcement in relation to the consultation would follow in 2017.

As at 31 December 2016, a provision of £2,258 million remained unutilised relating to reactive complaints and associated administration costs. Total cash payments were £2,200 million during the year to 31 December 2016. Spend continues to reduce following the completion of the re-review of previously handled cases (remediation).

The provision is consistent with total expected reactive complaint volumes of 4.9 million (including complaints falling under the Plevin rules and guidance) in light of the FCA proposals reflected in the provision increase, which was equivalent to approximately 7,700 net complaints per week on average through to the proposed industry deadline of June 2019. Weekly complaint levels in the second half of 2016 have been approximately 8,300 versus approximately 8,600 in the first half, and are expected to vary significantly through to the proposed industry deadline.

Sensitivities

The Group estimates that it has sold approximately 16 million PPI policies since 2000. These include policies that were not mis-sold and those that have been successfully claimed upon. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for approximately 50 per cent of the policies sold since 2000.

NOTE 38: OTHER PROVISIONS continued

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

Key metrics and sensitivities are highlighted in the table below:

Sensitivities (exclude claims where no PPI policy was held)	Actuals to date	Anticipated future	Sensitivity
Customer initiated complaints since origination (m)[1]	3.9	1.0	0.1 = £210m
Average uphold rate per policy[2]	74%	87%	1% = £30m
Average redress per upheld policy[2]	£1,700	£1,470	£100 = £125m
Administrative expenses (£m)	3,190	460	1 case = £450

1 Sensitivity includes complaint handling costs.

2 Actuals to date are based on the last six months to 31 December 2016. Anticipated future and sensitivities are impacted by a proportion of complaints falling under the *Plevin* rules and guidance.

Other regulatory provisions

Packaged bank accounts

In the year ended 31 December 2016 the Group has provided an additional £280 million in respect of complaints relating to alleged mis-selling of packaged bank accounts raising the total amount provided to £505 million. As at 31 December 2016, £215 million of the provision remained unutilised. The total amount provided represents the Group's best estimate of the likely future cost, however a number of risks and uncertainties remain in particular with respect to future volumes.

Arrears handling related activities

Following a review of the Group's secured and unsecured arrears handling activities, the Group has put in place a number of actions to further improve its handling of customers in these areas. As a result, the Group has provided an additional £261 million in the year ended 31 December 2016 (bringing the total provision to £397 million), for the costs of identifying and rectifying certain arrears management fees and activities. As at 31 December 2016, the unutilised provision was £383 million (31 December 2015: £136 million).

Customer claims in relation to insurance branch business in Germany

The Group continues to receive claims in Germany from customers relating to policies issued by Clerical Medical Investment Group Limited (subsequently renamed Scottish Widows Limited). The German industry-wide issue regarding notification of contractual 'cooling off' periods has continued to lead to an increasing number of claims in 2016. Accordingly a provision increase of £94 million was recognised in the year ended 31 December 2016 giving a total provision of £639 million; the remaining unutilised provision as at 31 December 2016 is £168 million (31 December 2015: £124 million). The validity of the claims facing the Group depends upon the facts and circumstances in respect of each claim. As a result the ultimate financial effect, which could be significantly different from the current provision, will be known only once all relevant claims have been resolved.

Other legal actions and regulatory matters

In the course of its business, the Group is engaged in discussions with the PRA, FCA and other UK and overseas regulators and other governmental authorities on a range of matters. The Group also receives complaints and claims from customers in connection with its past conduct and, where significant, provisions are held against the costs expected to be incurred as a result of the conclusions reached. In the year ended 31 December 2016, the Group charged an additional £450 million in respect of matters across all divisions. At 31 December 2016, the Group held unutilised provisions totalling £573 million for these other legal actions and regulatory matters.

Vacant leasehold property

Vacant leasehold property provisions are made by reference to a prudent estimate of expected sub-let income, compared to the head rent, and the possibility of disposing of the Group's interest in the lease, taking into account conditions in the property market. These provisions are reassessed on a biannual basis and will normally run off over the period of under-recovery of the leases concerned, currently averaging 3 years; where a property is disposed of earlier than anticipated, any remaining balance in the provision relating to that property is released.

Other

Following the sale of TSB Banking Group plc in 2015, the Group raised a provision of £665 million in relation to the Transitional Service Agreement entered into between Lloyds Bank plc and TSB and the contribution to be provided to TSB in moving to alternative IT provision; £611 million of this provision remained unutilised at 31 December 2016.

Provisions are made for staff and other costs related to Group restructuring initiatives at the point at which the Group becomes irrevocably committed to the expenditure. At 31 December 2016 provisions of £239 million (31 December 2015: £201 million) were held.

Other provisions also include those arising out of the insolvency of a third party insurer, which remains exposed to asbestos and pollution claims in the US. The ultimate cost and timing of payments are uncertain. The provision held of £35 million at 31 December 2016 represents management's current best estimate of the cost after having regard to actuarial estimates of future losses.

Notes to the consolidated financial statements continued

NOTE 39: SUBORDINATED LIABILITIES

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

	Preference shares £m	Preferred securities £m	Undated subordinated liabilities £m	Enhanced capital notes £m	Dated subordinated liabilities £m	Total £m
At 1 January 2016	**980**	**3,748**	**965**	**3,610**	**14,009**	**23,312**
Issued during the year:						
4.65% Subordinated Fixed Rate Notes 2026 (US$1,500 million)	–	–	–	–	1,061	1,061
Tender offers and redemptions in respect of Enhanced Capital Notes	–	–	–	(3,568)	–	(3,568)
Other repurchases and redemptions during the year:						
7.5% Undated Subordinated Step-up Notes	–	–	(5)	–	–	(5)
4.939% Non-voting Non-cumulative Perpetual Preferred Securities	–	(32)	–	–	–	(32)
7.286% Perpetual Regulatory Tier One Securities (Series A)	–	(150)	–	–	–	(150)
4.25% Subordinated Undated Instruments	–	–	(7)	–	–	(7)
Floating Rate Primary Capital Notes	–	–	(108)	–	–	(108)
Primary Capital Undated Floating Rate Notes:						
Series 1	–	–	(101)	–	–	(101)
Series 2	–	–	(142)	–	–	(142)
Series 3	–	–	(110)	–	–	(110)
6.267% Non-Cumulative Callable Fixed to Floating Rate Preference Shares callable 2016	(319)	–	–	–	–	(319)
5.125% Undated Subordinated Step-up Notes callable 2016	–	–	(2)	–	–	(2)
13% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016	–	–	–	–	(244)	(244)
10.125% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016	–	–	–	–	(233)	(233)
11.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016	–	–	–	–	(960)	(960)
10.75% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016	–	–	–	–	(466)	(466)
9.875% Subordinated Fixed to Fixed Rate Notes 2021 callable 2016	–	–	–	–	(456)	(456)
Callable Floating Rate Subordinated Notes 2016	–	–	–	–	(186)	(186)
Callable Floating Rate Subordinated Notes 2016	–	–	–	–	(143)	(143)
Subordinated Callable Notes 2016	–	–	–	–	(382)	(382)
	(319)	(182)	(475)	–	(3,070)	(4,046)
Foreign exchange and other movements	203	568	109	(42)	2,234	3,072
At 31 December 2016	**864**	**4,134**	**599**	**–**	**14,234**	**19,831**

NOTE 39: SUBORDINATED LIABILITIES continued

	Preference shares £m	Preferred securities £m	Undated subordinated liabilities £m	Enhanced capital notes £m	Dated subordinated liabilities £m	Total £m
At 1 January 2015	1,091	3,819	1,852	3,683	15,597	26,042
Issued during the year:						
5.3% Subordinated Fixed Rate Notes 2045 (US$824 million)	–	–	–	–	543	543
4.582% Subordinated Fixed Rate Notes 2025 (US$1,353 million)	–	–	–	–	893	893
	–	–	–	–	1,436	1,436
Repurchases and redemptions during the year:						
6.625% Subordinated Notes 2015	–	–	–	–	(350)	(350)
4.875% Subordinated Notes 2015	–	–	–	–	(723)	(723)
7.834% Sterling Step-up Non-Voting Non-Cumulative Preferred Securities callable 2015	–	(5)	–	–	–	(5)
8.117% Non-cumulative Perpetual Preferred Securities (Class A)	–	(250)	–	–	–	(250)
6.0884% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2015	(10)	–	–	–	–	(10)
6.625% Undated Subordinated Step-Up Notes callable 2010	–	–	(5)	–	–	(5)
6.9625% Callable Subordinated Fixed to Floating Rate Notes 2020 callable 2015	–	–	–	–	(737)	(737)
5.125% Step-up Perpetual Subordinated Notes callable 2015 (Scottish Widows plc)	–	–	(560)	–	–	(560)
5.92% Non-cumulative Fixed to Floating Rate Preference shares callable 2015	(140)	–	–	–	–	(140)
Floating Rate Undated Subordinated Step-up Notes	–	–	(29)	–	–	(29)
6.05% Fixed to Floating Rate Undated Subordinated Notes	–	–	(18)	–	–	(18)
5.125% Undated Subordinated Fixed to Floating Rate Notes	–	–	(50)	–	–	(50)
5.109% Callable Fixed to Floating Rate Notes 2017	–	–	–	–	(14)	(14)
6.305% Subordinated Callable Fixed to Floating Notes 2017	–	–	–	–	(35)	(35)
6.50% Subordinated Fixed Rate Notes 2020	–	–	–	–	(764)	(764)
6% Subordinated Notes 2033	–	–	–	–	(191)	(191)
4.25% Perpetual Fixed to Floating Rate Reset Subordinated Guaranteed Notes	–	–	(276)	–	–	(276)
	(150)	(255)	(938)	–	(2,814)	(4,157)
Foreign exchange and other movements	39	184	51	(73)	(210)	(9)
At 31 December 2015	980	3,748	965	3,610	14,009	23,312

These securities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer, other than creditors whose claims rank equally with, or are junior to, the claims of the holders of the subordinated liabilities. The subordination of specific subordinated liabilities is determined in respect of the issuer and any guarantors of that liability. The claims of holders of preference shares and preferred securities are generally junior to those of the holders of undated subordinated liabilities, which in turn are junior to the claims of holders of the dated subordinated liabilities. The subordination of the dated Enhanced Capital Notes (ECNs) ranked equally with that of the dated subordinated liabilities. The Group has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during 2016 (2015: none).

Notes to the consolidated financial statements continued

NOTE 40: SHARE CAPITAL

(1) Authorised share capital

As permitted by the Companies Act 2006, the Company removed references to authorised share capital from its articles of association at the annual general meeting on 5 June 2009. This change took effect from 1 October 2009.

(2) Issued and fully paid share capital

	2016 Number of shares	2015 Number of shares	2014 Number of shares	2016 £m	2015 £m	2014 £m
Ordinary shares of 10p (formerly 25p) each						
At 1 January	**71,373,735,357**	71,373,735,357	71,368,435,941	**7,138**	7,138	7,137
Issued under employee share schemes	**–**	–	5,299,416	**–**	–	1
At 31 December	**71,373,735,357**	71,373,735,357	71,373,735,357	**7,138**	7,138	7,138
Limited voting ordinary shares of 10p (formerly 25p) each						
At 1 January and 31 December	**80,921,051**	80,921,051	80,921,051	**8**	8	8
Total issued share capital				**7,146**	7,146	7,146

Share issuances

No shares were issued in 2016 or 2015; in 2014, 5 million shares were issued in respect of employee share schemes.

(3) Share capital and control

There are no restrictions on the transfer of shares in the Company other than as set out in the articles of association and:

– certain restrictions which may from time to time be imposed by law and regulations (for example, insider trading laws);

– where directors and certain employees of the Company require the approval of the Company to deal in the Company's shares; and

– pursuant to the rules of some of the Company's employee share plans where certain restrictions may apply while the shares are subject to the plans.

Where, under an employee share plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised by the registered owner at the direction of the participant. Outstanding awards and options would normally vest and become exercisable on a change of control, subject to the satisfaction of any performance conditions at that time.

In addition, the Company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights.

Information regarding significant direct or indirect holdings of shares in the Company can be found on page 82.

The directors have authority to allot and issue ordinary and preference shares and to make market purchases of ordinary and preference shares as granted at the annual general meeting on 12 May 2016. The authority to issue shares and the authority to make market purchases of shares will expire at the next annual general meeting. Shareholders will be asked, at the annual general meeting, to give similar authorities.

Subject to any rights or restrictions attached to any shares, on a show of hands at a general meeting of the Company every holder of shares present in person or by proxy and entitled to vote has one vote and on a poll every member present and entitled to vote has one vote for every share held.

Further details regarding voting at the annual general meeting can be found in the notes to the notice of the annual general meeting.

Ordinary shares

The holders of ordinary shares (excluding the limited voting ordinary shares), who held 99.9 per cent of the total ordinary share capital at 31 December 2016, are entitled to receive the Company's report and accounts, attend, speak and vote at general meetings and appoint proxies to exercise voting rights. Holders of ordinary shares (excluding the limited voting ordinary shares) may also receive a dividend (subject to the provisions of the Company's articles of association) and on a winding up may share in the assets of the Company.

Limited voting ordinary shares

The limited voting ordinary shares are held by the Lloyds Bank Foundations (the Foundations). The holders of the limited voting ordinary shares, who held 0.1 per cent of the total ordinary share capital at 31 December 2016, are entitled to receive copies of every circular or other document sent out by the Company to the holders of other ordinary shares. These shares carry no rights to dividends but rank pari passu with the ordinary shares in respect of other distributions and in the event of winding up. These shares do not have any right to vote at general meetings other than on resolutions concerning the winding up of the Company, or for a variation in the class rights of the limited voting ordinary shares. In the event of an offer for more than 50 per cent of the issued ordinary share capital of the Company, each limited voting ordinary share will convert into an ordinary share and shall rank equally with the ordinary shares in all respects from the date of conversion.

The Company has entered into deeds of covenant with the Foundations under the terms of which the Company makes annual donations. The deeds of covenant in effect as at 31 December 2016 provide that such annual donations will cease in certain circumstances, including the Company providing nine years' notice. Such notice has been given to the Lloyds TSB Foundation for Scotland.

Preference shares

The Company has in issue various classes of preference shares which are all classified as liabilities under IFRS which are included in note 39.

NOTE 41: SHARE PREMIUM ACCOUNT

	2016 £m	2015 £m	2014 £m
At 1 January	**17,412**	17,281	17,279
Issued under employee share schemes	**–**	–	2
Redemption of preference shares[1]	**210**	131	–
At 31 December	**17,622**	17,412	17,281

1 During the year ended 31 December 2016, the Company redeemed all of its outstanding 6.267% Non-cumulative Fixed to Floating Rate Callable US Dollar Preference Shares at their combined sterling equivalent par value of £210 million. These preference shares had been accounted for as subordinated liabilities. On redemption an amount of £210 million was transferred from the distributable merger reserve to the share premium account (2015: £131 million in respect of the redemption of the outstanding 6.0884% Non-cumulative Fixed to Floating Rate Preference Shares and 5.92% Non-cumulative Fixed to Floating Rate Preference Shares).

NOTE 42: OTHER RESERVES

	2016 £m	2015 £m	2014 £m
Other reserves comprise:			
Merger reserve	**7,766**	7,976	8,107
Capital redemption reserve[1]	**4,115**	4,115	4,115
Revaluation reserve in respect of available-for-sale financial assets	**759**	(438)	(67)
Cash flow hedging reserve	**2,136**	727	1,139
Foreign currency translation reserve	**(124)**	(120)	(78)
At 31 December	**14,652**	12,260	13,216

1 There were no movements in this reserve during 2014, 2015 or 2016.

The merger reserve primarily comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc.

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

The revaluation reserve in respect of available-for-sale financial assets represents the cumulative after tax unrealised change in the fair value of financial assets classified as available-for-sale since initial recognition; in the case of available-for-sale financial assets obtained on acquisitions of businesses, since the date of acquisition; and in the case of transferred assets that were previously held at amortised cost, by reference to that amortised cost.

The cash flow hedging reserve represents the cumulative after tax gains and losses on effective cash flow hedging instruments that will be reclassified to the income statement in the periods in which the hedged item affects profit or loss.

The foreign currency translation reserve represents the cumulative after-tax gains and losses on the translation of foreign operations and exchange differences arising on financial instruments designated as hedges of the Group's net investment in foreign operations.

	2016 £m	2015 £m	2014 £m
Merger reserve			
At 1 January	**7,976**	8,107	8,107
Redemption of preference shares (note 41)	**(210)**	(131)	–
At 31 December	**7,766**	7,976	8,107

Notes to the consolidated financial statements continued

NOTE 42: OTHER RESERVES continued

Movements in other reserves were as follows:

	2016 £m	2015 £m	2014 £m
Revaluation reserve in respect of available-for-sale financial assets			
At 1 January	(438)	(67)	(615)
Adjustment on transfer from held-to-maturity portfolio	1,544	–	–
Deferred tax	(417)	–	–
	1,127	–	–
Change in fair value of available-for-sale financial assets	356	(318)	690
Deferred tax	(25)	(18)	(65)
Current tax	(3)	2	–
	328	(334)	625
Income statement transfers:			
Disposals (note 9)	(575)	(51)	(131)
Deferred tax	196	3	52
Current tax	(52)	(1)	–
	(431)	(49)	(79)
Impairment	173	4	2
Deferred tax	–	8	–
	173	12	2
At 31 December	759	(438)	(67)

	2016 £m	2015 £m	2014 £m
Cash flow hedging reserve			
At 1 January	727	1,139	(1,055)
Change in fair value of hedging derivatives	2,432	537	3,896
Deferred tax	(610)	(186)	(765)
	1,822	351	3,131
Income statement transfers (note 5)	(557)	(956)	(1,153)
Deferred tax	144	193	216
	(413)	(763)	(937)
At 31 December	2,136	727	1,139

	2016 £m	2015 £m	2014 £m
Foreign currency translation reserve			
At 1 January	(120)	(78)	(75)
Currency translation differences arising in the year	(110)	(59)	(25)
Foreign currency gains on net investment hedges (tax: £nil)	106	17	22
At 31 December	(124)	(120)	(78)

NOTE 43: RETAINED PROFITS

	2016 £m	2015 £m	2014 £m
At 1 January	**4,416**	5,692	4,088
Profit for the year	**2,413**	860	1,412
Dividends paid[1]	**(2,014)**	(1,070)	–
Issue costs of other equity instruments (net of tax)	**–**	–	(21)
Distributions on other equity instruments (net of tax)	**(321)**	(314)	(225)
Post-retirement defined benefit scheme remeasurements	**(1,028)**	(215)	539
Movement in treasury shares	**(175)**	(816)	(286)
Value of employee services:			
Share option schemes	**141**	107	123
Other employee award schemes	**168**	172	233
Adjustment on sale of non-controlling interest in TSB	**–**	–	(171)
At 31 December	**3,600**	4,416	5,692

1 Net of a credit in respect of unclaimed dividends written-back in accordance with the Company's Articles of Association.

Retained profits are stated after deducting £495 million (2015: £740 million; 2014: £565 million) representing 730 million (2015: 943 million; 2014: 648 million) treasury shares held.

The payment of dividends by subsidiaries and the ability of members of the Group to lend money to other members of the Group may be subject to regulatory or legal restrictions, the availability of reserves and the financial and operating performance of the entity. Details of such restrictions and the methods adopted by the Group to manage the capital of its subsidiaries are provided under Capital Risk on page 161.

NOTE 44: OTHER EQUITY INSTRUMENTS

	2016 £m	2015 £m	2014 £m
At 1 January	**5,355**	5,355	–
Additional Tier 1 securities issued in the year:			
Sterling notes (£3,725 million nominal)	**–**	–	3,725
Euro notes (€750 million nominal)	**–**	–	622
US dollar notes ($1,675 million nominal)	**–**	–	1,008
At 31 December	**5,355**	5,355	5,355

The AT1 securities are Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities with no fixed maturity or redemption date.

The principal terms of the AT1 securities are described below:

- The securities rank behind the claims against Lloyds Banking Group plc of (a) unsubordinated creditors, (b) claims which are, or are expressed to be, subordinated to the claims of unsubordinated creditors of Lloyds Banking Group plc but not further or otherwise or (c) whose claims are, or are expressed to be, junior to the claims of other creditors of Lloyds Banking Group, whether subordinated or unsubordinated, other than those whose claims rank, or are expressed to rank, pari passu with, or junior to, the claims of the holders of the AT1 Securities in a winding-up occurring prior to the Conversion Trigger.
- The securities bear a fixed rate of interest until the first call date. After the initial call date, in the event that they are not redeemed, the AT1 securities will bear interest at rates fixed periodically in advance for five year periods based on market rates.
- Interest on the securities will be due and payable only at the sole discretion of Lloyds Banking Group plc, and Lloyds Banking Group plc may at any time elect to cancel any Interest Payment (or any part thereof) which would otherwise be payable on any Interest Payment Date. There are also certain restrictions on the payment of interest as specified in the terms.
- The securities are undated and are repayable, at the option of Lloyds Banking Group plc, in whole at the first call date, or on any fifth anniversary after the first call date. In addition, the AT1 securities are repayable, at the option of Lloyds Banking Group plc, in whole for certain regulatory or tax reasons. Any repayments require the prior consent of the PRA.
- The securities convert into ordinary shares of Lloyds Banking Group plc, at a pre-determined price, should the fully loaded Common Equity Tier 1 ratio of the Group fall below 7.0 per cent.

Notes to the consolidated financial statements continued

NOTE 45: DIVIDENDS ON ORDINARY SHARES

The directors have recommended a final dividend, which is subject to approval by the shareholders at the Annual General Meeting, of 1.7 pence per share (2015: 1.5 pence per share; 2014: 0.75 pence per share) representing a total dividend of £1,212 million (2015: £1,070 million; 2014: £535 million), which will be paid on 16 May 2017. The directors have also recommended a special dividend of 0.5 pence per share (2015: 0.5 pence per share; 2014: nil) representing a total dividend of £356 million (2015: £357 million; 2014: nil). These financial statements do not reflect these recommended dividends.

Dividends paid during the year were as follows:

	2016 pence per share	2015 pence per share	2014 pence per share	2016 £m	2015 £m	2014 £m
Recommended by directors at previous year end:						
Final dividend	1.50	0.75	–	1,070	535	–
Special dividend	0.50	–	–	357	–	–
Interim dividend paid in the year	0.85	0.75	–	607	535	–
	2.85	1.50	–	2,034	1,070	–

The trustees of the following holdings of Lloyds Banking Group plc shares in relation to employee share schemes retain the right to receive dividends but have chosen to waive their entitlement to the dividends on those shares as indicated: the Lloyds Banking Group Share Incentive Plan (holding at 31 December 2016: 27,898,019 shares, 31 December 2015: 24,275,824 shares, waived rights to all dividends), the HBOS Share Incentive Plan Trust (holding at 31 December 2016: 445,625 shares, 31 December 2015: 446,169 shares, waived rights to all dividends), the Lloyds Banking Group Employee Share Ownership Trust (holding at 31 December 2016: 10,699,978 shares, 31 December 2015: 164,141,179 shares, on which it waived rights to all dividends), Lloyds Group Holdings (Jersey) Limited (holding at 31 December 2016: 42,846 shares, 31 December 2015: 42,846 shares, waived rights to all but a nominal amount of one penny in total) and the Lloyds Banking Group Qualifying Employee Share Ownership Trust (holding at 31 December 2016: nil shares, 31 December 2015: 1,398 shares, waived rights to all but a nominal amount of one penny in total).

NOTE 46: SHARE-BASED PAYMENTS

Charge to the income statement

The charge to the income statement is set out below:

	2016 £m	2015 £m	2014 £m
Deferred bonus plan	266	255	213
Executive and SAYE plans:			
Options granted in the year	16	12	29
Options granted in prior years	138	99	78
	154	111	107
Share plans:			
Shares granted in the year	15	15	14
Shares granted in prior years	7	6	6
	22	21	20
Total charge to the income statement	442	387	340

During the year ended 31 December 2016 the Group operated the following share-based payment schemes, all of which are equity settled.

Deferred bonus plans

The Group operates a number of deferred bonus plans that are equity settled. Bonuses in respect of employee performance in 2016 have been recognised in the charge in line with the proportion of the deferral period completed.

NOTE 46: SHARE-BASED PAYMENTS continued

Save-As-You-Earn schemes

Eligible employees may enter into contracts through the Save-As-You-Earn schemes to save up to £500 per month and, at the expiry of a fixed term of three or five 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.

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

	2016		2015	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**850,146,220**	**50.99**	783,626,383	48.73
Granted	**454,667,560**	**47.49**	156,797,949	60.70
Exercised	**(401,286,043)**	**40.74**	(32,683,177)	41.83
Forfeited	**(10,590,490)**	**56.02**	(27,740,207)	48.69
Cancelled	**(204,238,535)**	**60.23**	(24,943,674)	56.04
Expired	**(10,005,816)**	**57.08**	(4,911,054)	48.34
Outstanding at 31 December	**678,692,896**	**51.76**	850,146,220	50.99
Exercisable at 31 December	**–**	**–**	533,654	180.66

The weighted average share price at the time that the options were exercised during 2016 was £0.67 (2015: £0.77). The weighted average remaining contractual life of options outstanding at the end of the year was 2.9 years (2015: 1.9 years).

The weighted average fair value of SAYE options granted during 2016 was £0.13 (2015: £0.17). The fair values of the SAYE options have been determined using a standard Black-Scholes model.

For the HBOS sharesave plan, no options were exercised during 2015 or 2016 and the outstanding options lapsed on 31 December 2016. The options outstanding at 31 December 2015 had an exercise price of £1.8066 and a weighted average remaining contractual life of 0.4 years.

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 is used not only to 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.

For options granted on 27 March 2014 under the Commercial Banking Transformation Plan (CBTP), the number of options that may be delivered in March 2017 may vary by a factor of 0-4 from the original 'on-target' award, depending on the degree to which the performance conditions have been met. An 'on-target' vesting is contingent upon Commercial Banking achieving £2.5 billion underlying profit and 2 per cent Return on Risk-weighted Assets ('RoRWA') on 31 December 2016. The Plan will pay out at between £1.9 billion and £3 billion underlying profit, and between 1.6 per cent and 2.5 per cent RoRWA.

Participants are not entitled to any dividends paid during the vesting period.

	2016		2015	
	Number of options	Weighted average exercise price (pence)	Number of options	Weighted average exercise price (pence)
Outstanding at 1 January	**221,397,597**	**Nil**	233,389,084	Nil
Granted	**4,298,701**	**Nil**	9,813,363	Nil
Exercised	**(2,700,679)**	**Nil**	(13,313,421)	Nil
Forfeited	**(3,863,477)**	**Nil**	(8,374,250)	Nil
Lapsed	**(169,861)**	**Nil**	(117,179)	Nil
Outstanding at 31 December	**218,962,281**	**Nil**	221,397,597	Nil
Exercisable at 31 December	**4,504,392**	**Nil**	3,972,911	Nil

The weighted average fair value of options granted in the year was £0.68 (2015: £0.75). The fair values of options granted have been determined using a standard Black-Scholes model. The weighted average share price at the time that the options were exercised during 2016 was £0.64 (2015: £0.83). The weighted average remaining contractual life of options outstanding at the end of the year was 5.1 years (2015: 6.1 years).

Notes to the consolidated financial statements continued

NOTE 46: SHARE-BASED PAYMENTS continued

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.

Participants may be entitled to any dividends paid during the vesting period if the performance conditions are met. An amount equal in value to any dividends paid between the award date and the date the Remuneration Committee determine that the performance conditions were met may be paid, based on the number of shares that vest. The Remuneration Committee will determine if any dividends are to be paid in cash or in shares. Details of the performance conditions for the plan are provided in the Directors' remuneration report.

At the end of the performance period for the 2013 grant, the targets had not been fully met and therefore these awards vested in 2016 at a rate of 94.18 per cent.

	2016 Number of shares	2015 Number of shares
Outstanding at 1 January	**398,066,746**	522,836,111
Granted	**132,194,032**	121,676,131
Vested	**(140,879,465)**	(196,193,904)
Forfeited	**(33,713,900)**	(50,251,592)
Dividend award	**2,560,615**	–
Outstanding at 31 December	**358,228,028**	398,066,746

Awards in respect of the 2014 grant will vest in 2017 at a rate of 55 per cent.

The weighted average fair value of awards granted in the year was £0.64 (2015: £0.78).

The fair value calculations at 31 December 2016 for grants made in the year, using Black-Scholes models and Monte Carlo simulation, are based on the following assumptions:

	Save-As-You-Earn	**Executive Share Plan 2003**	**LTIP**	**Commercial Banking Transformation Plan**
Weighted average risk-free interest rate	**0.25%**	**0.36%**	**0.39%**	**0.43%**
Weighted average expected life	**3.2 years**	**1.9 years**	**3.0 years**	**0.8 years**
Weighted average expected volatility	**30%**	**26%**	**24%**	**33%**
Weighted average expected dividend yield	**4.5%**	**3.1%**	**0.0%**	**4.5%**
Weighted average share price	**£0.59**	**£0.69**	**£0.73**	**£0.78**
Weighted average exercise price	**£0.47**	**nil**	**nil**	**nil**

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.

Matching shares

The Group undertakes to match shares purchased by employees up to the value of £45 per month; these matching shares 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 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 2016 was 35,956,224 (2015: 18,001,413), with an average fair value of £0.61 (2015: £0.78), based on market prices at the date of award.

Fixed share awards

Fixed share awards were introduced in 2014 in order to ensure that total fixed remuneration is commensurate with role and to provide a competitive reward package for certain Lloyds Banking Group employees, with an appropriate balance of fixed and variable remuneration, in line with regulatory requirements. The fixed share awards are delivered in Lloyds Banking Group shares, released over five years with 20 per cent being released each year following the year of award. The number of shares purchased in 2016 was 10,031,272 (2015: 8,237,469).

The fixed share award is not subject to any performance conditions, performance adjustment or clawback. On an employee leaving the Group, there is no change to the timeline for which shares will become unrestricted.

NOTE 47: 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.

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

	2016 £m	2015 £m	2014 £m
Compensation			
Salaries and other short-term benefits	17	14	15
Post-employment benefits	–	–	1
Share-based payments	23	18	17
Total compensation	40	32	33

Aggregate contributions in respect of key management personnel to defined contribution pension schemes were £0.1 million (2015: £0.1 million; 2014: £0.1 million).

	2016 million	2015 million	2014 million
Share option plans			
At 1 January	9	13	14
Granted, including certain adjustments (includes entitlements of appointed key management personnel)	3	3	–
Exercised/lapsed (includes entitlements of former key management personnel)	(9)	(7)	(1)
At 31 December	3	9	13

	2016 million	2015 million	2014 million
Share plans			
At 1 January	82	102	105
Granted, including certain adjustments (includes entitlements of appointed key management personnel)	29	37	19
Exercised/lapsed (includes entitlements of former key management personnel)	(46)	(57)	(22)
At 31 December	65	82	102

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:

	2016 £m	2015 £m	2014 £m
Loans			
At 1 January	5	3	2
Advanced (includes loans of appointed key management personnel)	3	4	2
Repayments (includes loans of former key management personnel)	(4)	(2)	(1)
At 31 December	4	5	3

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 2.49 per cent and 23.95 per cent in 2016 (2015: 3.99 per cent and 23.95 per cent; 2014: 0.5 per cent and 23.95 per cent).

No provisions have been recognised in respect of loans given to key management personnel (2016 and 2015: £nil).

	2016 £m	2015 £m	2014 £m
Deposits			
At 1 January	13	16	13
Placed (includes deposits of appointed key management personnel)	41	58	32
Withdrawn (includes deposits of former key management personnel)	(42)	(61)	(29)
At 31 December	12	13	16

Deposits placed by key management personnel attracted interest rates of up to 4.0 per cent (2015: 4.7 per cent; 2014: 4.7 per cent).

At 31 December 2016, the Group did not provide any guarantees in respect of key management personnel (2015 and 2014: none).

At 31 December 2016, transactions, arrangements and agreements entered into by the Group's banking subsidiaries with directors and connected persons included amounts outstanding in respect of loans and credit card transactions of £0.4 million with five directors and two connected persons (2015: £1 million with four directors and six connected persons; 2014: £1 million with six directors and six connected persons).

Notes to the consolidated financial statements continued

NOTE 47: RELATED PARTY TRANSACTIONS continued

Subsidiaries

Details of the Group's subsidiaries and related undertakings are provided on pages 293 to 300. In accordance with IFRS 10 Consolidated financial statements, transactions and balances with subsidiaries have been eliminated on consolidation.

Pension funds

The Group provides banking and some investment management services to certain of its pension funds. At 31 December 2016, customer deposits of £171 million (2015: £145 million) and investment and insurance contract liabilities of £406 million (2015: £694 million) related to the Group's pension funds.

Collective investment vehicles

The Group manages 139 (2015: 168) collective investment vehicles, such as Open Ended Investment Companies (OEICs) and of these 83 (2015: 95) are consolidated. The Group invested £265 million (2015: £818 million) and redeemed £826 million (2015: £616 million) in the unconsolidated collective investment vehicles during the year and had investments, at fair value, of £2,405 million (2015: £2,129 million) at 31 December. The Group earned fees of £192 million from the unconsolidated collective investment vehicles during 2016 (2015: £187 million).

Joint ventures and associates

At 31 December 2016 there were loans and advances to customers of £173 million (2015: £225 million) outstanding and balances within customer deposits of £15 million (2015: £8 million) relating to 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 2016, these companies had total assets of approximately £4,712 million (2015: £3,911 million), total liabilities of approximately £5,033 million (2015: £4,104 million) and for the year ended 31 December 2016 had turnover of approximately £4,401 million (2015: £4,660 million) and made a loss of approximately £27 million (2015: net loss of £181 million). In addition, the Group has provided £1,550 million (2015: £1,710 million) of financing to these companies on which it received £127 million (2015: £125 million) of interest income in the year.

NOTE 48: CONTINGENT LIABILITIES AND COMMITMENTS

Interchange fees

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

- The European Commission continues to pursue certain competition investigations into MasterCard and Visa probing, amongst other things, MIFs paid in respect of cards issued outside the EEA;
- Litigation continues in the English Courts against both Visa and MasterCard. This litigation has been brought by several retailers who are seeking damages for allegedly 'overpaid' MIFs. From publicly available information, it is understood these damages claims are running to different timescales with respect to the litigation process. It is also possible that new claims may be issued;
- Any ultimate impact on the Group of the above investigations and the litigation against Visa and MasterCard remains uncertain at this time.

Visa Inc completed its acquisition of Visa Europe on 21 June 2016. The Group's share of the sale proceeds comprised cash consideration of approximately £330 million (of which approximately £300 million was received on completion of the sale and £30 million is deferred for three years) and preferred stock, which the Group measures at fair value. The preferred stock is convertible into Class A Common Stock of Visa Inc or its equivalent upon the occurrence of certain events. As part of this transaction, the Group and certain other UK banks also entered into a Loss Sharing Agreement (LSA) with Visa Inc, which clarifies the allocation of liabilities between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. The maximum amount of liability to which the Group may be subject under the LSA is capped at the cash consideration which was received by the Group at completion. Visa Inc may also have recourse to a general indemnity, currently in place under Visa Europe's Operating Regulations, for damages claims concerning inter or intra-regional MIF setting activities.

LIBOR and other trading rates

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

Certain Group companies, together with other panel banks, have also been named as defendants in private lawsuits, including purported class action suits, in the US in connection with their roles as panel banks contributing to the setting of US Dollar, Japanese Yen and Sterling LIBOR and the Australian BBSW Reference Rate. The lawsuits, which contain broadly similar allegations, allege violations of the Sherman Antitrust Act, the Racketeer Influenced and Corrupt Organizations Act and the Commodity Exchange Act, as well as various state statutes and common law doctrines. Certain of the plaintiffs' claims, including those asserted under US anti-trust laws, were dismissed by the US Federal Court for Southern District of New York (the District Court). In November 2015 OTC and exchange-based plaintiffs' claims against the Group were dismissed for lack of personal jurisdiction. On 20 December 2016, the Federal Court for Southern District of New York dismissed all antitrust class action claims against LBG and its affiliates in the Multi District Litigation arising from the alleged manipulation of USD LIBOR. Further appeals in relation to the anti-trust claims remain possible.

Certain Group companies are also named as defendants in UK based claims raising LIBOR manipulation allegations in connection with interest rate hedging products.

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

NOTE 48: CONTINGENT LIABILITIES AND COMMITMENTS continued

UK shareholder litigation

In August 2014, the Group and a number of former directors were named as defendants in a claim filed in the English High Court by a number of claimants who held shares in Lloyds TSB Group plc (LTSB) prior to the acquisition of HBOS plc, alleging breaches of duties in relation to information provided to shareholders in connection with the acquisition and the recapitalisation of LTSB. It is currently not possible to determine the ultimate impact on the Group (if any), but the Group intends to defend the claim vigorously.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is the UK's independent statutory compensation fund of last resort for customers of authorised financial services firms and pays compensation if a firm is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on the authorised financial services industry. Each deposit-taking institution contributes towards the FSCS levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year, which runs from 1 April to 31 March.

Following the default of a number of deposit takers in 2008, the FSCS borrowed funds from HM Treasury to meet the compensation costs for customers of those firms. At 31 March 2016, the end of the latest FSCS scheme year for which it has published accounts, the principal balance outstanding on these loans was £15,655 million (31 March 2015: £15,797 million). Although it is anticipated that the substantial majority of this loan will be repaid from funds the FSCS receives from asset sales, surplus cash flow or other recoveries in relation to the assets of the firms that defaulted, any shortfall will be funded by deposit-taking participants of the FSCS. The amount of future levies payable by the Group depends on a number of factors including the amounts recovered by the FSCS from asset sales, the Group's participation in the deposit-taking market at 31 December, the level of protected deposits and the population of deposit-taking participants.

Tax authorities

The Group provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to tax authorities including open matters where Her Majesty's Revenue and Customs (HMRC) adopt a different interpretation and application of tax law. The Group has an open matter in relation to a claim for group relief of losses incurred in its former Irish banking subsidiary, which ceased trading on 31 December 2010. In 2013 HMRC informed the Group that their interpretation of the UK rules, permitting the offset of such losses, denies the claim; if HMRC's position is found to be correct management estimate that this would result in an increase in current tax liabilities of approximately £600 million and a reduction in the Group's deferred tax asset of approximately £400 million. The Group does not agree with HMRC's position and, having taken appropriate advice, does not consider that this is a case where additional tax will ultimately fall due. There are a number of other open matters on which the Group is in discussion with HMRC (including the tax treatment of certain costs arising from the divestment of TSB Banking Group plc); none of these is expected to have a material impact on the financial position of the Group.

Residential mortgage repossessions

In August 2014, the Northern Ireland High Court handed down judgment in favour of the borrowers in relation to three residential mortgage test cases concerning certain aspects of the Group's practice with respect to the recalculation of contractual monthly instalments of customers in arrears. The FCA is actively engaged with the industry in relation to these considerations. The Group will respond as appropriate to this and any investigations, proceedings, or regulatory action that may in due course be instigated as a result of these issues. The FCA has issued a consultation on new guidance on the treatment of customers with mortgage payment shortfalls. The guidance covers remediation for mortgage customers who may have been affected by the way firms calculate these customers' monthly mortgage instalments. The output from this consultation is expected in the first quarter of 2017.

Update to the Financial Conduct Authority's announcement in November 2015 on a deadline for PPI complaints and Plevin v Paragon Personal Finance Limited

On 2 August 2016, the Financial Conduct Authority (FCA) published a further consultation paper (CP16/20: Rules and guidance on payment protection insurance complaints: feedback on CP15/39 and further consultation), following on from the original consultation published in November 2015.

The FCA continues to propose the introduction of a two year deadline by which consumers would need to make their PPI complaints and indicates the deadline period will start in June 2017 and end in June 2019, later than originally indicated by the FCA. The FCA has also consulted further on changes to the proposed rules and guidance that should apply when firms handle PPI complaints in light of the Supreme Court's decision in Plevin v Paragon Personal Finance Limited [2014] UKSC 61. The Group awaits the FCA's final decision. A further announcement by the FCA is expected in 2017.

Mortgage arrears handling activities

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

HBOS Reading – customer review

The Group is commencing a review into a number of customer cases from the former HBOS Impaired Assets Office based in Reading. This review follows the conclusion of a criminal trial in which a number of individuals, including two former HBOS employees, were convicted of conspiracy to corrupt, fraudulent trading and associated money laundering offences which occurred prior to the acquisition of HBOS by the Group in 2009. The review is at an early stage and it is currently not possible to determine the ultimate financial impact on the Group.

Other legal actions and regulatory matters

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

Notes to the consolidated financial statements continued

NOTE 48: CONTINGENT LIABILITIES AND COMMITMENTS continued

	2016 £m	2015 £m
Contingent liabilities		
Acceptances and endorsements	21	52
Other:		
Other items serving as direct credit substitutes	779	458
Performance bonds and other transaction-related contingencies	2,237	2,123
	3,016	2,581
Total contingent liabilities	3,037	2,633

The contingent liabilities of the Group arise in the normal course of its banking business and it is not practicable to quantify their future financial effect.

	2016 £m	2015 £m
Commitments		
Forward asset purchases and forward deposits placed	648	421
Undrawn formal standby facilities, credit lines and other commitments to lend:		
Less than 1 year original maturity:		
Mortgage offers made	10,749	9,995
Other commitments	62,697	57,809
	73,446	67,804
1 year or over original maturity	40,074	44,691
Total commitments	114,168	112,916

Of the amounts shown above in respect of undrawn formal standby facilities, credit lines and other commitments to lend, £63,203 million (2015: £63,086 million) was 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:

	2016 £m	2015 £m
Not later than 1 year	264	267
Later than 1 year and not later than 5 years	855	885
Later than 5 years	944	1,049
Total operating lease commitments	2,063	2,201

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 in respect of investment property (note 26), capital expenditure contracted but not provided for at 31 December 2016 amounted to £543 million (2015: £388 million). Of this amount, £541 million (2015: £380 million) related 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.

NOTE 49: 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 table analyses the carrying amounts of the financial assets and liabilities by category and by balance sheet heading.

		At fair value through profit or loss						
	Derivatives designated as hedging instruments £m	Held for trading £m	Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2016								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	47,452	–	47,452
Items in the course of collection from banks	–	–	–	–	–	706	–	706
Trading and other financial assets at fair value through profit or loss	–	45,253	105,921	–	–	–	–	151,174
Derivative financial instruments	2,712	33,426	–	–	–	–	–	36,138
Loans and receivables:								
Loans and advances to banks	–	–	–	–	26,902	–	–	26,902
Loans and advances to customers	–	–	–	–	457,958	–	–	457,958
Debt securities	–	–	–	–	3,397	–	–	3,397
	–	–	–	–	488,257	–	–	488,257
Available-for-sale financial assets	–	–	–	56,524	–	–	–	56,524
Total financial assets	2,712	78,679	105,921	56,524	488,257	48,158	–	780,251
Financial liabilities								
Deposits from banks	–	–	–	–	–	16,384	–	16,384
Customer deposits	–	–	–	–	–	415,460	–	415,460
Items in course of transmission to banks	–	–	–	–	–	548	–	548
Trading and other financial liabilities at fair value through profit or loss	–	45,079	9,425	–	–	–	–	54,504
Derivative financial instruments	1,964	32,960	–	–	–	–	–	34,924
Notes in circulation	–	–	–	–	–	1,402	–	1,402
Debt securities in issue	–	–	–	–	–	76,314	–	76,314
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	94,390	94,390
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	20,112	20,112
Unallocated surplus within insurance businesses	–	–	–	–	–	–	243	243
Subordinated liabilities	–	–	–	–	–	19,831	–	19,831
Total financial liabilities	1,964	78,039	9,425	–	–	529,939	114,745	734,112

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

	Derivatives designated as hedging instruments £m	At fair value through profit or loss: Held for trading £m	At fair value through profit or loss: Designated upon initial recognition £m	Available-for-sale £m	Loans and receivables £m	Held at amortised cost £m	Insurance contracts £m	Total £m
At 31 December 2015								
Financial assets								
Cash and balances at central banks	–	–	–	–	–	58,417	–	58,417
Items in the course of collection from banks	–	–	–	–	–	697	–	697
Trading and other financial assets at fair value through profit or loss	–	42,661	97,875	–	–	–	–	140,536
Derivative financial instruments	2,686	26,781	–	–	–	–	–	29,467
Loans and receivables:								
Loans and advances to banks	–	–	–	–	25,117	–	–	25,117
Loans and advances to customers	–	–	–	–	455,175	–	–	455,175
Debt securities	–	–	–	–	4,191	–	–	4,191
	–	–	–	–	484,483	–	–	484,483
Available-for-sale financial assets	–	–	–	33,032	–	–	–	33,032
Held-to-maturity investments	–	–	–	–	–	19,808	–	19,808
Total financial assets	2,686	69,442	97,875	33,032	484,483	78,922	–	766,440
Financial liabilities								
Deposits from banks	–	–	–	–	–	16,925	–	16,925
Customer deposits	–	–	–	–	–	418,326	–	418,326
Items in course of transmission to banks	–	–	–	–	–	717	–	717
Trading and other financial liabilities at fair value through profit or loss	–	43,984	7,879	–	–	–	–	51,863
Derivative financial instruments	2,437	23,864	–	–	–	–	–	26,301
Notes in circulation	–	–	–	–	–	1,112	–	1,112
Debt securities in issue	–	–	–	–	–	82,056	–	82,056
Liabilities arising from insurance contracts and participating investment contracts	–	–	–	–	–	–	80,294	80,294
Liabilities arising from non-participating investment contracts	–	–	–	–	–	–	22,777	22,777
Unallocated surplus within insurance businesses	–	–	–	–	–	–	257	257
Subordinated liabilities	–	–	–	–	–	23,312	–	23,312
Total financial liabilities	2,437	67,848	7,879	–	–	542,448	103,328	723,940

NOTE 49: FINANCIAL INSTRUMENTS continued

(2) Fair value measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a measure as at a specific date and may be significantly different from the amount which will actually be paid or received on maturity or settlement date.

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.

The Group manages valuation adjustments for its derivative exposures on a net basis; the Group determines their fair values on the basis of their net exposures. In all other cases, fair values of financial assets and liabilities measured at fair value are determined on the basis of their gross exposures.

The carrying amount of the following financial instruments is a reasonable approximation of fair value: cash and balances at central banks, items in the course of collection from banks, items in course of transmission to banks, notes in circulation and liabilities arising from non-participating investment contracts.

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 are not financial instruments or for other assets and liabilities which are not carried at fair value in the Group's consolidated balance sheet. 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 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.

Valuation of financial assets and liabilities

Assets and liabilities carried at fair value or for which fair values are disclosed have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1

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 equity shares, treasury bills and other government securities.

Level 2

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

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.

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.

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

(3) Financial assets and liabilities carried at fair value

Critical accounting estimates and judgements

The valuation techniques for level 2 and, particularly, level 3 financial instruments involve management judgement and estimates the extent of which depends on the complexity of the instrument and the availability of market observable information. In addition, in line with market practice, the Group applies credit, debit and funding valuation adjustments in determining the fair value of its uncollateralised derivative positions. A description of these adjustments is set out in this note on page 253. Further details of the Group's level 3 financial instruments and the sensitivity of their valuation including the effect of applying reasonably possible alternative assumptions in determining their fair value are set out below. Details about sensitivities to market risk arising from trading assets and other treasury positions can be found in the risk management section on page 146.

(A) Financial assets, excluding derivatives

Valuation hierarchy

At 31 December 2016, the Group's financial assets carried at fair value, excluding derivatives, totalled £207,698 million (31 December 2015: £173,568 million). The table below analyses these financial assets by balance sheet classification, asset type and valuation methodology (level 1, 2 or 3, as described on page 247). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

Valuation hierarchy

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	30,473	–	30,473
Loans and advances to banks	–	2,606	–	2,606
Debt securities:				
Government securities	24,959	1,773	–	26,732
Other public sector securities	–	1,279	46	1,325
Bank and building society certificates of deposit	–	244	–	244
Asset-backed securities:				
Mortgage-backed securities	–	654	53	707
Other asset-backed securities	4	1,092	442	1,538
Corporate and other debt securities	112	17,968	1,752	19,832
	25,075	23,010	2,293	50,378
Equity shares	66,147	37	1,513	67,697
Treasury and other bills	20	–	–	20
Total trading and other financial assets at fair value through profit or loss	91,242	56,126	3,806	151,174
Available-for-sale financial assets				
Debt securities:				
Government securities	48,542	172	–	48,714
Bank and building society certificates of deposit	–	142	–	142
Asset-backed securities:				
Mortgage-backed securities	–	108	–	108
Other asset-backed securities	–	184	133	317
Corporate and other debt securities	107	5,923	–	6,030
	48,649	6,529	133	55,311
Equity shares	435	17	761	1,213
Total available-for-sale financial assets	49,084	6,546	894	56,524
Total financial assets carried at fair value, excluding derivatives	**140,326**	**62,672**	**4,700**	**207,698**

NOTE 49: FINANCIAL INSTRUMENTS continued

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2015				
Trading and other financial assets at fair value through profit or loss				
Loans and advances to customers	–	30,109	–	30,109
Loans and advances to banks	–	3,065	–	3,065
Debt securities:				
Government securities	20,881	1,235	1	22,117
Other public sector securities	–	759	1,280	2,039
Bank and building society certificates of deposit	–	135	–	135
Asset-backed securities:				
Mortgage-backed securities	–	1,295	63	1,358
Other asset-backed securities	–	839	8	847
Corporate and other debt securities	38	18,241	2,037	20,316
	20,919	22,504	3,389	46,812
Equity shares	58,457	292	1,727	60,476
Treasury and other bills	74	–	–	74
Total trading and other financial assets at fair value through profit or loss	79,450	55,970	5,116	140,536
Available-for-sale financial assets				
Debt securities:				
Government securities	25,259	70	–	25,329
Bank and building society certificates of deposit	–	186	–	186
Asset-backed securities:				
Mortgage-backed securities	–	197	–	197
Other asset-backed securities	–	264	55	319
Corporate and other debt securities	7	5,801	–	5,808
	25,266	6,518	55	31,839
Equity shares	43	521	629	1,193
Total available-for-sale financial assets	25,309	7,039	684	33,032
Total financial assets carried at fair value, excluding derivatives	104,759	63,009	5,800	173,568

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

Movements in Level 3 portfolio

The table below analyses movements in level 3 financial assets, excluding derivatives, carried at fair value (recurring measurement).

	2016			2015		
	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets carried at fair value, excluding derivatives (recurring basis) £m	Trading and other financial assets at fair value through profit or loss £m	Available-for-sale £m	Total level 3 assets carried at fair value, excluding derivatives (recurring basis) £m
At 1 January	5,116	684	5,800	5,104	270	5,374
Exchange and other adjustments	8	12	20	–	–	–
Gains recognised in the income statement within other income	437	–	437	192	–	192
Gains recognised in other comprehensive income within the revaluation reserve in respect of available-for-sale financial assets	–	312	312	–	302	302
Purchases	833	258	1,091	965	68	1,033
Sales	(2,597)	(527)	(3,124)	(1,070)	(11)	(1,081)
Transfers into the level 3 portfolio	186	155	341	71	55	126
Transfers out of the level 3 portfolio	(177)	–	(177)	(146)	–	(146)
At 31 December	3,806	894	4,700	5,116	684	5,800
Gains recognised in the income statement, within other income, relating to the change in fair value of those assets held at 31 December	642	–	642	34	–	34

Valuation methodology for financial assets, excluding derivatives

Loans and advances to customers and banks

These assets are principally reverse repurchase agreements. The fair value of these assets is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security purchased under the reverse repurchase agreement.

Debt securities

Debt securities measured at fair value and classified as level 2 are valued by discounting expected cash flows using an observable credit spread applicable to the particular instrument.

Where there is limited trading activity in debt securities, the Group uses valuation models, consensus pricing information from third party pricing services and broker or lead manager quotes to determine an appropriate valuation. Debt securities are classified as level 3 if there is a significant valuation input that cannot be corroborated through market sources or where there are materially inconsistent values for an input. Asset classes classified as level 3 mainly comprise certain collateralised loan obligations and collateralised debt obligations.

Equity investments

Unlisted equity and fund investments are valued using different techniques in accordance with the Group's valuation policy and 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. 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.

Unlisted equity investments and investments in property partnerships held in the life assurance funds are valued using third party valuations. 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.

NOTE 49: FINANCIAL INSTRUMENTS continued

(B) Financial liabilities, excluding derivatives

Valuation hierarchy

At 31 December 2016, the Group's financial liabilities carried at fair value, excluding derivatives, comprised its trading and other financial liabilities at fair value through profit or loss and totalled £54,504 million (31 December 2015: £51,863 million). (Financial guarantees are also recognised at fair value, on initial recognition, and are classified as level 3; but the balance is not material). The table below analyses these financial liabilities by balance sheet classification and valuation methodology (level 1, 2 or 3, as described on page 247). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and 2 during the year.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
At 31 December 2016				
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss	–	9,423	2	9,425
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	42,067	–	42,067
Short positions in securities	2,417	65	–	2,482
Other	–	530	–	530
	2,417	42,662	–	45,079
Total financial liabilities carried at fair value, excluding derivatives	**2,417**	**52,085**	**2**	**54,504**
At 31 December 2015				
Trading and other financial liabilities at fair value through profit or loss				
Liabilities held at fair value through profit or loss	–	7,878	1	7,879
Trading liabilities:				
Liabilities in respect of securities sold under repurchase agreements	–	38,431	–	38,431
Short positions in securities	4,153	287	–	4,440
Other	–	1,113	–	1,113
	4,153	39,831	–	43,984
Total financial liabilities carried at fair value, excluding derivatives	4,153	47,709	1	51,863

The table below analyses movements in the level 3 financial liabilities portfolio, excluding derivatives. There were no transfers into or out of level 3 during 2015 or 2016.

	2016 £m	2015 £m
At 1 January	1	5
Losses (gains) recognised in the income statement within other income	1	–
Redemptions	–	(4)
At 31 December	**2**	1
Gains recognised in the income statement, within other income, relating to the change in fair value of those liabilities held at 31 December	1	–

Valuation methodology for financial liabilities, excluding derivatives

Liabilities held at fair value through profit or loss

These principally comprise debt securities in issue which are classified as level 2 and their fair value is determined using techniques whose inputs are based on observable market data. The carrying amount of the securities is adjusted to reflect the effect of changes in own credit spreads. The resulting gain or loss is recognised in the income statement.

At 31 December 2016, the own credit adjustment arising from the fair valuation of £9,423 million (2015: £7,878 million) of the Group's debt securities in issue designated at fair value through profit or loss resulted in a loss of £28 million (2015: gain of £114 million).

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

Trading liabilities in respect of securities sold under repurchase agreements

The fair value of these liabilities is determined using discounted cash flow techniques. The discount rates are derived from observable repo curves specific to the type of security sold under the repurchase agreement.

(C) Derivatives

All of the Group's derivative assets and liabilities are carried at fair value. At 31 December 2016, such assets totalled £36,138 million (31 December 2015: £29,467 million) and liabilities totalled £34,924 million (31 December 2015: £26,301 million). The table below analyses these derivative balances by valuation methodology (level 1, 2 or 3, as described on page 247). The fair value measurement approach is recurring in nature. There were no significant transfers between level 1 and level 2 during the year.

	2016				2015			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Derivative assets	**270**	**34,469**	**1,399**	**36,138**	43	27,955	1,469	29,467
Derivative liabilities	**(358)**	**(33,606)**	**(960)**	**(34,924)**	(41)	(25,537)	(723)	(26,301)

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 which are valued using standard models with observable inputs, except for the items classified as level 3, which are valued using publicly available yield and credit default swap (CDS) curves.
- Less complex interest rate and foreign exchange option products which 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.

The table below analyses movements in level 3 derivative assets and liabilities carried at fair value.

	2016		2015	
	Derivative assets £m	Derivative liabilities £m	Derivative assets £m	Derivative liabilities £m
At 1 January	**1,469**	**(723)**	2,771	(1,456)
Exchange and other adjustments	**74**	**(53)**	(25)	18
Gains (losses) recognised in the income statement within other income	**220**	**(299)**	(87)	(36)
Purchases (additions)	**24**	**(13)**	72	(74)
(Sales) redemptions	**(91)**	**128**	(125)	120
Derecognised pursuant to tender offers and redemptions in respect of Enhanced Capital Notes	**(476)**	**–**	–	–
Transfers into the level 3 portfolio	**216**	**–**	126	(114)
Transfers out of the level 3 portfolio	**(37)**	**–**	(1,263)	819
At 31 December	**1,399**	**(960)**	1,469	(723)
Gains (losses) recognised in the income statement, within other income, relating to the change in fair value of those assets or liabilities held at 31 December	**284**	**(262)**	(95)	(12)

NOTE 49: FINANCIAL INSTRUMENTS continued

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.

(i) Uncollateralised derivative valuation adjustments, excluding monoline counterparties

The following table summarises the movement on this valuation adjustment account during 2015 and 2016:

	2016 £m	2015 £m
At 1 January	598	608
Income statement charge (credit)	163	(38)
Transfers	(17)	28
At 31 December	**744**	598

Represented by:

	2016 £m	2015 £m
Credit Valuation Adjustment	685	511
Debit Valuation Adjustment	(123)	(78)
Funding Valuation Adjustment	182	165
	744	598

Credit and Debit Valuation Adjustments (CVA and DVA) are applied to the Group's over-the-counter derivative exposures with counterparties that are not subject to standard interbank collateral arrangements. These exposures largely relate to the provision of risk management solutions for corporate customers within the Commercial Banking division.

A CVA is taken where the Group has a positive future uncollateralised exposure (asset). A DVA is taken where the Group has a negative future uncollateralised exposure (liability). These adjustments reflect interest rates and expectations of counterparty creditworthiness and the Group's own credit spread respectively.

The CVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised asset;

– expectations of future market volatility of the underlying asset; and

– expectations of counterparty creditworthiness.

In circumstances where exposures to a counterparty become impaired, any associated derivative valuation adjustment is transferred and assessed for specific loss alongside other non-derivative assets and liabilities that the counterparty may have with the Group.

Market Credit Default Swap (CDS) spreads are used to develop the probability of default for quoted counterparties. For unquoted counterparties, internal credit ratings and market sector CDS curves and recovery rates are used. The Loss Given Default (LGD) is based on market recovery rates and internal credit assessments.

The combination of a one notch deterioration in the credit rating of derivative counterparties and a ten per cent increase in LGD increases the CVA by £64 million. Current market value is used to estimate the projected exposure for products not supported by the model, which are principally complex interest rate options that are traded in very low volumes. For these, the CVA is calculated on an add-on basis (in total contributing £1 million of the overall CVA balance at 31 December 2016).

The DVA is sensitive to:

– the current size of the mark-to-market position on the uncollateralised liability;

– expectations of future market volatility of the underlying liability; and

– the Group's own CDS spread.

A one per cent rise in the CDS spread would lead to an increase in the DVA of £152 million to £275 million.

The risk exposures that are used for the CVA and DVA calculations are strongly influenced by interest rates. Due to the nature of the Group's business the CVA/DVA exposures tend to be on average the same way around such that the valuation adjustments fall when interest rates rise. A one per cent rise in interest rates would lead to a £221 million fall in the overall valuation adjustment to £341 million. The CVA model used by the Group does not assume any correlation between the level of interest rates and default rates.

The Group has also recognised a Funding Valuation Adjustment to adjust for the net cost of funding uncollateralised derivative positions. This adjustment is calculated on the expected future exposure discounted at a suitable cost of funds. A ten basis points increase in the cost of funds will increase the funding valuation adjustment by approximately £32 million.

(ii) Market liquidity

The Group includes mid to bid-offer valuation adjustments against the expected cost of closing out the net market risk in the Group's trading positions within a timeframe that is consistent with historical trading activity and spreads that the trading desks have accessed historically during the ordinary course of business in normal market conditions.

At 31 December 2016, the Group's derivative trading business held mid to bid-offer valuation adjustments of £96 million (2015: £76 million).

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

(D) Sensitivity of level 3 valuations

	Valuation techniques	Significant unobservable inputs[1]	At 31 December 2016 Carrying value £m	At 31 December 2016 Effect of reasonably possible alternative assumptions[2] Favourable changes £m	At 31 December 2016 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m	At 31 December 2015 Carrying value £m	At 31 December 2015 Effect of reasonably possible alternative assumptions[2] Favourable changes £m	At 31 December 2015 Effect of reasonably possible alternative assumptions[2] Unfavourable changes £m
Trading and other financial assets at fair value through profit or loss								
Debt securities	Discounted cash flows	Credit spreads (bps) (1ps/2ps)	**29**	**5**	**(5)**	92	7	(7)
Asset-backed securities	Lead manager or broker quote	n/a	**59**	**–**	**–**	62	–	–
Equity and venture capital investments	Market approach	Earnings multiple (0.9/10.0)	**2,163**	**63**	**(68)**	2,279	72	(72)
	Underlying asset/ net asset value (incl. property prices)[3]	n/a	**54**	**2**	**(3)**	145	8	(14)
Unlisted equities and debt securities, property partnerships in the life funds	Underlying asset/ net asset value (incl. property prices)[3]	n/a	**1,501**	**–**	**(32)**	2,538	–	(48)
			3,806			5,116		
Available-for-sale financial assets								
Asset-backed securities	Lead manager or broker quote/consensus pricing	n/a	**133**	**–**	**–**	55	–	–
Equity and venture capital investments	Underlying asset/net asset value (incl. property prices)[3]	n/a	**761**	**48**	**(53)**	339	25	(27)
Other	Various	n/a	**–**	**–**	**–**	290	–	–
			894			684		
Derivative financial assets								
Embedded equity conversion feature	Lead manager or broker quote	Equity conversion feature spread	**–**	**–**	**–**	545	14	(14)
Interest rate derivatives	Option pricing model	Interest rate volatility (0%/115%)	**1,399**	**(3)**	**(19)**	924	20	(19)
			1,399			1,469		
Level 3 financial assets carried at fair value			**6,099**			7,269		
Trading and other financial liabilities at fair value through profit or loss			**2**	**–**	**–**	1	–	–
Derivative financial liabilities								
Interest rate derivatives	Option pricing model	Interest rate volatility (0%/115%)	**960**	**–**	**–**	723	–	–
			960			723		
Level 3 financial liabilities carried at fair value			**962**			724		

1 Ranges are shown where appropriate and represent the highest and lowest inputs used in the level 3 valuations.

2 Where the exposure to an unobservable input is managed on a net basis, only the net impact is shown in the table.

3 Underlying asset/net asset values represent fair value.

NOTE 49: FINANCIAL INSTRUMENTS continued

Unobservable inputs

Significant unobservable inputs affecting the valuation of debt securities, unlisted equity investments and derivatives are as follows:

– Interest rates and inflation rates are referenced in some derivatives where the payoff that the holder of the derivative receives depends on the behaviour of those underlying references through time.
– Credit spreads represent the premium above the benchmark reference instrument required to compensate for lower credit quality; higher spreads lead to a lower fair value.
– Volatility parameters represent key attributes of option behaviour; higher volatilities typically denote a wider range of possible outcomes.
– Earnings multiples are used to value certain unlisted equity investments; a higher earnings multiple will result in a higher fair value.

Reasonably possible alternative assumptions

Valuation techniques applied to many of the Group's level 3 instruments often involve the use of two or more inputs whose relationship is interdependent. The calculation of the effect of reasonably possible alternative assumptions included in the table above reflects such relationships.

Debt securities

Reasonably possible alternative assumptions have been determined in respect of the Group's structured credit investment by flexing credit spreads.

Derivatives

Reasonably possible alternative assumptions have been determined in respect of swaptions in the Group's derivative portfolios which are priced using industry standard option pricing models. Such models require interest rate volatilities which may be unobservable at longer maturities. To derive reasonably possible alternative valuations these volatilities have been flexed within a range of nil per cent to 115 per cent (2015: 1 per cent and 63 per cent).

Unlisted equity, venture capital investments and investments in property partnerships

The valuation techniques used for unlisted equity and venture capital investments vary depending on the nature of the investment. Reasonably possible alternative valuations for these investments have been calculated by reference to the approach taken, as appropriate to the business sector and investment circumstances and as such the following inputs have been considered:

– for valuations derived from earnings multiples, consideration is given to the risk attributes, growth prospects and financial gearing of comparable businesses when selecting an appropriate multiple;
– the discount rates used in discounted cash flow valuations; and
– in line with International Private Equity and Venture Capital Guidelines, the values of underlying investments in fund investments portfolios.

Notes to the consolidated financial statements continued

NOTE 49: FINANCIAL INSTRUMENTS continued

(4) Financial assets and liabilities carried at amortised cost

(A) Financial assets

Valuation hierarchy

The table below analyses the fair values of the financial assets of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 247). Loans and receivables are mainly classified as level 3 due to significant unobservable inputs used in the valuation models. Where inputs are observable, debt securities are classified as level 1 or 2.

			Valuation hierarchy		
	Carrying value £m	Fair value £m	Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2016					
Loans and receivables:					
Loans and advances to customers: unimpaired	**451,339**	**450,986**	**–**	**–**	**450,986**
Loans and advances to customers: impaired	**6,619**	**6,475**	**–**	**–**	**6,475**
Loans and advances to customers	**457,958**	**457,461**	**–**	**–**	**457,461**
Loans and advances to banks	**26,902**	**26,812**	**–**	**–**	**26,812**
Debt securities	**3,397**	**3,303**	**–**	**3,288**	**15**
Reverse repos included in above amounts:					
Loans and advances to customers	**8,304**	**8,304**	**–**	**–**	**8,304**
Loans and advances to banks	**902**	**902**	**–**	**–**	**902**
At 31 December 2015					
Loans and receivables:					
Loans and advances to customers: unimpaired	448,010	447,808	–	–	447,808
Loans and advances to customers: impaired	7,165	6,989	–	–	6,989
Loans and advances to customers	455,175	454,797	–	–	454,797
Loans and advances to banks	25,117	25,130	–	–	25,130
Debt securities	4,191	4,107	7	4,090	10
Held-to-maturity investments	19,808	19,851	19,851	–	–
Reverse repos included in above amounts:					
Loans and advances to customers	–	–	–	–	–
Loans and advances to banks	963	963	–	–	963

Valuation methodology

Loans and advances to customers
The Group provides loans and advances to commercial, corporate and personal customers at both fixed and variable rates due to their short term nature. The carrying value of the variable rate loans and those relating to lease financing is assumed to be their fair value.

To determine the fair value of loans and advances to customers, loans are segregated into portfolios of similar characteristics. A number of techniques are used to estimate the fair value of fixed rate lending; these take account of expected credit losses based on historic trends, prevailing market interest rates and expected future cash flows. For retail exposures, fair value is usually 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. 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 value of commercial 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. No adjustment is made to put it in place by the Group to manage its interest rate exposure.

Loans and advances to banks
The carrying value of short dated loans and advances to banks is assumed to be their fair value. The fair value of loans and advances to banks is estimated by discounting the anticipated cash flows at a market discount rate adjusted for the credit spread of the obligor or, where not observable, the credit spread of borrowers of similar credit quality.

Debt securities
The fair values of debt securities, which were previously within assets held for trading and were reclassified to loans and receivables, 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.

Reverse repurchase agreements
The carrying amount is deemed a reasonable approximation of fair value given the short-term nature of these instruments.

NOTE 49: FINANCIAL INSTRUMENTS continued

(B) Financial liabilities

Valuation hierarchy

The table below analyses the fair values of the financial liabilities of the Group which are carried at amortised cost by valuation methodology (level 1, 2 or 3, as described on page 247).

	Carrying value £m	Fair value £m	Valuation hierarchy Level 1 £m	Level 2 £m	Level 3 £m
At 31 December 2016					
Deposits from banks	**16,384**	**16,395**	**–**	**16,395**	**–**
Customer deposits	**415,460**	**416,490**	**–**	**408,571**	**7,919**
Debt securities in issue	**76,314**	**79,650**	**–**	**79,434**	**216**
Subordinated liabilities	**19,831**	**22,395**	**–**	**22,395**	**–**
Repos included in above amounts:					
Deposits from banks	**7,279**	**7,279**	**–**	**7,279**	**–**
Customer deposits	**2,462**	**2,462**	**–**	**2,462**	**–**
At 31 December 2015					
Deposits from banks	16,925	16,934	–	16,934	–
Customer deposits	418,326	418,512	–	407,417	11,095
Debt securities in issue	82,056	85,093	–	81,132	3,961
Subordinated liabilities	23,312	26,818	–	26,818	–
Repos included in above amounts:					
Deposits from banks	7,061	7,061	–	7,061	–
Customer deposits	–	–	–	–	–

Valuation methodology

Deposits from banks and customer deposits
The fair value of bank and customer deposits repayable on demand is assumed 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
The fair value of short-term debt securities in issue is approximately equal to their carrying value. Fair value for other debt securities is calculated based on quoted market prices where available. Where quoted market prices are not available, fair value is estimated using discounted cash flow techniques at a rate which reflects market rates of interest and the Group's own credit spread.

Subordinated liabilities
The fair value of subordinated liabilities is determined by reference to quoted market prices where available or by reference to quoted market prices of similar instruments. Subordinated liabilities are classified as level 2, since the inputs used to determine their fair value are largely observable.

Repurchase agreements
The carrying amount is deemed a reasonable approximation of fair value given the short term nature of these instruments.

(5) Reclassifications of financial assets

In 2015 the Group had 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, and reflecting the Group's positive intent and ability to hold them until maturity in the economic environment at the time, the Group concluded that certain of these securities would be able to be held until they reached maturity and consequently, on 1 May 2015, government securities with a fair value of £19,938 million were reclassified from available-for-sale financial assets to held-to-maturity investments. During 2016, the Group has reassessed this holding of government securities classified as held-to-maturity in light of the current low interest rate environment and they have been reclassified as available-for-sale; this resulted in a credit of £1,544 million to the available-for-sale revaluation reserve (£1,127 million after tax).

Notes to the consolidated financial statements continued

NOTE 50: TRANSFERS OF FINANCIAL ASSETS

There were no significant transferred financial assets which were derecognised in their entirety, but with ongoing exposure. Details of transferred financial assets that continue to be recognised in full are as follows.

The Group enters into repurchase and securities lending transactions in the normal course of business that do not result in derecognition of the financial assets covered as substantially all of the risks and rewards, including credit, interest rate, prepayment and other price risks are retained by the Group. In all cases, the transferee has the right to sell or repledge the assets concerned.

As set out in note 19, included within loans and receivables are loans transferred under the Group's securitisation and covered bond programmes. As the Group retains all of a majority of the risks and rewards associated with these loans, including credit, interest rate, prepayment and liquidity risk, they remain on the Group's balance sheet. Assets transferred into the Group's securitisation and covered bond programmes are not available to be used by the Group whilst the assets are within the programmes. However, the Group retains the right to remove loans from the covered bond programmes where they are in excess of the programme's requirements. In addition, where the Group has retained some of the notes issued by securitisation and covered bond programmes, the Group has the ability to sell or pledge these retained notes.

The table below sets out the carrying values of the transferred assets and the associated liabilities. For repurchase and securities lending transactions, the associated liabilities represent the Group's obligation to repurchase the transferred assets. For securitisation programmes, the associated liabilities represent the external notes in issue (note 31). Except as otherwise noted below, none of the liabilities shown in the table below have recourse only to the transferred assets.

	2016		2015	
	Carrying value of transferred assets £m	Carrying value of associated liabilities £m	Carrying value of transferred assets £m	Carrying value of associated liabilities £m
Repurchase and securities lending transactions				
Trading and other financial assets at fair value through profit or loss	**10,256**	**3,380**	13,711	7,460
Available-for-sale financial assets	**24,681**	**21,809**	18,141	14,295
Loans and receivables:				
Loans and advances to customers	**583**	**–**	1,491	–
Securitisation programmes				
Loans and receivables:				
Loans and advances to customers[1]	**52,184**	**7,253**	58,090	7,763

1 The carrying value of associated liabilities excludes securitisation notes held by the Group of £26,435 million (31 December 2015: £29,303 million).

NOTE 51: OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES

The following information relates to financial assets and liabilities which have been offset in the balance sheet and those which have not been offset but for which the Group has enforceable master netting agreements or collateral arrangements in place with counterparties.

At 31 December 2016	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet[2] £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[3]: Cash collateral received/pledged £m	Related amounts where set off in the balance sheet not permitted[3]: Non-cash collateral received/pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	118,095	–	118,095	–	(3,265)	114,830
Reverse repos	35,298	(2,219)	33,079	–	(33,079)	–
	153,393	(2,219)	151,174	–	(36,344)	114,830
Derivative financial instruments	92,390	(56,252)	36,138	(6,472)	(19,906)	9,760
Loans and advances to banks:						
Excluding reverse repos	26,000	–	26,000	(2,826)	–	23,174
Reverse repos	902	–	902	–	(902)	–
	26,902	–	26,902	(2,826)	(902)	23,174
Loans and advances to customers:						
Excluding reverse repos	451,290	(1,636)	449,654	(1,793)	(6,331)	441,530
Reverse repos	8,304	–	8,304	–	(8,304)	–
	459,594	(1,636)	457,958	(1,793)	(14,635)	441,530
Debt securities	3,397	–	3,397	–	–	3,397
Available-for-sale financial assets	56,524	–	56,524	–	(21,475)	35,049
Financial liabilities						
Deposits from banks:						
Excluding repos	9,105	–	9,105	(5,080)	(695)	3,330
Repos	7,279	–	7,279	–	(7,279)	–
	16,384	–	16,384	(5,080)	(7,974)	3,330
Customer deposits:						
Excluding repos	415,153	(2,155)	412,998	(1,391)	(6,331)	405,276
Repos	2,462	–	2,462	–	(2,462)	–
	417,615	(2,155)	415,460	(1,391)	(8,793)	405,276
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	12,437	–	12,437	–	–	12,437
Repos	44,286	(2,219)	42,067	–	(42,067)	–
	56,723	(2,219)	54,504	–	(42,067)	12,437
Derivative financial instruments	90,657	(55,733)	34,924	(4,620)	(24,820)	5,484

Notes to the consolidated financial statements continued

NOTE 51: OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES continued

At 31 December 2015	Gross amounts of assets and liabilities[1] £m	Amounts offset in the balance sheet[2] £m	Net amounts presented in the balance sheet £m	Related amounts where set off in the balance sheet not permitted[3] Cash collateral received/ pledged £m	Non-cash collateral received/ pledged £m	Potential net amounts if offset of related amounts permitted £m
Financial assets						
Trading and other financial assets at fair value through profit or loss:						
Excluding reverse repos	107,362	–	107,362	–	(7,175)	100,187
Reverse repos	39,083	(5,909)	33,174	–	(33,174)	–
	146,445	(5,909)	140,536	–	(40,349)	100,187
Derivative financial instruments	62,937	(33,470)	29,467	(3,228)	(20,091)	6,148
Loans and advances to banks:						
Excluding reverse repos	24,154	–	24,154	(1,810)	–	22,344
Reverse repos	963	–	963	–	(963)	–
	25,117	–	25,117	(1,810)	(963)	22,344
Loans and advances to customers:						
Excluding reverse repos	457,546	(2,371)	455,175	(1,001)	(7,250)	446,924
Reverse repos	–	–	–	–	–	–
	457,546	(2,371)	455,175	(1,001)	(7,250)	446,924
Debt securities	4,191	–	4,191	–	–	4,191
Available-for-sale financial assets	33,032	–	33,032	–	(13,895)	19,137
Held-to-maturity investments	19,808	–	19,808	–	–	19,808
Financial liabilities						
Deposits from banks:						
Excluding repos	9,864	–	9,864	(2,770)	(1,387)	5,707
Repos	7,061	–	7,061	–	(7,061)	–
	16,925	–	16,925	(2,770)	(8,448)	5,707
Customer deposits:						
Excluding repos	420,330	(2,004)	418,326	(458)	(7,250)	410,618
Repos	–	–	–	–	–	–
	420,330	(2,004)	418,326	(458)	(7,250)	410,618
Trading and other financial liabilities at fair value through profit or loss:						
Excluding repos	13,432	–	13,432	–	–	13,432
Repos	44,340	(5,909)	38,431	–	(38,431)	–
	57,772	(5,909)	51,863	–	(38,431)	13,432
Derivative financial instruments	60,138	(33,837)	26,301	(2,811)	(22,586)	904

1 After impairment allowance.

2 The amounts set off in the balance sheet as shown above represent derivatives and repurchase agreements with central clearing houses which meet the criteria for offsetting under IAS 32.

3 The Group enters into derivatives and repurchase and reverse repurchase agreements with various counterparties which are governed by industry standard master netting agreements. The Group holds and provides cash and securities collateral in respect of derivative transactions covered by these agreements. The right to set off balances under these master netting agreements or to set off cash and securities collateral only arises in the event of non-payment or default and, as a result, these arrangements do not qualify for offsetting under IAS 32.

The effects of over collateralisation have not been taken into account in the above table.

NOTE 52: FINANCIAL RISK MANAGEMENT

As a bancassurer, 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 primary risks affecting the Group through its use of financial instruments are: credit risk; market risk, which includes interest rate risk and foreign exchange risk; liquidity risk; capital risk; and insurance risk. Information about the Group's exposure to each of the above risks and capital can be found on pages 115 to 169. The following additional disclosures, which provide quantitative information about the risks within financial instruments held or issued by the Group, should be read in conjunction with that earlier information.

Market risk

Interest rate risk

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. The rates on the remaining deposits are 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 many personal loans and mortgages, bear interest rates which are contractually fixed.

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.

At 31 December 2016 the aggregate notional principal of interest rate swaps designated as fair value hedges was £194,416 million (2015: £121,063 million) with a net fair value asset of £725 million (2015: asset of £848 million) (note 16). The losses on the hedging instruments were £1,946 million (2015: losses of £618 million). The gains on the hedged items attributable to the hedged risk were £2,017 million (2015: gains of £511 million).

In addition the Group has cash flow hedges which are primarily used to hedge the variability in the cost of funding within the commercial business. Note 16 shows when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges. The notional principal of the interest rate swaps designated as cash flow hedges at 31 December 2016 was £384,182 million (2015: £460,829 million) with a net fair value liability of £352 million (2015: liability of £718 million) (note 16). In 2016, ineffectiveness recognised in the income statement that arises from cash flow hedges was a gain of £24 million (2015: gain of £3 million).

Currency risk

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 market and liquidity risk function in London. Associated VaR and the closing, average, maximum and minimum are disclosed on page 151.

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 net investment in certain foreign operations using currency borrowings. At 31 December 2016 the aggregate principal of these currency borrowings was £695 million (2015: £670 million). In 2016, an ineffectiveness loss of £2 million before tax and £1 million after tax (2015: ineffectiveness gain of £5 million before tax and £4 million after tax) was recognised in the income statement arising from net investment hedges.

The Group's main overseas operations are in the Americas and Europe. Details of the Group's structural foreign currency exposures, after net investment hedges, are as follows:

Functional currency of Group operations

	2016			2015		
	Euro £m	US Dollar £m	Other non-sterling £m	Euro £m	US Dollar £m	Other non-sterling £m
Gross exposure	**247**	**479**	**36**	246	447	32
Net investment hedges	**(216)**	**(479)**	**–**	(254)	(415)	(1)
Total structural foreign currency exposures, after net investment hedges	**31**	**–**	**36**	(8)	32	31

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NOTE 52: FINANCIAL RISK MANAGEMENT continued

Credit risk

The Group's credit risk exposure arises in respect of the instruments below and predominantly in the United Kingdom. Information about the Group's exposure to credit risk, credit risk management, measurement and mitigation can be found on pages 124 to 144.

A. Maximum credit exposure

The maximum credit risk exposure of the Group 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, which includes amounts held to cover unit-linked and With Profits funds liabilities, is considered to be the balance sheet carrying amount or, for non-derivative off-balance sheet transactions and financial guarantees, their contractual nominal amounts.

	At 31 December 2016			At 31 December 2015		
	Maximum exposure £m	Offset[2] £m	Net exposure £m	Maximum exposure £m	Offset[2] £m	Net exposure £m
Loans and receivables:						
Loans and advances to banks, net[1]	26,902	–	26,902	25,117	–	25,117
Loans and advances to customers, net[1]	457,958	(6,331)	451,627	455,175	(7,250)	447,925
Debt securities, net[1]	3,397	–	3,397	4,191	–	4,191
	488,257	(6,331)	481,926	484,483	(7,250)	477,233
Available-for-sale financial assets[3]	55,311	–	55,311	31,839	–	31,839
Held-to-maturity investments	–	–	–	19,808	–	19,808
Trading and other financial assets at fair value through profit or loss:[3,4]						
Loans and advances	33,079	–	33,079	33,174	–	33,174
Debt securities, treasury and other bills	50,398	–	50,398	46,886	–	46,886
	83,477	–	83,477	80,060	–	80,060
Derivative assets	36,138	(18,539)	17,599	29,467	(19,466)	10,001
Assets arising from reinsurance contracts held	714	–	714	675	–	675
Financial guarantees	6,883	–	6,883	7,165	–	7,165
Off-balance sheet items:						
Acceptances and endorsements	21	–	21	52	–	52
Other items serving as direct credit substitutes	779	–	779	458	–	458
Performance bonds and other transaction-related contingencies	2,237	–	2,237	2,123	–	2,123
Irrevocable commitments	63,203	–	63,203	63,086	–	63,086
	66,240	–	66,240	65,719	–	65,719
	737,020	(24,870)	712,150	719,216	(26,716)	692,500

1 Amounts shown net of related impairment allowances.

2 Offset items comprise deposit amounts available for offset, and amounts available for offset under master netting arrangements, that 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.

3 Excluding equity shares.

4 Includes assets within the Group's unit-linked funds for which credit risk is borne by the policyholders and assets within the Group's With-Profits funds for which credit risk is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back related contract liabilities.

B. Concentrations of exposure

The Group's management of concentration risk includes single name, industry sector and country limits as well as controls over the Group's overall exposure to certain products. Further information on the Group's management of this risk is included within Credit risk mitigation, Risk management on page 124.

At 31 December 2016 the most significant concentrations of exposure were in mortgages (comprising 67 per cent of total loans and advances to customers) and to financial, business and other services (comprising 11 per cent of the total). For further information on concentrations of the Group's loans, refer to note 18.

Following the continuing reduction in the Group's non-UK activities, an analysis of credit risk exposures by geographical region has not been provided.

NOTE 52: FINANCIAL RISK MANAGEMENT continued

C. Credit quality of assets

Loans and receivables

The disclosures in the table below and those on page 264 are produced under the underlying basis used for the Group's segmental reporting. The Group believes that, for reporting periods following a significant acquisition such as the acquisition of HBOS in 2009, this underlying basis, which includes the allowance for loan losses at the acquisition date 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.

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

Loans and advances

		Loans and advances to customers				
	Loans and advances to banks £m	Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2016						
Neither past due nor impaired	**26,888**	**296,303**	**39,478**	**109,364**	**445,145**	**33,079**
Past due but not impaired	**14**	**7,340**	**386**	**305**	**8,031**	**–**
Impaired – no provision required	**–**	**784**	**392**	**689**	**1,865**	**–**
– provision held	**–**	**3,536**	**1,038**	**2,056**	**6,630**	**–**
Gross	**26,902**	**307,963**	**41,294**	**112,414**	**461,671**	**33,079**
Allowance for impairment losses	**–**	**(1,696)**	**(458)**	**(1,378)**	**(3,532)**	**–**
Fair value adjustments	**–**				**(181)**	**–**
Net balance sheet carrying value	**26,902**				**457,958**	**33,079**
At 31 December 2015						
Neither past due nor impaired	25,006	302,063	38,886	100,001	440,950	33,174
Past due but not impaired	111	8,233	393	463	9,089	–
Impaired – no provision required	–	732	690	1,092	2,514	–
– provision held	–	3,269	911	2,896	7,076	–
Gross	25,117	314,297	40,880	104,452	459,629	33,174
Allowance for impairment losses	–	(1,617)	(448)	(2,107)	(4,172)	–
Fair value adjustments	–				(282)	–
Net balance sheet carrying value	25,117				455,175	33,174

The criteria that the Group uses to determine that there is objective evidence of an impairment loss are disclosed in note 2(H). Included in loans and receivables are advances which are individually determined to be impaired with a gross amount before impairment allowances of £2,870 million (31 December 2015: £4,406 million).

The table below sets out the reconciliation of the allowance for impairment losses of £2,412 million (2015: £3,033 million) shown in note 21 to the allowance for impairment losses on an underlying basis of £3,532 million (2015: £4,172 million) shown above:

	2016 £m	2015 £m
Allowance for impairment losses on loans and advances to customers	**2,412**	3,033
HBOS allowance at 16 January 2009[1]	**11,147**	11,147
HBOS charge covered by fair value adjustments[2]	**12,236**	12,166
Amounts subsequently written off	**(22,699)**	(22,623)
	684	690
Foreign exchange and other movements	**436**	449
Allowance for impairment losses on loans and advances to customers on an underlying basis	**3,532**	4,172

1 Comprises an allowance held at 31 December 2008 of £10,693 million and a charge for the period from 1 January 2009 to 16 January 2009 of £454 million.

2 This represents the element of the charge on loans and advances to customers in HBOS's results that was included within the Group's fair value adjustments in respect of the acquisition of HBOS on 16 January 2009.

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NOTE 52: FINANCIAL RISK MANAGEMENT continued

Loans and advances which are neither past due nor impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2016						
Good quality	**26,745**	**295,286**	**34,195**	**72,083**		**33,049**
Satisfactory quality	**87**	**814**	**4,479**	**30,433**		**30**
Lower quality	**3**	**39**	**387**	**6,433**		**–**
Below standard, but not impaired	**53**	**164**	**417**	**415**		**–**
Total loans and advances which are neither past due nor impaired	**26,888**	**296,303**	**39,478**	**109,364**	**445,145**	**33,079**
At 31 December 2015						
Good quality	24,670	301,403	33,589	63,453		33,156
Satisfactory quality	311	527	4,448	28,899		15
Lower quality	4	27	476	7,210		3
Below standard, but not impaired	21	106	373	439		–
Total loans and advances which are neither past due nor impaired	25,006	302,063	38,886	100,001	440,950	33,174

The definitions of good quality, satisfactory quality, lower quality and below standard, but not impaired applying to retail and commercial are not the same, reflecting the different characteristics of these exposures and the way they are managed internally, and consequently totals are not provided. Commercial 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. Further information about the Group's internal probabilities of default rating models can be found on page 124.

Loans and advances which are past due but not impaired

	Loans and advances to banks £m	Loans and advances to customers: Retail – mortgages £m	Retail – other £m	Commercial £m	Total £m	Loans and advances designated at fair value through profit or loss £m
At 31 December 2016						
0-30 days	**14**	**3,547**	**285**	**157**	**3,989**	**–**
30-60 days	**–**	**1,573**	**75**	**37**	**1,685**	**–**
60-90 days	**–**	**985**	**2**	**74**	**1,061**	**–**
90-180 days	**–**	**1,235**	**6**	**14**	**1,255**	**–**
Over 180 days	**–**	**–**	**18**	**23**	**41**	**–**
Total loans and advances which are past due but not impaired	**14**	**7,340**	**386**	**305**	**8,031**	**–**
At 31 December 2015						
0-30 days	111	4,066	276	248	4,590	–
30-60 days	–	1,732	81	100	1,913	–
60-90 days	–	1,065	9	52	1,126	–
90-180 days	–	1,370	8	19	1,397	–
Over 180 days	–	–	19	44	63	–
Total loans and advances which are past due but not impaired	111	8,233	393	463	9,089	–

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

NOTE 52: FINANCIAL RISK MANAGEMENT continued

Debt securities classified as loans and receivables

An analysis by credit rating of the Group's debt securities classified as loans and receivables is provided below:

	2016			2015		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Asset-backed securities:						
Mortgage-backed securities	2,089	–	2,089	2,528	–	2,528
Other asset-backed securities	1,192	98	1,290	1,140	94	1,234
	3,281	98	3,379	3,668	94	3,762
Corporate and other debt securities	29	65	94	417	109	526
Gross exposure	3,310	163	3,473	4,085	203	4,288
Allowance for impairment losses			(76)			(97)
Total debt securities classified as loans and receivables			3,397			4,191

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2016: £91 million; 2015: £87 million) and not rated (2016: £72 million; 2015: £116 million).

Available-for-sale financial assets (excluding equity shares)

An analysis of the Group's available-for-sale financial assets is included in note 22. The credit quality of the Group's available-for-sale financial assets (excluding equity shares) is set out below:

	2016			2015		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Debt securities:						
Government securities	48,714	–	48,714	25,329	–	25,329
Bank and building society certificates of deposit	142	–	142	186	–	186
Asset-backed securities:						
Mortgage-backed securities	108	–	108	197	–	197
Other asset-backed securities	312	5	317	315	4	319
	420	5	425	512	4	516
Corporate and other debt securities	6,030	–	6,030	5,808	–	5,808
Total held as available-for-sale financial assets	55,306	5	55,311	31,835	4	31,839

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2016: £5 million; 2015: £4 million) and not rated (2016: £nil; 2015: £nil).

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NOTE 52: FINANCIAL RISK MANAGEMENT continued

Debt securities, treasury and other bills held at fair value through profit or loss

An analysis of the Group's trading and other financial assets at fair value through profit or loss is included in note 15. The credit quality of the Group's debt securities, treasury and other bills held at fair value through profit or loss is set out below:

	2016			2015		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Debt securities, treasury and other bills held at fair value through profit or loss						
Trading assets:						
Government securities	11,828	–	11,828	8,269	–	8,269
Asset-backed securities:						
Mortgage-backed securities	47	–	47	516	–	516
Other asset-backed securities	69	–	69	85	–	85
	116	–	116	601	–	601
Corporate and other debt securities	221	3	224	582	30	612
Total held as trading assets	12,165	3	12,168	9,452	30	9,482
Other assets held at fair value through profit or loss:						
Government securities	14,904	–	14,904	13,848	–	13,848
Other public sector securities	1,318	7	1,325	2,023	16	2,039
Bank and building society certificates of deposit	244	–	244	135	–	135
Asset-backed securities:						
Mortgage-backed securities	633	27	660	801	41	842
Other asset-backed securities	1,178	291	1,469	762	–	762
	1,811	318	2,129	1,563	41	1,604
Corporate and other debt securities	17,445	2,163	19,608	17,371	2,333	19,704
Total debt securities held at fair value through profit or loss	35,722	2,488	38,210	34,940	2,390	37,330
Treasury bills and other bills	20	–	20	74	–	74
Total other assets held at fair value through profit or loss	35,742	2,488	38,230	35,014	2,390	37,404
Total held at fair value through profit or loss	47,907	2,491	50,398	44,466	2,420	46,886

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2016: £485 million; 2015: £544 million) and not rated (2016: £2,006 million; 2015: £1,876 million).

Credit risk in respect of trading and other financial assets at fair value through profit or loss held within the Group's unit-linked funds is borne by the policyholders and credit risk in respect of with-profits funds is largely borne by the policyholders. Consequently, the Group has no significant exposure to credit risk for such assets which back those contract liabilities.

NOTE 52: FINANCIAL RISK MANAGEMENT continued

Derivative assets

An analysis of derivative assets is given in note 16. 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. In respect of the Group's net credit risk relating to derivative assets of £17,599 million (2015: £10,001 million), cash collateral of £6,472 million (2015: £3,228 million) was held and a further £613 million was due from OECD banks (2015: £94 million).

	2016			2015		
	Investment grade[1] £m	Other[2] £m	Total £m	Investment grade[1] £m	Other[2] £m	Total £m
Trading and other	31,373	2,053	33,426	24,764	2,017	26,781
Hedging	2,664	48	2,712	2,653	33	2,686
Total derivative financial instruments	34,037	2,101	36,138	27,417	2,050	29,467

1 Credit ratings equal to or better than 'BBB'.

2 Other comprises sub-investment grade (2016: £1,830 million; 2015: £1,418 million) and not rated (2016: £271 million; 2015: £632 million).

Financial guarantees and irrevocable loan commitments

Financial guarantees 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.

D. Collateral held as security for financial assets

A general description of collateral held as security in respect of financial instruments is provided on page 126. The Group holds collateral against loans and receivables and irrevocable loan commitments; qualitative and, where appropriate, quantitative information is provided in respect of this collateral below. Collateral held as security for trading and other financial assets at fair value through profit or loss and for derivative assets is also shown below.

Loans and receivables

The disclosures below are produced under the underlying basis used for the Group's segmental reporting. The Group believes that, for reporting periods following a significant acquisition, such as the acquisition of HBOS in 2009, this underlying basis, which includes the allowance for loan losses at the acquisition on a gross basis, more fairly reflects the underlying provisioning status of the loans.

The Group holds collateral in respect of loans and advances to banks and customers as set out below. The Group does not hold collateral against debt securities, comprising asset-backed securities and corporate and other debt securities, which are classified as loans and receivables.

Loans and advances to banks

There were reverse repurchase agreements which are accounted for as collateralised loans within loans and advances to banks with a carrying value of £902 million (2015: £963 million), against which the Group held collateral with a fair value of £785 million (2015: £1,009 million).

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Loans and advances to customers

Retail lending

Mortgages

An analysis by loan-to-value ratio of the Group's residential mortgage lending is provided below. The value of collateral used in determining the loan-to-value ratios 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.

	2016				2015			
	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m	Neither past due nor impaired £m	Past due but not impaired £m	Impaired £m	Gross £m
Less than 70 per cent	220,497	5,288	2,334	228,119	211,631	4,907	1,965	218,503
70 per cent to 80 per cent	39,789	1,004	648	41,441	45,764	1,350	671	47,785
80 per cent to 90 per cent	23,589	621	495	24,705	27,529	935	528	28,992
90 per cent to 100 per cent	7,983	223	355	8,561	10,908	610	247	11,765
Greater than 100 per cent	4,445	204	488	5,137	6,231	431	590	7,252
Total	296,303	7,340	4,320	307,963	302,063	8,233	4,001	314,297

Notes to the consolidated financial statements continued

NOTE 52: FINANCIAL RISK MANAGEMENT continued

Other

The majority of non-mortgage retail lending is unsecured. At 31 December 2016, impaired non-mortgage lending amounted to £972 million, net of an impairment allowance of £458 million (2015: £1,153 million, net of an impairment allowance of £448 million). The fair value of the collateral held in respect of this lending was £139 million (2015: £107 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation and the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Unimpaired non-mortgage retail lending amounted to £39,864 million (2015: £39,279 million). Lending decisions are predominantly based on an obligor's ability to repay from normal business operations rather than reliance on the disposal of any security provided. Collateral values are rigorously assessed at the time of loan origination and are thereafter monitored in accordance with business unit credit policy.

The Group credit risk disclosures for unimpaired non-mortgage retail lending report assets gross of collateral and therefore disclose the maximum loss exposure. The Group believes that this approach is appropriate. The value of collateral is reassessed if there is observable evidence of distress of the borrower. Unimpaired non-mortgage retail lending, including any associated collateral, is managed on a customer-by-customer basis rather than a portfolio basis. No aggregated collateral information for the entire unimpaired non-mortgage retail lending portfolio is provided to key management personnel.

Commercial lending

Reverse repurchase transactions

At 31 December 2016 there were reverse repurchase agreements which were accounted for as collateralised loans with a carrying value of £8,304 million (2015: £nil), against which the Group held collateral with a fair value of £7,490 million (2015: £nil), all of which the Group was able to repledge. Included in these amounts were collateral balances in the form of cash provided in respect of reverse repurchase agreements of £8 million (2015: £nil). These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Impaired secured lending

The value of collateral is re-evaluated and its legal soundness re-assessed if there is observable evidence of distress of the borrower; this evaluation is used to determine potential loss allowances and management's strategy to try to either repair the business or recover the debt.

At 31 December 2016, impaired secured commercial lending amounted to £204 million, net of an impairment allowance of £401 million (2015: £1,245 million, net of an impairment allowance of £577 million). The fair value of the collateral held in respect of impaired secured commercial lending was £1,160 million (2015: £1,367 million). In determining the fair value of collateral, no specific amounts have been attributed to the costs of realisation. For the purposes of determining the total collateral held by the Group in respect of impaired secured commercial lending, the value of collateral for each loan has been limited to the principal amount of the outstanding advance in order to eliminate the effects of any over-collateralisation and to provide a clearer representation of the Group's exposure.

Impaired secured commercial lending and associated collateral relates to lending to property companies and to customers in the financial, business and other services; transport, distribution and hotels; and construction industries.

Unimpaired secured lending

Unimpaired secured commercial lending amounted to £36,275 million (2015: £51,298 million).

For unimpaired secured commercial lending, the Group reports assets gross of collateral and therefore discloses the maximum loss exposure. The Group believes that this approach is appropriate as collateral values at origination and during a period of good performance may not be representative of the value of collateral if the obligor enters a distressed state.

Unimpaired secured commercial lending is predominantly managed on a cash flow basis. On occasion, it may include an assessment of underlying collateral, although, for impaired lending, this will not always involve assessing it on a fair value basis. No aggregated collateral information for the entire unimpaired secured commercial lending portfolio is provided to key management personnel.

Trading and other financial assets at fair value through profit or loss (excluding equity shares)

Included in trading and other financial assets at fair value through profit or loss are reverse repurchase agreements treated as collateralised loans with a carrying value of £33,079 million (2015: £33,174 million). Collateral is held with a fair value of £30,850 million (2015: £36,493 million), all of which the Group is able to repledge. At 31 December 2016, £27,303 million had been repledged (2015: £15,438 million).

In addition, securities held as collateral in the form of stock borrowed amounted to £47,816 million (2015: £58,621 million). Of this amount, £16,204 million (2015: £29,859 million) had been resold or repledged as collateral for the Group's own transactions.

These transactions were generally conducted under terms that are usual and customary for standard secured lending activities.

Derivative assets, after offsetting of amounts under master netting arrangements

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. In respect of the net derivative assets after offsetting of amounts under master netting arrangements of £17,599 million (2015: £10,001 million), cash collateral of £6,472 million (2015: £3,228 million) was held.

Irrevocable loan commitments and other credit-related contingencies

At 31 December 2016, the Group held irrevocable loan commitments and other credit-related contingencies of £66,240 million (2015: £65,719 million). Collateral is held as security, in the event that lending is drawn down, on £10,053 million (2015: £9,551 million) of these balances.

Collateral repossessed

During the year, £241 million of collateral was repossessed (2015: £203 million), consisting primarily of residential property.

In respect of retail portfolios, the Group does not 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 commercial lending. In such cases, the assets are carried on the Group's balance sheet and are classified according to the Group's accounting policies.

NOTE 52: FINANCIAL RISK MANAGEMENT continued

E. Collateral pledged as security

The Group pledges assets primarily for repurchase agreements and securities lending transactions which are generally conducted under terms that are usual and customary for standard securitised borrowing contracts.

Repurchase transactions

Deposits from banks

Included in deposits from banks are deposits held as collateral for facilities granted, with a carrying value of £7,279 million (2015: £7,061 million) and a fair value of £8,395 million (2015: £6,707 million).

Customer deposits

Customer deposits included deposits held as collateral for facilities granted with a carrying value of £2,462 million (2015: £nil) and a fair value of £2,277 million (2015: £nil). No collateral balances in the form of cash were provided in respect of repurchase agreements (2015: £5 million).

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

The fair value of collateral pledged in respect of repurchase transactions, accounted for as secured borrowing, where the secured party is permitted by contract or custom to repledge was £45,702 million (2015: £44,655 million).

Securities lending transactions

The following on balance sheet financial assets have been lent to counterparties under securities lending transactions:

	2016 £m	2015 £m
Trading and other financial assets at fair value through profit or loss	6,991	6,478
Loans and advances to customers	583	1,491
Available-for-sale financial assets	3,206	4,247
	10,780	12,216

Securitisations and covered bonds

In addition to the assets detailed above, the Group also holds assets that are encumbered through the Group's asset-backed conduits and its securitisation and covered bond programmes. Further details of these assets are provided in notes 19 and 20.

Liquidity risk

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. Liquidity risk is managed through a series of measures, tests and reports that are primarily based on contractual maturity. The Group carries out monthly stress testing of its liquidity position against a range of scenarios, including those prescribed by the PRA. The Group's liquidity risk appetite is also calibrated against a number of stressed liquidity metrics.

Notes to the consolidated financial statements continued

NOTE 52: FINANCIAL RISK MANAGEMENT continued

The table below analyses assets and liabilities of the Group into relevant maturity groupings based on the remaining contractual period at the balance sheet date; balances with no fixed maturity are included in the over 5 years category. Certain balances, included in the table below on the basis of their residual maturity, are repayable on demand upon payment of a penalty.

Maturities of assets and liabilities

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-2 years £m	2-5 years £m	Over 5 years £m	Total £m
At 31 December 2016									
Assets									
Cash and balances at central banks	**47,446**	**2**	**4**	**–**	**–**	**–**	**–**	**–**	**47,452**
Trading and other financial assets at fair value through profit or loss	**20,168**	**14,903**	**7,387**	**2,914**	**817**	**1,680**	**6,011**	**97,294**	**151,174**
Derivative financial instruments	**956**	**1,700**	**1,393**	**786**	**651**	**2,230**	**4,165**	**24,257**	**36,138**
Loans and advances to banks	**9,801**	**6,049**	**3,894**	**1,201**	**867**	**1,281**	**3,692**	**117**	**26,902**
Loans and advances to customers	**20,179**	**10,651**	**14,235**	**12,400**	**10,773**	**26,007**	**69,300**	**294,413**	**457,958**
Debt securities held as loans and receivables	**8**	**–**	**–**	**242**	**–**	**–**	**34**	**3,113**	**3,397**
Available-for-sale financial assets	**127**	**259**	**73**	**637**	**222**	**1,887**	**16,080**	**37,239**	**56,524**
Other assets	**5,025**	**583**	**584**	**1,560**	**1,059**	**1,846**	**4,808**	**22,783**	**38,248**
Total assets	**103,710**	**34,147**	**27,570**	**19,740**	**14,389**	**34,931**	**104,090**	**479,216**	**817,793**
Liabilities									
Deposits from banks	**3,772**	**2,779**	**1,062**	**503**	**13**	**43**	**7,859**	**353**	**16,384**
Customer deposits	**347,753**	**18,936**	**8,961**	**10,482**	**8,477**	**13,859**	**6,430**	**562**	**415,460**
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	**18,381**	**19,640**	**8,779**	**1,696**	**1,179**	**3,843**	**5,575**	**30,335**	**89,428**
Debt securities in issue	**4,065**	**8,328**	**6,433**	**4,158**	**1,224**	**6,939**	**25,020**	**20,147**	**76,314**
Liabilities arising from insurance and investment contracts	**1,583**	**2,190**	**2,737**	**2,463**	**2,377**	**8,588**	**19,971**	**74,593**	**114,502**
Other liabilities	**3,282**	**2,266**	**1,213**	**2,164**	**1,440**	**413**	**2,737**	**23,544**	**37,059**
Subordinated liabilities	**–**	**390**	**161**	**393**	**–**	**1,750**	**4,527**	**12,610**	**19,831**
Total liabilities	**378,836**	**54,529**	**29,346**	**21,859**	**14,710**	**35,435**	**72,119**	**162,144**	**768,978**
At 31 December 2015									
Assets									
Cash and balances at central banks	58,411	2	4	–	–	–	–	–	58,417
Trading and other financial assets at fair value through profit or loss	25,696	12,877	6,526	3,008	680	1,495	6,411	83,843	140,536
Derivative financial instruments	1,226	1,257	841	585	607	1,480	3,889	19,582	29,467
Loans and advances to banks	9,802	4,676	4,157	915	1,095	1,784	2,076	612	25,117
Loans and advances to customers	19,392	6,351	11,864	8,318	11,426	28,061	68,685	301,078	455,175
Debt securities held as loans and receivables	9	–	–	1	98	208	28	3,847	4,191
Available-for-sale financial assets	109	269	56	535	120	1,000	7,178	23,765	33,032
Held-to-maturity investments	–	–	–	–	–	297	3,357	16,154	19,808
Other assets	4,620	1,068	884	1,589	1,421	2,204	9,561	19,598	40,945
Total assets	119,265	26,500	24,332	14,951	15,447	36,529	101,185	468,479	806,688
Liabilities									
Deposits from banks	6,586	1,076	5,958	42	132	22	2,543	566	16,925
Customer deposits	340,445	20,365	13,758	10,584	9,277	15,927	6,742	1,228	418,326
Derivative financial instruments, trading and other financial liabilities at fair value through profit or loss	24,326	14,191	5,070	1,625	806	4,020	5,135	22,991	78,164
Debt securities in issue	5,822	7,273	5,556	4,757	1,661	11,697	21,984	23,306	82,056
Liabilities arising from insurance and investment contracts	1,580	1,558	2,279	2,066	2,269	7,817	20,674	64,828	103,071
Other liabilities	4,240	2,800	449	2,326	1,906	634	5,079	20,420	37,854
Subordinated liabilities	269	307	329	466	2,083	648	9,321	9,889	23,312
Total liabilities	383,268	47,570	33,399	21,866	18,134	40,765	71,478	143,228	759,708

The above tables are provided on a contractual basis. The Group's assets and liabilities may be repaid or otherwise mature earlier or later than implied by their contractual terms and readers are, therefore, advised to use caution when using this data to evaluate the Group's liquidity position. In particular, amounts in respect of customer deposits are usually contractually payable on demand or at short notice. However, in practice, these deposits are not usually withdrawn on their contractual maturity.

NOTE 52: FINANCIAL RISK MANAGEMENT continued

The table below analyses financial instrument liabilities of the Group, 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.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2016						
Deposits from banks	**3,686**	**4,154**	**1,541**	**5,883**	**1,203**	**16,467**
Customer deposits	**347,573**	**19,151**	**28,248**	**20,789**	**1,294**	**417,055**
Trading and other financial liabilities at fair value through profit or loss	**14,390**	**19,718**	**11,845**	**1,938**	**13,513**	**61,404**
Debt securities in issue	**7,590**	**8,721**	**12,533**	**36,386**	**17,635**	**82,865**
Liabilities arising from non-participating investment contracts	**20,112**	**–**	**–**	**–**	**–**	**20,112**
Subordinated liabilities	**41**	**674**	**1,289**	**9,279**	**18,542**	**29,825**
Total non-derivative financial liabilities	**393,392**	**52,418**	**55,456**	**74,275**	**52,187**	**627,728**
Derivative financial liabilities:						
Gross settled derivatives – outflows	**33,128**	**24,088**	**25,366**	**52,925**	**36,462**	**171,969**
Gross settled derivatives – inflows	**(31,359)**	**(22,401)**	**(23,510)**	**(49,239)**	**(32,382)**	**(158,891)**
Gross settled derivatives – net flows	**1,769**	**1,687**	**1,856**	**3,686**	**4,080**	**13,078**
Net settled derivatives liabilities	**21,669**	**117**	**620**	**1,167**	**3,020**	**26,593**
Total derivative financial liabilities	**23,438**	**1,804**	**2,476**	**4,853**	**7,100**	**39,671**
At 31 December 2015						
Deposits from banks	6,673	1,143	6,156	2,785	400	17,157
Customer deposits	339,387	21,234	34,012	23,932	312	418,877
Trading and other financial liabilities at fair value through profit or loss	15,055	15,465	5,365	5,897	10,662	52,444
Debt securities in issue	7,526	9,131	18,467	34,515	24,540	94,179
Liabilities arising from non-participating investment contracts	22,777	–	–	–	–	22,777
Subordinated liabilities	522	366	4,132	13,238	20,476	38,734
Total non-derivative financial liabilities	391,940	47,339	68,132	80,367	56,390	644,168
Derivative financial liabilities:						
Gross settled derivatives – outflows	31,932	28,059	27,510	29,962	28,508	145,971
Gross settled derivatives – inflows	(30,432)	(26,967)	(26,337)	(27,883)	(26,521)	(138,140)
Gross settled derivatives – net flows	1,500	1,092	1,173	2,079	1,987	7,831
Net settled derivatives liabilities	16,600	115	321	953	2,587	20,576
Total derivative financial liabilities	18,100	1,207	1,494	3,032	4,574	28,407

The Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value, upon initial recognition, on the balance sheet. The majority of the Group's financial guarantee contracts are callable on demand, were the guaranteed party to fail to meet its obligations. It is, however, expected that most guarantees will expire unused. The contractual nominal amounts of these guarantees totalled £6,883 million at 31 December 2016 (2015: £7,165 million) with £3,815 million expiring within one year; £667 million between one and three years; £1,334 million between three and five years; and £1,067 million over five years (2015: £4,014 million expiring within one year; £942 million between one and three years; £1,182 million between three and five years; and £1,027 million over five years).

The majority of the Group's non-participating investment contract liabilities are unit-linked. These unit-linked products are invested in accordance with unit fund mandates. Clauses are included in policyholder contracts to permit the deferral of sales, where necessary, so that linked assets can be realised without being a forced seller.

The principal amount for undated subordinated liabilities with no redemption option is included within the over five years column; interest of approximately £23 million (2015: £39 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond five years.

Notes to the consolidated financial statements continued

NOTE 52: FINANCIAL RISK MANAGEMENT continued

Further information on the Group's liquidity exposures is provided on pages 154 to 157.

Liabilities 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	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2016	**1,283**	**1,836**	**6,266**	**23,425**	**61,580**	**94,390**
At 31 December 2015	1,477	1,081	4,745	10,444	62,547	80,294

For insurance and participating investment contracts which are neither unit-linked nor in the Group's with-profit funds, in particular annuity liabilities, the aim is to invest in assets such that the cash flows on investments match those on the projected future liabilities.

The following tables set out the amounts and residual maturities of the Group's off balance sheet contingent liabilities and commitments.

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2016									
Acceptances and endorsements	**13**	**6**	**–**	**–**	**1**	**1**	**–**	**–**	**21**
Other contingent liabilities	**427**	**782**	**163**	**153**	**122**	**466**	**280**	**623**	**3,016**
Total contingent liabilities	**440**	**788**	**163**	**153**	**123**	**467**	**280**	**623**	**3,037**
Lending commitments	**48,210**	**3,546**	**5,276**	**4,783**	**11,628**	**17,212**	**18,775**	**4,090**	**113,520**
Other commitments	**–**	**3**	**–**	**41**	**1**	**79**	**122**	**402**	**648**
Total commitments	**48,210**	**3,549**	**5,276**	**4,824**	**11,629**	**17,291**	**18,897**	**4,492**	**114,168**
Total contingents and commitments	**48,650**	**4,337**	**5,439**	**4,977**	**11,752**	**17,758**	**19,177**	**5,115**	**117,205**

	Up to 1 month £m	1-3 months £m	3-6 months £m	6-9 months £m	9-12 months £m	1-3 years £m	3-5 years £m	Over 5 years £m	Total £m
At 31 December 2015									
Acceptances and endorsements	16	34	–	–	–	1	1	–	52
Other contingent liabilities	331	441	433	116	142	365	107	646	2,581
Total contingent liabilities	347	475	433	116	142	366	108	646	2,633
Lending commitments	46,443	1,989	4,444	3,276	11,575	18,803	19,234	6,731	112,495
Other commitments	–	–	2	31	5	4	83	296	421
Total commitments	46,443	1,989	4,446	3,307	11,580	18,807	19,317	7,027	112,916
Total contingents and commitments	46,790	2,464	4,879	3,423	11,722	19,173	19,425	7,673	115,549

NOTE 53: CONSOLIDATED CASH FLOW STATEMENT

(A) Change in operating assets

	2016 £m	2015 £m	2014 £m
Change in loans and receivables	**710**	6,081	12,852
Change in derivative financial instruments, trading and other financial assets at fair value through profit or loss	**(13,889)**	20,689	(11,767)
Change in other operating assets	**961**	7,930	(1,957)
Change in operating assets	**(12,218)**	34,700	(872)

(B) Change in operating liabilities

	2016 £m	2015 £m	2014 £m
Change in deposits from banks	**(654)**	6,107	(3,029)
Change in customer deposits	**(3,690)**	(4,252)	7,745
Change in debt securities in issue	**(6,552)**	5,657	(11,089)
Change in derivative financial instruments, trading and other liabilities at fair value through profit or loss	**11,265**	(16,924)	24,020
Change in investment contract liabilities	**(2,665)**	(3,922)	(342)
Change in other operating liabilities	**(363)**	1,349	(5,313)
Change in operating liabilities	**(2,659)**	(11,985)	11,992

NOTE 53: CONSOLIDATED CASH FLOW STATEMENT continued

(C) Non-cash and other items

	2016 £m	2015 £m	2014 £m
Depreciation and amortisation	2,380	2,112	1,935
Revaluation of investment properties	83	(416)	(513)
Allowance for loan losses	592	441	737
Write-off of allowance for loan losses, net of recoveries	(1,272)	(3,467)	(5,761)
Impairment of available-for-sale financial assets	173	4	2
Change in insurance contract liabilities	14,084	(2,856)	4,070
Payment protection insurance provision	1,000	4,000	2,200
Other regulatory provisions	1,085	837	925
Other provision movements	(40)	337	222
Net charge (credit) in respect of defined benefit schemes	287	315	(478)
Impact of consolidation and deconsolidation of OEICs[1]	(3,157)	(5,978)	(5,277)
Unwind of discount on impairment allowances	(32)	(56)	(126)
Foreign exchange impact on balance sheet[2]	(155)	507	770
Loss on ECN transactions	721	–	1,336
Interest expense on subordinated liabilities	1,864	1,970	2,374
Loss (profit) on disposal of businesses	–	46	(208)
Net gain on sale of available-for-sale financial assets	(575)	(51)	(131)
Hedging valuation adjustments on subordinated debt	153	(162)	559
Value of employee services	309	279	340
Transactions in own shares	(175)	(816)	(286)
Accretion of discounts and amortisation of premiums and issue costs	465	339	122
Share of post-tax results of associates and joint ventures	1	3	(32)
Transfers to income statement from reserves	(557)	(956)	(1,153)
Profit on disposal of tangible fixed assets	(93)	(51)	(44)
Other non-cash items	(17)	(11)	(8)
Total non-cash items	**17,124**	(3,630)	1,575
Contributions to defined benefit schemes	(630)	(433)	(538)
Payments in respect of payment protection insurance provision	(2,200)	(3,091)	(2,458)
Payments in respect of other regulatory provisions	(761)	(661)	(1,104)
Other	2	7	29
Total other items	(3,589)	(4,178)	(4,071)
Non-cash and other items	**13,535**	(7,808)	(2,496)

1 These OEICs (Open-ended investment companies) are mutual funds which are consolidated if the Group manages the funds and also has a sufficient beneficial interest. The population of OEICs to be consolidated varies at each reporting date as external investors acquire and divest holdings in the various funds. The consolidation of these funds is effected by the inclusion of the fund investments and a matching liability to the unitholders; and changes in funds consolidated represent a non-cash movement on the balance sheet.

2 When considering the movement on each line of the balance sheet, the impact of foreign exchange rate movements is removed in order to show the underlying cash impact.

3 A number of capital transactions entered into by the Group involved the exchange of existing securities for new issues and as a result there was no related cash flow.

Notes to the consolidated financial statements continued

NOTE 53: CONSOLIDATED CASH FLOW STATEMENT continued

(D) Analysis of cash and cash equivalents as shown in the balance sheet

	2016 £m	2015 £m	2014 £m
Cash and balances at central banks	47,452	58,417	50,492
Less: mandatory reserve deposits[1]	(914)	(941)	(980)
	46,538	57,476	49,512
Loans and advances to banks	26,902	25,117	26,155
Less: amounts with a maturity of three months or more	(11,052)	(10,640)	(10,520)
	15,850	14,477	15,635
Total cash and cash equivalents	62,388	71,953	65,147

1 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 at 31 December 2016 is £14,475 million (2015: £13,545 million; 2014: £12,855 million) held within the Group's long-term insurance and investments businesses, which is not immediately available for use in the business.

(E) Disposal and closure of group undertakings and businesses

	2016 £m	2015 £m	2014 £m
Trading and other assets at fair value through profit or loss	–	3,420	11
Loans and advances to customers	–	21,333	256
Loans and advances to banks	–	5,539	55
Available-for-sale financial assets	–	654	–
Value of in-force business	–	60	–
Property, plant and equipment	–	150	–
	–	31,156	322
Customer deposits	–	(24,613)	(266)
Debt securities in issue	–	(9)	–
Liabilities arising from insurance contracts and participating investment contracts	–	(3,828)	–
Liabilities arising from non-participating investment contracts	–	(549)	–
Non-controlling interests	–	(825)	–
Other net assets (liabilities)	5	(314)	802
	5	(30,138)	536
Net assets	5	1,018	858
Non-cash consideration received	–	–	(518)
(Loss) profit on sale	–	(46)	208
Cash consideration received on losing control of group undertakings and businesses	5	972	548
Cash and cash equivalents disposed	–	(5,043)	(5)
Net cash inflow (outflow)	5	(4,071)	543

NOTE 54: ACQUISITION OF MBNA LIMITED

On 20 December 2016, the Group signed an agreement with Bank of America Merrill Lynch (BAML) to purchase 100 per cent of the share capital of MBNA Limited, a UK consumer credit card business, for a cash consideration of £1.9 billion. The Group is expected to acquire control of MBNA Limited during 2017, subject to the receipt of competition and regulatory approval.

NOTE 55: FUTURE ACCOUNTING DEVELOPMENTS

The following pronouncements are not applicable for the year ending 31 December 2016 and have not been applied in preparing these financial statements. Save as disclosed below, the impact of these accounting changes is still being assessed by the Group and reliable estimates cannot be made at this stage.

With the exception of IFRS 9, which was endorsed in November 2016, as at 21 February 2017 these pronouncements are awaiting EU endorsement.

IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement and is effective for annual periods beginning on or after 1 January 2018.

Classification and Measurement

IFRS 9 requires financial assets to be classified into one of three measurement categories, fair value through profit or loss, fair value through other comprehensive income or amortised cost. Financial assets will be measured at amortised cost if they are held within a business model the objective of which is to hold financial assets in order to collect contractual cash flows, and their contractual cash flows represent solely payments of principal and interest. Financial assets will be measured at fair value through other comprehensive income if they are held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets and their contractual cash flows represent solely payments of principal and interest. Financial assets not meeting either of these two business models; and all equity instruments (unless designated at inception to fair value through other comprehensive income); and all derivatives are measured at fair value through profit or loss. An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch.

The Group has undertaken an assessment to determine the potential impact of changes in classification and measurement of financial assets. The adoption of IFRS 9 is unlikely to result in significant changes to existing asset measurement bases, however, the final impact will be dependent on the facts and circumstances that exist on 1 January 2018.

IFRS 9 retains most of the existing requirements for financial liabilities. However, for financial liabilities designated at fair value through profit or loss, gains or losses attributable to changes in own credit risk may be presented in other comprehensive income. It is expected that the Group will elect to early adopt this presentation of gains and losses on financial liabilities from 1 January 2017. These gains and losses are currently recognised in profit or loss and are disclosed in note 30 to the financial statements.

Impairment Overview

The IFRS 9 impairment model will be applicable to all financial assets at amortised cost, debt instruments measured at fair value through other comprehensive income, lease receivables, loan commitments and financial guarantees not measured at fair value through profit or loss.

IFRS 9 replaces the existing 'incurred loss' impairment approach with an Expected Credit Loss ('ECL') model, resulting in earlier recognition of credit losses compared with IAS 39. Expected credit losses are the unbiased probability weighted average credit losses determined by evaluating a range of possible outcomes and future economic conditions.

The ECL model has three stages. Entities are required to recognise a 12 month expected loss allowance on initial recognition (stage 1) and a lifetime expected loss allowance when there has been a significant increase in credit risk since initial recognition (stage 2). Stage 3 requires objective evidence that an asset is credit-impaired, which is similar to the guidance on incurred losses in IAS 39.

Under IAS 39, provisions are recognised for losses that have been incurred but may not have been separately identified. An assessment is made of the likelihood of assets being impaired at the balance sheet date and being identified subsequently; the length of time taken to identify that an impairment event has occurred is known as the loss emergence period. The Group has a range of emergence periods which are dependent upon the characteristics of the portfolios, but typically range between one month and 12 months based on historical experience. Unsecured portfolios tend to have shorter emergence periods than secured portfolios. Under IFRS 9, all loans in stage 1 will require a loss allowance measured at an amount equal to 12 months ECL and is therefore longer than current emergence periods for certain portfolios.

The requirement to recognise lifetime ECL for loans which have experienced a significant increase in credit risk since origination, but which are not credit impaired, does not exist under IAS 39. The assessment of whether an asset is in stage 1 or 2 considers the relative change in the probability of default occurring over the expected life of the instrument, not the change in the amount of expected credit losses. This will involve setting quantitative tests combined with supplementary indicators such as credit risk classification. Reasonable and supportable forward looking information will also be used in determining the stage allocation. In general, assets more than 30 days past due, but not credit impaired, will be classed as stage 2.

IFRS 9 requires the use of more forward looking information including reasonable and supportable forecasts of future economic conditions. The need to consider a range of economic scenarios and how they could impact the loss allowance is a subjective feature of the IFRS 9 ECL model. The Group is developing the capability to model a number of economic scenarios and capture the impact on credit losses to ensure the overall ECL represents a reasonable distribution of economic outcomes. Appropriate governance and oversight will be established around the process.

IFRS 9 Impairment Models

For all material portfolios, IFRS 9 ECL calculation will leverage the systems, data and methodology used to calculate regulatory 'expected losses'. The Group anticipates the definition of default for IFRS 9 purposes will be aligned to the Basel definition of default to ensure consistency across the Group. However, the IFRS 9 ECL models differ from the regulatory models in a number of ways, for example stage 2 assets under IFRS 9 carry a lifetime expected loss amount whereas regulatory models generate 12 month expected losses for non-defaulted loans.

IFRS 9 models will use three key input parameters for the computation of expected loss, being probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD'). However, given the conservatism inherent in the regulatory expected losses calculation, some adjustments to these components must be made to ensure compliance with IFRS 9. Some of the key requirements are listed in the following table.

Notes to the consolidated financial statements continued

NOTE 55: FUTURE ACCOUNTING DEVELOPMENTS continued

Component	Regulatory capital	IFRS 9
EAD	– Anticipates additional drawings made by customers who are yet to default – Downturn EAD, appropriate to a severe but plausible economic downturn	– Maximum exposure is the contractual amount except for certain revolving facilities (as defined by the standard) – Forward looking EAD
PD	– 12 month PD – Through-the-cycle using long run average economic and risk data to reduce sensitivity to changes in the economic cycle – Default defined as 90 days past due, except 180 days past due definition for certain mortgage portfolios secured by UK residential real estate, plus unlikeliness to pay factors	– Forward-looking 12 month PD or lifetime PD, considering a range of possible outcomes – Point-in-time, sensitive to changes in the economic cycle – No explicit definition of default – Rebuttable presumption that default does not occur later than when a financial asset is 90 days past due
LGD	– Downturn LGD, appropriate to a severe by plausible economic downturn – Subject to floors, to mitigate the risk of underestimating credit losses due to a lack of historical data – Discount cash flows to take account of the uncertainties associated with the receipt of recoveries with respect to a defaulted exposure	– Forward looking LGD – No floors prescribed – Discount rate is effective interest rate as defined by IFRS 9

Impact of IFRS 9 on the Group

The adoption of IFRS 9 may result in an increase in the Group's balance sheet provisions for credit losses and may therefore negatively impact the Group's regulatory capital position. The extent of any increase in provisions will depend upon on a number factors including the composition of the Group's lending portfolios and forecast economic conditions at the date of implementation. Whilst the Group is still refining its methodology and completing the development of the models required to calculate the provision, it is not possible to provide a reliable estimate of the impact of adopting IFRS 9. It is also too early to estimate the ongoing impact of the IFRS 9 impairment model on the financial results although the requirement to transfer assets between stages and to incorporate forward looking data into the expected credit loss calculation, including multiple economic scenarios, could result in impairment charges being more volatile when compared to the current IAS 39 impairment model.

The regulatory capital impact of IFRS 9 could be affected by changes to the regulatory rules. The Basel Committee on Banking Supervision has issued two papers on the impacts of IFRS 9 on regulatory capital, a consultation paper on the 'Regulatory treatment of accounting provisions – interim approach and transitional arrangements'; and one discussing longer-term changes. It is not clear whether any transitional capital arrangements will be in place for 1 January 2018.

Hedge Accounting

The hedge accounting requirements of IFRS 9 are more closely aligned with risk management practices and follow a more principle-based approach than IAS 39. The standard does not address macro hedge accounting, which is being considered in a separate IASB project. There is an option to maintain the existing IAS 39 hedge accounting rules until the IASB completes its project on macro hedging. The Group currently expects to continue applying IAS 39 hedge accounting in accordance with this accounting policy choice.

IFRS 9 Implementation Programme

The Group has an established IFRS 9 programme to ensure a high quality implementation in compliance with the standard and additional regulatory guidance that has been issued. The programme involves Finance and Risk functions across the Group with Divisional and Group steering committees providing oversight. The key responsibilities of the programme include defining IFRS 9 methodology and accounting policy, development of ECL models, identifying data and system requirements, and establishing an appropriate operating model and governance framework. The programme is progressing in line with current delivery plans.

Credit risk methodologies have been defined and model build and approval is underway for core portfolios. The Retail secured model has been approved by the Model Governance Committee. Models and credit risk processes will be tested during the parallel run period to embed the changes and help improve the understanding of the new impairment models.

Finance systems and reporting requirements are being developed and tested. Existing controls and governance structures have been reviewed and changes identified as a result of IFRS 9. The governance framework includes the review, challenge and sign-off of forward looking information for a range of economic scenarios. Communication and training plans are in place and the impact on resources within Finance and Risk functions is being assessed to ensure the business is ready to implement the new standard.

IFRS 15 Revenue from Contracts with Customers

IFRS 15 replaces IAS 18 Revenue and IAS 11 Construction Contracts. Financial instruments, leases and insurance contracts are out of scope however, fee recognition associated with credit cards and packaged products, for example, will need to be reviewed. The standard is not currently expected to have a significant impact on the Group's profitability. Limited, or no systems or process impacts are expected as a result of adopting IFRS 15. IFRS 15 is effective for annual periods beginning on or after 1 January 2018.

IFRS 16 Leases

IFRS 16 replaces IAS 17 Leases and requires lessees to recognise a right of use asset and a liability for future payments arising from a lease contract. Lessees will recognise a finance charge on the liability and a depreciation charge on the asset which could affect the timing of the recognition of expenses on leased assets. This change will mainly impact the properties that the Group currently accounts for as operating leases. Finance systems will need to be changed to reflect the new accounting rules and disclosures. Lessor accounting requirements remain aligned to the current approach under IAS 17. IFRS 16 is effective for annual periods beginning on or after 1 January 2019.

Minor amendments to other accounting standards

During 2016, the IASB has issued amendments to IAS 7 Statement of Cash Flows (which require additional disclosure about an entity's financing activities) and IAS 12 Income Taxes (which clarify when a deferred tax asset should be recognised for unrealised losses) together with a number of other minor amendments to IFRSs, which will be effective for annual periods beginning on or after either 1 January 2017 or 1 January 2018. These revised requirements are not expected to have a significant impact on the Group.

Parent company balance sheet

at 31 December

	Note	2016 £ million	2015[1] £ million
Assets			
Non-current assets:			
Investment in subsidiaries	8	**44,188**	40,785
Loans to subsidiaries	8	**6,912**	14,548
Deferred tax asset		**38**	51
		51,138	55,384
Current assets:			
Derivative financial instruments		**461**	590
Other assets		**959**	909
Amounts due from subsidiaries	2	**67**	67
Cash and cash equivalents		**42**	24
Current tax recoverable		**465**	32
		1,994	1,622
Total assets		**53,132**	57,006
Equity and liabilities			
Capital and reserves:			
Share capital	3	**7,146**	7,146
Share premium account	3	**17,622**	17,412
Merger reserve	4	**7,423**	7,633
Capital redemption reserve	4	**4,115**	4,115
Retained profits[2]	5	**1,584**	785
Shareholders' equity		**37,890**	37,091
Other equity instruments	3	**5,355**	5,355
Total equity		**43,245**	42,446
Non-current liabilities:			
Debt securities in issue	6	**2,455**	–
Subordinated liabilities	7	**4,329**	3,065
		6,784	3,065
Current liabilities:			
Current tax liabilities		**–**	–
Other liabilities		**3,103**	11,495
		3,103	11,495
Total liabilities		**9,887**	14,560
Total equity and liabilities		**53,132**	57,006

1 See note 1.
2 The parent company recorded a profit after tax for the year of £3,135 million (2015: £897 million).

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

The directors approved the parent company financial statements on 21 February 2017.

Lord Blackwell
Chairman

António Horta-Osório
Group Chief Executive

George Culmer
Chief Financial Officer

Parent company statement of changes in equity

for the year ended 31 December

	Share capital and premium £ million	Merger reserve £ million	Capital redemption reserve £ million	Retained profits[1] £ million	Total shareholders' equity £ million	Other equity instruments £ million	Total equity £ million
Balance at 1 January 2014	24,424	7,764	4,115	1,414	37,717	–	37,717
Total comprehensive income[1]	–	–	–	379	379	–	379
Distributions on other equity instruments, net of tax	–	–	–	(225)	(225)	–	(225)
Issue of ordinary shares	3	–	–	–	3	–	3
Issue of other equity instruments	–	–	–	(21)	(21)	5,355	5,334
Movement in treasury shares	–	–	–	(182)	(182)	–	(182)
Value of employee services:							
Share option schemes, net of tax	–	–	–	122	122	–	122
Other employee award schemes	–	–	–	233	233	–	233
Balance at 31 December 2014	24,427	7,764	4,115	1,720	38,026	5,355	43,381
Total comprehensive income[1]	–	–	–	897	897	–	897
Dividends paid	–	–	–	(1,070)	(1,070)	–	(1,070)
Distributions on other equity instruments, net of tax	–	–	–	(314)	(314)	–	(314)
Redemption of preference shares	131	(131)	–	–	–	–	–
Movement in treasury shares	–	–	–	(753)	(753)	–	(753)
Value of employee services:							
Share option schemes, net of tax	–	–	–	133	133	–	133
Other employee award schemes	–	–	–	172	172	–	172
Balance at 31 December 2015	24,558	7,633	4,115	785	37,091	5,355	42,446
Total comprehensive income[1]	**–**	**–**	**–**	**3,135**	**3,135**	**–**	**3,135**
Dividends paid	**–**	**–**	**–**	**(2,014)**	**(2,014)**	**–**	**(2,014)**
Distributions on other equity instruments, net of tax	**–**	**–**	**–**	**(330)**	**(330)**	**–**	**(330)**
Redemption of preference shares	**210**	**(210)**	**–**	**–**	**–**	**–**	**–**
Movement in treasury shares	**–**	**–**	**–**	**(301)**	**(301)**	**–**	**(301)**
Value of employee services:							
Share option schemes, net of tax	**–**	**–**	**–**	**141**	**141**	**–**	**141**
Other employee award schemes	**–**	**–**	**–**	**168**	**168**	**–**	**168**
Balance at 31 December 2016	**24,768**	**7,423**	**4,115**	**1,584**	**37,890**	**5,355**	**43,245**

1 Total comprehensive income comprises only the profit (loss) for the year; no statement of comprehensive income has been shown for the parent company, as permitted by section 408 of the Companies Act 2006.

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

Parent company cash flow statement

for the year ended 31 December

	2016 £ million	2015[1] £ million	2014 £ million
Profit before tax	**3,463**	969	273
Fair value and exchange adjustments and other non-cash items	**2,482**	(594)	1,118
Change in other assets	**(50)**	(566)	558
Change in other liabilities and other items	**(8,392)**	458	(4,242)
Dividends received	**(3,759)**	(1,080)	(720)
Distributions on other equity instruments received	**(119)**	–	–
Tax (paid) received	**(679)**	(142)	301
Net cash provided by (used in) operating activities	**(7,054)**	(955)	(2,712)
Cash flows from investing activities			
Return of capital contribution	**441**	600	198
Dividends received	**3,759**	1,080	720
Distributions on other equity instruments received	**119**	–	–
Capital injection to Lloyds Bank plc	**(3,522)**	–	–
Amounts advanced to subsidiaries	**(4,978)**	(1,157)	(7,892)
Redemption of loans to subsidiaries	**13,166**	570	4,420
Net cash (used in) provided by investing activities	**8,985**	1,093	(2,554)
Cash flows from financing activities			
Dividends paid to ordinary shareholders	**(2,014)**	(1,070)	–
Distributions on other equity instruments	**(412)**	(394)	(287)
Issue of other equity instruments	**–**	–	5,329
Issue of subordinated liabilities	**1,061**	1,436	629
Interest paid on subordinated liabilities	**(229)**	(129)	(128)
Repayment of subordinated liabilities	**(319)**	(152)	(596)
Proceeds from issue of ordinary shares	**–**	–	3
Net cash used in financing activities	**(1,913)**	(309)	4,950
Change in cash and cash equivalents	**18**	(171)	(316)
Cash and cash equivalents at beginning of year	**24**	195	511
Cash and cash equivalents at end of year	**42**	24	195

1 See note 1.

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

Notes to the parent company financial statements

for the year ended 31 December

NOTE 1: BASIS OF PREPARATION AND ACCOUNTING POLICIES

The Company has applied International Financial Reporting Standards as adopted by the European Union in its financial statements for the year ended 31 December 2016. IFRS comprises accounting standards prefixed IFRS issued by the International Accounting Standards Board and those prefixed IAS issued by the IASB's predecessor body as well as interpretations issued by the IFRS Interpretations Committee and its predecessor body. The EU endorsed version of IAS 39 Financial Instruments: Recognition and Measurement relaxes some of the hedge accounting requirements; the Company has not taken advantage of this relaxation, and therefore there is no difference in application to the Company 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 all derivative contracts.

The accounting policies of the Company are the same as those of the Group which are set out in note 2 to the consolidated financial statements, except that it has no policy in respect of consolidation and investments in subsidiaries are carried at historical cost, less any provisions for impairment.

During 2016 the Company has reviewed the treatment of certain holdings of preference shares issued by its subsidiary, Lloyds Bank plc. As a result loans to subsidiaries and other liabilities have been increased by £585 million; comparatives have been restated accordingly.

NOTE 2: AMOUNTS DUE FROM SUBSIDIARIES

These comprise short-term lending to subsidiaries, repayable on demand. The fair values of amounts owed by subsidiaries are equal to their carrying amounts. No provisions have been recognised in respect of amounts owed by subsidiaries.

NOTE 3: SHARE CAPITAL, SHARE PREMIUM AND OTHER EQUITY INSTRUMENTS

Details of the Company's share capital, share premium account and other equity instruments are as set out in notes 40, 41 and 44 to the consolidated financial statements.

NOTE 4: OTHER RESERVES

The merger reserve comprises the premium on shares issued on 13 January 2009 under the placing and open offer and shares issued on 16 January 2009 on the acquisition of HBOS plc, offset by adjustments on the redemption of preference shares. Substantially all of the Company's merger reserve is available for distribution.

Movements in the merger reserve were as follows:

	2016 £m	2015 £m	2014 £m
At 1 January	7,633	7,764	7,764
Redemption of preference shares[1]	(210)	(131)	–
At 31 December	7,423	7,633	7,764

1 During the year ended 31 December 2016, the Company redeemed all of its outstanding 6.267% Non-cumulative Fixed to Floating Rate Callable US Dollar Preference Shares at their combined sterling equivalent par value of £210 million. These preference shares had been accounted for as subordinated liabilities. On redemption an amount of £210 million was transferred from the distributable merger reserve to the share premium account (2015: £131 million in respect of the redemption of the outstanding 6.0884% Non-cumulative Fixed to Floating Rate Preference Shares and 5.92% Non-cumulative Fixed to Floating Rate Preference Shares).

The capital redemption reserve represents transfers from the merger reserve in accordance with companies' legislation and amounts transferred from share capital following the cancellation of the deferred shares.

There were no movements in the capital redemption reserve in 2014, 2015 or 2016.

NOTE 5: RETAINED PROFITS

	2016 £m	2015 £m	2014 £m
At 1 January	785	1,720	1,414
Profit for the year	3,135	897	379
Issue costs of other equity instruments, net of tax	–	–	(21)
Dividends paid	(2,014)	(1,070)	–
Distributions on other equity instruments, net of tax	(330)	(314)	(225)
Movement in treasury shares	(301)	(753)	(182)
Value of employee services:			
Share option schemes	141	133	122
Other employee award schemes	168	172	233
At 31 December	1,584	785	1,720

Details of the Company's dividends are as set out in note 45 to the consolidated financial statements.

NOTE 6: DEBT SECURITIES IN ISSUE

These comprise the following issues by the Company: US$1 billion 3.1% notes due 2021 (issued July 2016); €639 million 0.75% notes due 2021 and €772 million 1% notes due 2023 (issued November 2016); and ¥41.9 billion 0.615% notes due 2021 and ¥19.1 billion 1.047% notes due 2026 (issued December 2016).

NOTE 7: SUBORDINATED LIABILITIES

These liabilities will, in the event of the winding-up of the issuer, be subordinated to the claims of depositors and all other creditors of the issuer. Any repayments of subordinated liabilities require the consent of the Prudential Regulation Authority.

	Preference shares £m	Undated subordinated liabilities £m	Dated subordinated liabilities £m	Total £m
At 1 January 2015	1,039	10	639	1,688
Issued during the year:				
5.3% Subordinated Fixed Rate Notes 2045 (US$824 million)	–	–	543	543
4.582% Subordinated Fixed Rate Notes 2025 (US$1,353 million)	–	–	893	893
	–	–	1,436	1,436
Repurchases and redemptions during the year:				
6.0884% Non-cumulative Fixed to Floating Rate Preference Shares[1]	(10)	–	–	(10)
5.92% Non-cumulative Fixed to Floating Rate Preference Shares callable 2015[1]	(140)	–	–	(140)
	(150)	–	–	(150)
Foreign exchange and other movements	22	–	69	91
At 31 December 2015	911	10	2,144	3,065
Issued during the year:				
4.65% Subordinated Fixed Rate Notes 2026 (US$1,500 million)	**–**	**–**	**1,061**	**1,061**
Repurchases and redemptions during the year:				
6.267% Non-Cumulative Fixed to Floating Rate Preference Shares callable 2016 (US$1,000 million)[1]	**(319)**	**–**	**–**	**(319)**
Foreign exchange and other movements	**(24)**	**–**	**546**	**522**
At 31 December 2016	**568**	**10**	**3,751**	**4,329**

1 See note 4.

NOTE 8: RELATED PARTY TRANSACTIONS

Key management personnel

The key management personnel of the Group and the Company are the same. The relevant disclosures are given in note 47 to the consolidated financial statements.

The Company has no employees (2015: nil).

As discussed in note 2 to the consolidated financial statements, the Group provides share-based compensation to employees through a number of schemes; these are all in relation to shares in the Company and the cost of providing those benefits is recharged to the employing companies in the Group.

Investment in subsidiaries

	2016 £m	2015 £m
At 1 January	**40,785**	41,102
Additional capital injections	**3,522**	–
Capital contribution	**322**	283
Return of capital contribution	**(441)**	(600)
At 31 December	**44,188**	40,785

Details of the subsidiaries and related undertakings are given on pages 293 to 300 and are incorporated by reference.

Certain subsidiary companies currently have insufficient distributable reserves to make dividend payments, however, there were no further significant restrictions on any of the Company'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.

Notes to the parent company financial statements continued

NOTE 8: RELATED PARTY TRANSACTIONS continued

Loans to subsidiaries

	2016 £m	2015[1] £m
At 1 January	14,548	13,848
Exchange and other adjustments	552	113
New issues	4,978	1,157
Redemptions	(13,166)	(570)
At 31 December	6,912	14,548

1 See note 1.

In addition the Company carries out banking activities through its subsidiary, Lloyds Bank plc. At 31 December 2016, the Company held deposits of £42 million with Lloyds Bank plc (2015: £24 million). Given the volume of transactions flowing through the account, it is not meaningful to provide gross inflow and outflow information. Included within other liabilities is £2,690 million (2015: £11,101 million) due to subsidiary undertakings. In addition, at 31 December 2016 the Company had interest rate and currency swaps with Lloyds Bank plc with an aggregate notional principal amount of £2,905 million and a net positive fair value of £461 million (2015: notional principal amount of £734 million and a net positive fair value of £45 million). Of this amount an aggregate notional principal amount of £1,529 million and a net positive fair value of £307 million (2015: notional principal amount of £325 million and a net positive fair value of £26 million) were designated as fair value hedges to manage the Company's issuance of subordinated liabilities.

Guarantees

The Company guarantees certain of its subsidiaries' liabilities to the Bank of England.

Other related party transactions

Related party information in respect of other related party transactions is given in note 47 to the consolidated financial statements.

NOTE 9: FINANCIAL INSTRUMENTS

Measurement basis of financial assets and liabilities

The accounting policies in note 2 to the consolidated financial statements describe how different classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the Company's financial assets and liabilities by category and by balance sheet heading.

	Derivatives designated as hedging instruments, held at fair value through profit or loss £m	Held for trading at fair value through profit or loss £m	Loans and receivables £m	Held at amortised cost £m	Total £m
At 31 December 2016					
Financial assets:					
Cash and cash equivalents	–	–	–	42	42
Derivative financial instruments	307	154	–	–	461
Loans to subsidiaries	–	–	6,912	–	6,912
Amounts due from subsidiaries	–	–	67	–	67
Total financial assets	307	154	6,979	42	7,482
Financial liabilities:					
Debt securities in issue	–	–	–	2,455	2,455
Subordinated liabilities	–	–	–	4,329	4,329
Total financial liabilities	–	–	–	6,784	6,784
At 31 December 2015[1]					
Financial assets:					
Cash and cash equivalents	–	–	–	24	24
Derivative financial instruments	26	564	–	–	590
Loans to subsidiaries	–	–	14,548	–	14,548
Amounts due from subsidiaries	–	–	67	–	67
Total financial assets	26	564	14,615	24	15,229
Financial liabilities:					
Subordinated liabilities	–	–	–	3,065	3,065
Total financial liabilities	–	–	–	3,065	3,065

1 See note 1.

Note 49 to the consolidated financial statements outlines the valuation hierarchy into which financial instruments measured at fair value are categorised.

The derivative assets designated as hedging instruments represent level 2 portfolios. The derivative assets classified as held for trading (not being designated as hedging instruments) shown above at 31 December 2015 represented level 3 portfolios.

NOTE 9: FINANCIAL INSTRUMENTS continued

The following reconciliation shows the movements in derivative financial instrument assets within level 3 portfolios:

	2016 £m	2015 £m
At 1 January	545	646
Derecognised following completion of the Group's ECN tender offers and redemptions	(476)	–
Losses recognised in the income statement	(69)	(101)
At 31 December	–	545

Interest rate risk and currency risk

The Company is exposed to interest rate risk and currency risk on its debt securities in issue and its subordinated debt.

As discussed in note 8, the Company has entered into interest rate and currency swaps with its subsidiary, Lloyds Bank plc, to manage these risks.

Credit risk

The majority of the Company's credit risk arises from amounts due from its wholly owned subsidiary, Lloyds Bank plc, and subsidiaries of that company.

Liquidity risk

The table below analyses financial instrument liabilities of the Company, 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.

	Up to 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m	Total £m
At 31 December 2016						
Debt securities in issue	13	–	27	1,809	820	2,669
Subordinated liabilities	–	30	229	1,043	7,893	9,195
Total financial instrument liabilities	13	30	256	2,852	8,713	11,864
At 31 December 2015						
Subordinated liabilities	2	–	191	770	6,487	7,450
Total financial instrument liabilities	2	–	191	770	6,487	7,450

The principal amount for undated subordinated liabilities with no redemption option is included within the over 5 years column; interest of approximately £1 million (2015: £1 million) per annum which is payable in respect of those instruments for as long as they remain in issue is not included beyond 5 years.

Fair values of financial assets and liabilities

The valuation techniques for the Company's financial instruments are as discussed in note 49 to the consolidated financial statements.

Valuation hierarchy

The table below analyses the assets and liabilities of the Company. With the exception of derivatives all assets and liabilities are held at amortised cost. They are categorised into levels 1 to 3 based on the degree to which their fair value is observable. No assets or liabilities were categorised as level 1 (2015: nil).

Fair value of financial assets and liabilities

	2016				2015[1]			
			Valuation hierarchy				Valuation hierarchy	
	Carrying value £m	Fair value £m	Level 2 £m	Level 3 £m	Carrying value £m	Fair value £m	Level 2 £m	Level 3 £m
Derivative financial instruments	461	461	461	–	590	590	45	545
Loans to subsidiaries	6,912	6,912	6,912	–	14,548	14,548	14,548	–
Amounts due from subsidiaries	67	67	67	–	67	67	67	–
Total financial assets	7,440	7,440	7,440	–	15,205	15,205	14,660	545
Debt securities in issue	2,455	2,452	2,452	–	–	–	–	–
Subordinated liabilities	4,329	5,111	5,111	–	3,065	3,639	3,639	–
Total financial liabilities	6,784	7,563	7,563	–	3,065	3,639	3,639	–

1 See note 1.

The carrying amount of cash and cash equivalents (2016: £42 million; 2015: £24 million) is a reasonable approximation of fair value.

Notes to the parent company financial statements continued

NOTE 9: FINANCIAL INSTRUMENTS continued

Sensitivity of level 3 valuations at 31 December 2015

	Valuation technique(s)	Significant unobservable inputs[1]	Carrying value £m	Effect of reasonably possible alternative assumptions: Favourable changes £m	Effect of reasonably possible alternative assumptions: Unfavourable changes £m
Financial assets carried at fair value at December 2015					
Derivative financial assets					
Embedded equity conversion feature	Lead manager or broker quote	Equity conversion feature spread (171 bps/386 bps)	545	14	(14)
			545		

1 Ranges represented the highest and lowest inputs used in the level 3 valuations.

NOTE 10: OTHER INFORMATION

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

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ENCOURAGING BRITISH BUSINESSES TO GO GREEN

We have launched an innovative £1 billion Green Loan Initiative, incentivising green investment in the commercial real estate sector through discounted interest rates. We have completed the first deals and ultimately want to fund 10 million square feet of Britain's real estate space to become energy efficient by 2020.

10 million sq. ft.

of commercial real estate space to become energy efficient by 2020

Shareholder information

Annual general meeting (AGM)

The AGM will be held at the Edinburgh International Conference Centre, The Exchange, Edinburgh EH3 8EE on Thursday 11 May 2017 at 11.00 am. Further details about the meeting, including the proposed resolutions and where shareholders can stream the meeting live, can be found in our Notice of AGM which will be available shortly on our website at www.lloydsbankinggroup.com

Reports and communications

The Group issues regulatory announcements through the Regulatory News Service (RNS); shareholders can subscribe for free via the 'Investors & Performance' section of our website at www.lloydsbankinggroup.com, where our statutory reports and shareholder communications are available. A summary of the reports and communications to be issued in 2017 are listed below:

		Available format			
Report/Communication	Month	Online	Email	RNS	Paper
Preliminary results and publication of Annual Report and Accounts	Feb	✔	✔	✔	
Pillar 3 report	Mar/Aug	✔			
Group Chief Executive update to shareholders	Mar	✔	✔		✔
Mailing of Annual Report and Accounts, Annual Review or Performance Summary	Mar	✔	✔		✔
Notice of AGM and voting materials	Mar	✔	✔		✔
Q1 interim management statement[1]	Apr	✔	✔	✔	
Country analysis[2]	Jun/Jul	✔			
Interim results	Jul	✔	✔	✔	
Group Chief Executive update to shareholders	Aug	✔	✔		✔
Q3 interim management statement[1]	Oct	✔	✔	✔	

1 Despite changes to regulations which remove the requirement to issue interim management statements, Lloyds Banking Group still intends to issue these reports.

2 To be published on the Group's website by 1 July 2017 in accordance with the Capital Requirements (country analysis) Regulations 2013.

Share dealing facilities

We offer a choice of three share dealing services for our UK shareholders and customers. To see the full range of services available for each, please use the contact details below:

Service Provider	Telephone Dealing	Internet Dealing
Bank of Scotland Share Dealing	0345 606 1188	www.bankofscotland.co.uk/sharedealing
Halifax Share Dealing	03457 22 55 25	www.halifax.co.uk/sharedealing
Lloyds Bank Direct Investments	0345 60 60 560	www.lloydsbank.com/share-dealing.asp

Note:

All internet services are available 24/7. Telephone dealing services are available between 8.00 am and 9.15 pm, Monday to Friday and 9.00 am to 1.00 pm on Saturday. To open a share dealing account with any of these services, you must be 18 years of age or over and be resident in the UK, Jersey, Guernsey or the Isle of Man.

Share dealing for the Lloyds Banking Group Shareholder Account

Share dealing services for the Lloyds Banking Group Shareholder Account are provided by Equiniti Shareview Dealing, operated by Equiniti Financial Services Limited. Details of the services provided can be found either on the Shareholder Information page of our website at www.lloydsbankinggroup.com or by contacting Equiniti using the contact details provided on the next page.

Share price information

Shareholders can access both the latest and historical share prices via our website at www.lloydsbankinggroup.com as well as listings in most national newspapers. For a real time buying or selling price, you will need to contact a stockbroker, or you can contact the share dealing providers detailed above.

Individual Savings Accounts (ISAs)

There are a number of options for investing in Lloyds Banking Group shares through an ISA. For details of services and products provided by the Group please contact Bank of Scotland Share Dealing, Halifax Share Dealing or Lloyds Bank Direct Investments using the contact details above.

American Depositary Receipts (ADRs)

Our shares are traded in the USA through a New York Stock Exchange-listed sponsored ADR facility with The Bank of New York Mellon as the depositary. The ADRs are traded on the New York Stock Exchange under the symbol LYG. The CUSIP number is 539439109 and the ratio of ADRs to ordinary shares is 1:4.

For details contact: BNY Mellon Depositary Receipts, PO Box 30170, College Station, TX 77842-3170. Telephone: 1-866-259-0336 (US toll free), international callers: +1 201-680-6825. Alternatively visit www.adrbnymellon.com or email shrrelations@cpushareownerservices.com

Analysis of shareholders

At 31 December 2016	Shareholders		Number of ordinary shares	
Size of shareholding	Number	%	Millions	%
1 – 999	2,042,405	81.39	616.5	0.86
1,000 – 9,999	402,830	16.05	1,066.4	1.49
10,000 – 99,999	60,751	2.42	1,486.4	2.08
100,000 – 999,999	2,386	0.10	554.2	0.77
1,000,000 – 4,999,999	483	0.02	1,154.3	1.62
5,000,000 – 9,999,999	198	0.01	1,439.2	2.02
10,000,000 – 49,999,999	278	0.01	6,399.1	8.97
50,000,000 – 99,999,999	65	0.00	4,639.7	6.50
100,000,000 – 499,999,999	84	0.00	18,591.5	26.05
500,000,000 – 999,999,999	15	0.00	11,359.5	15.92
1,000,000,000 and over	10	0.00	24,066.9	33.72
	2,509,505	100.00	71,373.7	100.00

Security – share fraud and scams

Shareholders should exercise caution when unsolicited callers offer the chance to buy or sell shares with promises of huge returns. If it sounds too good to be true, it usually is and we would ask that shareholders take steps to protect themselves. We strongly recommend seeking advice from an independent financial adviser authorised by the Financial Conduct Authority (FCA). Shareholders can verify whether a firm is authorised via the Financial Services Register which is available at www.fca.org.uk

If a shareholder is concerned that they may have been targeted by such a scheme, please contact the FCA Consumer Helpline on 0800 111 6768 or use the online 'Share Fraud Reporting Form' available from their website (see above). We would also recommend contacting the Police through Action Fraud on 0300 123 2040 or visiting www.actionfraud.org.uk for further information.

IMPORTANT SHAREHOLDER AND REGISTRAR INFORMATION

Company website

www.lloydsbankinggroup.com

Shareholder information

help.shareview.co.uk
(from here you will be able to email your query securely)

Registrar

Equiniti Limited
Aspect House, Spencer Road, Lancing
West Sussex BN99 6DA

Shareholder helpline

0371 384 2990* from within the UK
+44 121 415 7066 from outside the UK

*Lines are open from 8.30 am to 5.30 pm Monday to Friday, excluding English and Welsh public holidays.

The company registrar is Equiniti Limited. They provide a shareholder service, including a telephone helpline and shareview which is a free secure portfolio service.

Register today to manage your shareholding online

Get online in just three easy steps:

step 1

Register at www.shareview.co.uk/info/register

step 2

Receive activation code in post

step 3

Log on

Forward looking statements

This Annual Report contains certain forward looking statements with respect to the business, strategy and plans of Lloyds Banking Group and its current goals and expectations relating to its future financial condition and performance. Statements that are not historical facts, including statements about Lloyds Banking Group's or its directors' and/or management's beliefs and expectations, are forward looking statements. Words such as 'believes', 'anticipates', 'estimates', 'expects', 'intends', 'aims', 'potential', 'will', 'would', 'could', 'considered', 'likely', 'estimate' and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon circumstances that will or may occur in the future.

Examples of such forward looking statements include, but are not limited to: projections or expectations of the Group's future financial position including profit attributable to shareholders, provisions, economic profit, dividends, capital structure, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), expenditures or any other financial items or ratios; litigation, regulatory and governmental investigations; the Group's future financial performance; the level and extent of future impairments and write-downs; statements of plans, objectives or goals of Lloyds Banking Group or its management including in respect of statements about the future business and economic environments in the UK and elsewhere including, but not limited to, future trends in interest rates, foreign exchange rates, credit and equity market levels and demographic developments; statements about competition, regulation, disposals and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual business, strategy, plans and/or results (including but not limited to the payment of dividends) to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by the Group or on its behalf include, but are not limited to: general economic and business conditions in the UK and internationally; market related trends and developments; fluctuations in interest rates (including low or negative rates), exchange rates, stock markets and currencies; the ability to access sufficient sources of capital, liquidity and funding when required; changes to the Group's credit ratings; the ability to derive cost savings and other benefits including, but without limitation as a result of any acquisitions, disposals and other strategic transactions; changing customer behaviour including consumer spending, saving and borrowing habits; changes to borrower or counterparty credit quality; instability in the global financial markets, including Eurozone instability, the exit by the UK from the European Union (EU) and the potential for one or more other countries to exit the EU or the Eurozone and the impact of any sovereign credit rating downgrade or other sovereign financial issues; technological changes and risks to cyber security; natural, pandemic and other disasters, adverse weather and similar contingencies outside the Group's control; inadequate or failed internal or external processes or systems; acts of war, other acts of hostility, terrorist acts and responses to those acts, geopolitical, pandemic or other such events; changes in laws, regulations, accounting standards or taxation, including as a result of the exit by the UK from the EU, or a further possible referendum on Scottish independence; changes to regulatory capital or liquidity requirements and similar contingencies outside the Group's control; the policies, decisions and actions of governmental or regulatory authorities or courts in the UK, the EU, the United States or elsewhere including the implementation and interpretation of key legislation and regulation; the ability to attract and retain senior management and other employees; requirements or limitations on the Group as a result of HM Treasury's investment in the Group; actions or omissions by the Group's directors, management or employees including industrial action; changes to the Group's post-retirement defined benefit scheme obligations; the extent of any future impairment charges or write-downs caused by, but not limited to, depressed asset valuations, market disruptions and illiquid markets; the value and effectiveness of any credit protection purchased by the Group; the inability to hedge certain risks economically; the adequacy of loss reserves; the actions of competitors, including non-bank financial services, lending companies and digital innovators and disruptive technologies; and exposure to regulatory or competition scrutiny, legal, regulatory or competition proceedings, investigations or complaints. Please refer to the latest Annual Report on Form 20-F filed with the US Securities and Exchange Commission for a discussion of certain factors together with examples of forward looking statements.

Lloyds Banking Group may also make or disclose written and/or oral forward looking statements in reports filed with or furnished to the US Securities and Exchange Commission, Lloyds Banking Group annual reviews, half-year announcements, proxy statements, offering circulars, prospectuses, press releases and other written materials and in oral statements made by the directors, officers or employees of Lloyds Banking Group to third parties, including financial analysts. Except as required by any applicable law or regulation, the forward looking statements contained in this Annual Report are made as of the date hereof, and Lloyds Banking Group expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward looking statements contained in this Annual Report to reflect any change in Lloyds Banking Group's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

The information, statements and opinions contained in this Annual Report do not constitute a public offer under any applicable law or an offer to sell any securities or financial instruments or any advice or recommendation with respect to such securities or financial instruments.

Abbreviations

ADRs	American Depositary Receipts
BSU	Business Support Unit
CDS	Credit Default Swap
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
CUIP	Collective unidentified impairment provision
CVA	Credit Valuation Adjustment
DVA	Debit Valuation Adjustment
EBA	European Banking Authority
ECNs	Enhanced Capital Notes
EP	Economic Profit
EPS	Earnings Per Share
FCA	Financial Conduct Authority
FLS	Funding for Lending Scheme
FRC	Financial Reporting Council
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICG	Individual Capital Guidance
IFRS	International Financial Reporting Standards
LCR	Liquidity Coverage Ratio
LIBOR	London Inter-Bank Offered Rate
LTIP	Long-Term Incentive Plan
OEICs	Open Ended Investment Companies
PFI	Private Finance Initiative
PPI	Payment Protection Insurance
PPP	Public Private Partnership
PRA	Prudential Regulation Authority
PVNBP	Present Value of New Business Premiums
SEC	Securities and Exchange Commission
TSR	Total Shareholder Return
VaR	Value-at-Risk

Alternative performance measures

As described on page 37, the Group analyses its performance on an underlying basis. The Group also calculates a number of metrics that are used throughout the banking and insurance industries on an underlying basis as these provide management with a relevant and consistent view of these measures from period to period. A description of the Group's alternative performance measures and their calculation is set out below.

Asset quality ratio	The underlying impairment charge for the period (on an annualised basis) in respect of loans and advances to customers after releases and write-backs expressed as a percentage of average loans and advances to customers.
Banking net interest margin	Banking net interest income on customer and product balances in the banking businesses as a percentage of average banking gross interest-earning assets.
Cost:income ratio	Operating costs as a percentage of total income net of insurance claims less operating lease depreciation calculated on an underlying basis.
Gross asset quality ratio	The underlying impairment charge for the period (on an annualised basis) in respect of loans and advances to customers before releases and write-backs expressed as a percentage of average loans and advances to customers.
Impaired loans as a percentage of advances	Impaired loans and advances to customers adjusted to exclude Retail and Consumer Finance loans in recoveries expressed as a percentage of closing gross loans and advances to customers.
Loan to deposit ratio	The ratio of loans and advances to customers net of allowance for impairment losses and excluding reverse repurchase agreements divided by customer deposits excluding repurchase agreements.
Operating jaws	The difference between the period on period percentage change in total income net of insurance claims less operating lease depreciation and the period on period change in operating costs calculated on an underlying basis.
Present value of new business premium	The total single premium sales received in the period (on an annualised basis) plus the discounted value of premiums expected to be received over the term of the new regular premium contracts.
Required equity	The amount of shareholders' equity and non-controlling interests required to achieve a common equity tier 1 ratio of 12.0 per cent after allowing for regulatory adjustments and deductions.
Return on assets	Underlying profit before tax divided by average total assets.
Return on required equity	Statutory profit after tax adjusted to reflect the notional earnings on any excess or shortfall in equity less the post-tax profit attributable to other equity holders, divided by the average required equity for the period.
Return on risk-weighted assets	Underlying profit before tax divided by average risk-weighted assets.
Return on tangible equity	Statutory profit after tax adjusted to add back amortisation of intangible assets, after tax, profit attributable to non-controlling interests and other equity holders divided by average tangible net assets.
Tangible net assets per share	Net assets excluding intangible assets such as goodwill and acquisition-related intangibles divided by the weighted average number of ordinary shares in issue.
Underlying profit	Statutory profit adjusted for certain items as detailed in the Basis of Preparation.
Underlying return on required equity	Underlying profit after tax at the standard UK corporation tax rate adjusted to reflect the banking tax surcharge and the notional earnings on any excess or shortfall in equity less the post-tax profit attributable to other equity holders divided by the average required equity for the period.
Underlying return on tangible equity	Underlying profit after tax at the standard UK corporation tax rate adjusted to add back amortisation of intangible assets, after tax, profit attributable to non-controlling interests and other equity holders, divided by average tangible net assets.

Glossary

Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan is unpaid or overdue. Such a customer is also said to be in a state of delinquency and the entire outstanding balance is delinquent.
Asset quality ratio	The impairment charge for the year in respect of loans and advances to customers expressed as a percentage of average loans and advances to customers.
Basel II	The capital adequacy framework issued by the Basel Committee on Banking Supervision in June 2006 in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
Basel III	The capital reforms and introduction of a global liquidity standard proposed by the Basel Committee on Banking Supervision in 2010 and due to be phased in, through CRD IV, from 1 January 2014 onward.
Basis point	One hundredth of a per cent (0.01 per cent). 100 basis points is 1 per cent. Used in quoting movements in interest rates or yields on securities.
Central counterparty (CCP)	An institution mediating between the buyer and seller in a financial transaction, such as a derivative contract or repurchase agreement. Where a CCP is used, a single bilateral contract between the buyer and the seller is replaced with two contracts, one between the buyer and the CCP and one between the CCP seller.
Collectively assessed loan impairment provision	A provision established following an impairment assessment on a collective basis for homogeneous groups of loans, such as credit card receivables and personal loans, that are not considered individually significant and for loan losses that have been incurred but not separately identified at the balance sheet date.
Collective unidentified impairment provision	A provision held for loan losses that have been incurred but not separately identified at the balance sheet date.
Commercial paper	Commercial paper is an unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date. Commercial paper can be issued as an unsecured obligation of the Group or, for example when issued by the Group's conduits, as an asset-backed obligation (in such case it is referred to as **asset-backed commercial paper**). Commercial paper is usually issued for periods from as little as a week up to nine months.
Commercial Real Estate	Includes office buildings, industrial property, medical centres, hotels, malls, retail stores, shopping centres, farm land, multifamily housing buildings, warehouses, garages, and industrial properties.
Common equity tier 1 capital (CET1)	The highest quality form of regulatory capital under CRD IV that comprises common shares issued and related share premium, retained earnings and other reserves excluding the cash flow hedging reserve, less specified regulatory adjustments.
Conduits	A financial vehicle that holds asset-backed securities which are financed with short-term deposits (generally **commercial paper**) that use the asset-backed securities as collateral. The conduit will often have a liquidity line provided by a bank that it can draw down on in the event that it is unable to issue funding to the market.
Contractual maturities	Contractual maturity refers to the final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal will be repaid and interest is due to be paid.

Glossary continued

Coverage ratio	Impairment provisions as a percentage of impaired loans.
CRD IV	On 27 June 2013, the European Commission published, through the Official Journal of the European Union, its legislation for a Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR), which together form the CRD IV package. Amendments published on 30 November 2013 were made to the Regulation. The package implements the Basel III reforms in addition to the inclusion of new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration. CRD IV rules apply from 1 January 2014 onwards, with certain requirements set to be phased in.
Credit default swap	A credit default swap is a type of credit derivative. It is an arrangement whereby the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of protection. The entity selling protection receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.
Credit derivatives	A credit derivative is a financial instrument that derives its value from the credit rating of an underlying instrument carrying the credit risk of the issuing entity. The principal type of credit derivatives are **credit default swaps**, which are used by the Group as part of its trading activity and to manage its own exposure to credit risk.
Credit valuation adjustments	These are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty. Further details are given in note 49.
Debt restructuring	This is when the terms and provisions of outstanding debt agreements are changed. This is often done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as reducing the debt or interest charged on the loan.
Debt securities	Debt securities are assets held by the Group representing certificates of indebtedness of credit institutions, public bodies or other undertakings, excluding those issued by Central Banks.
Delinquency	See **Arrears**.
Embedded equity conversion feature	An embedded equity conversion feature is a derivative contained within the terms and conditions of a debt instrument that enables or requires the instrument to be converted into equity under a particular set of circumstances. The Group's Enhanced Capital Notes (ECNs) contain such a feature whereby these notes convert to ordinary shares in the event that the consolidated core tier 1 ratio of the Group falls below 5 per cent.
Encumbered assets	Assets recognised on the Group's balance sheet which have been pledged as collateral against an existing liability, and as a result are assets which are unavailable to the Group to secure funding, satisfy collateral needs or be sold to reduce potential future funding requirements.
Enhanced Capital Notes (ECNs)	The Group's ECNs are subordinated notes issued by the Group that contained an embedded equity conversion feature.
Expected loss	This is the amount of loss that can be expected by the Group calculated in accordance with PRA rules. In broad terms it is calculated by multiplying the Default Frequency by the **Loss Given Default** by the **Exposure at Default**.
Exposure at default	An estimate of the amount expected to be owed by a customer at the time of the customer's default.
Fair value adjustment	Fair value adjustments arise on acquisition when assets and liabilities are acquired at fair values that are different from the carrying values in the acquired company. In respect of the Group's acquisition of HBOS the principal adjustments were write-downs in respect of loans and advances to customers and debt issued.
Forbearance	Forbearance takes place when a concession is made on the contractual terms of a loan in response to an obligor's financial difficulties.
Full time equivalent	A full time employee works a standard five day week. The hours or days worked by part time employees are measured against this standard and accumulated along with the number of full time employees and counted as full time equivalents. This is a more consistent measure of the amount of time worked than employee numbers which will fluctuate as the mix of part-time and full-time employees changes.
Funded/unfunded exposures	Exposures where the notional amount of the transaction is either funded or unfunded.
Funding risk	The risk that the Group does not have sufficiently stable and diverse sources of funding or the funding structure is inefficient.
Impaired loans	Impaired loans are loans where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
Impairment allowances	Impairment allowances are a provision held on the balance sheet as a result of the raising of a charge against profit for the incurred loss inherent in the lending book. An impairment allowance may either be individual or collective.
Impairment losses	An impairment loss is the reduction in value that arises following an impairment review of an asset that determines that the asset's value is lower than it's carrying value. For impaired financial assets measured at amortised cost, impairment losses are the difference between the carrying value and the present value of estimated future cash flows, discounted at the asset's original effective interest rate. Impairment losses can be difficult to assess and the critical accounting estimates and judgements in note 3 detail the key assessments made when determining impairment losses.
Individually/collectively assessed	Impairment is measured individually for assets that are individually significant, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available.
Individually assessed loan impairment provisions	Impairment loss provisions for individually significant impaired loans are assessed on a case-by-case basis, taking into account the financial condition of the counterparty, any guarantor and the realisable value of any collateral held.
Interest rate risk	Interest rate risk in arises from the different repricing characteristics of the Group's non-trading assets, liabilities and off-balance sheet positions of the Group. Interest rate risk arises predominantly from the mismatch between interest rate sensitive assets and liabilities, but also to the investment term of capital and reserves, and the need to minimise income volatility.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's own assessment, based on Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events as they apply on a solo level and on a consolidated level.
Internal Ratings-Based approach (IRB)	A methodology of estimating the credit risk within a portfolio by utilising internal risk parameters to calculate credit risk regulatory capital requirements. There are two approaches to IRB: Foundation IRB and Advanced IRB.
Investment grade	This refers to the highest range of credit ratings, from 'AAA' to 'BBB' as measured by external credit rating agencies.
ISDA (International Swaps and Derivatives Association) master agreement	A standardised contract developed by the ISDA which is used as an umbrella contract for bilateral derivative contracts.
Liquidity Coverage Ratio (LCR)	The ratio of the stock of high quality liquid assets to expected net cash outflows over the following 30 days. High quality liquid assets should be unencumbered, liquid in markets during a time of stress and ideally, be central bank eligible.
Liquidity risk	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.

Term	Definition
Loan-to-value ratio (LTV)	The loan-to-value ratio is a mathematical calculation which expresses the amount of a mortgage balance outstanding as a percentage of the total appraised value of the property.
Loans past due	Loans are past due when a counterparty has failed to make a payment when contractually due.
Loss emergence period	The loss emergence period is the estimated period between impairment occurring and the loss being specifically identified and evidenced by the establishment of an appropriate impairment allowance.
Loss Given Default	The estimated loss that will arise if a customer defaults. It is calculated after taking account of credit risk mitigation and includes the cost of recovery.
Master netting agreement	An agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.
Medium Term Notes	Medium term notes are a form of corporate borrowing covering maturity periods ranging from nine months to 30 years. Details of the notes issued under the Group's medium term notes programmes are given in note 31.
Negative equity mortgages	Negative equity occurs when the value of the property purchased using the mortgage is below the balance outstanding on the loan. Negative equity is the value of the asset less the outstanding balance on the loan.
Net asset value per ordinary share	Shareholders' equity divided by the number of ordinary shares and limited voting ordinary shares in issue, adjusted to exclude shares held under certain employee share ownership plans.
Net Stable Funding Ratio (NSFR)	The ratio of available stable funding to required stable funding over a one year time horizon, assuming a stressed scenario. The ratio is required to be over 100% with effect from 2018. Available stable funding would include such items as equity capital, preferred stock with a maturity of over 1 year, or liabilities with a maturity of over 1 year.
Net interest income	The difference between interest received on assets and interest paid on liabilities.
Net interest margin	Net interest margin is net interest income as a percentage of average interest-earning assets.
Over-the-counter derivatives	Over-the-counter derivatives are derivatives for which the terms and conditions can be freely negotiated by the counterparties involved, unlike exchange traded derivatives which have standardised terms.
Pre-positioned and encumbered assets held with central banks	Assets which have been delivered to central banks to facilitate future drawdowns under central bank funding schemes and assets which are encumbered under such schemes.
Probability of default	The likelihood that a customer will default on their obligation within the next year.
Regulatory capital	The amount of capital that the Group holds, determined in accordance with rules established by the PRA for the consolidated Group and by local regulators for individual Group companies.
Repurchase agreements or 'repos'	Short-term funding agreements which allow a borrower to sell a financial asset, such as ABS or Government bonds as collateral for cash. As part of the agreement the borrower agrees to repurchase the security at some later date, usually less than 30 days, repaying the proceeds of the loan.
Risk appetite	The amount and type of risk that the Group is prepared to seek, accept or tolerate.
Risk-weighted assets	A measure of a bank's assets adjusted for their associated risks. Risk weightings are established in accordance with the Basel Capital Accord as implemented by the PRA.
Securitisation	Securitisation is a process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities.
Sovereign exposures	Exposures to central governments and central government departments, central banks and entities owned or guaranteed by the aforementioned.
Specialist mortgages	Specialist mortgages include those mortgage loans provided to customers who have self-certified their income (normally as a consequence of being self-employed) or who are otherwise regarded as a sub-prime credit risk. New mortgage lending of this type has not been offered by the Group since early 2009.
Standardised Approach	In relation to credit risk, a method for calculating credit risk capital requirements using External Credit Assessment Institutions (ECAI) ratings of obligors (where available) and supervisory risk weights. In relation to operational risk, a method of calculating the operational risk capital requirement by the application of a supervisory defined percentage charge to the gross income of specified business lines.
Stress testing	Stress and scenario testing is the term used to describe techniques where plausible events are considered as vulnerabilities to ascertain how this will impact the capital resources which are required to be held.
Structured entities (SEs)	SEs are entities that have been designed so that voting or similar rights are not the dominant factor in determining who controls the entity, such as when voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. SEs often have specific restrictions around their ongoing activities and are created to accomplish a narrow and well-defined objective.
Sub-investment grade	This refers to credit ratings issued by external credit rating agencies that are below 'BBB' grade or its equivalent.
Subordinated liabilities	Liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer. Details of the Group's subordinated liabilities are set out in note 39.
Trading book	Positions in financial instruments and commodities held for trading purposes or to hedge other elements of the trading book.
Unencumbered assets – readily realisable	Assets regarded by the Group to be readily realisable in the normal course of business, to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, and are not subject to any restrictions on their use for these purposes.
Unencumbered assets – other realisable	Assets where there are no restrictions on their use to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, but are not readily realisable in the normal course of business in their current form.
Unencumbered assets – cannot be used	Assets that have not been pledged but which the Group has assessed could not be pledged and therefore could not be used to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements.
Value-at-Risk	Value-at-Risk is an estimate of the potential loss in earnings which might arise from market movements under normal market conditions, if the current positions were to be held unchanged for one business day. It is measured to specified level of confidence, often 95 per cent or 99 per cent.
Write downs	The depreciation or lowering of the value of an asset in the books to reflect a decline in their value, or expected cash flows.

Glossary continued

Disclosures arising from Enhanced Disclosure Task Force (EDTF) recommendations

The 32 recommendations listed below are made in the report 'Enhancing the Risk Disclosures of Banks' issued by the Enhanced Disclosure Task Force of the Financial Stability Board on 29 October 2012.

The Group's Pillar 3 Report can be found at www.lloydsbankinggroup.com

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	Market risk	
22	Describe linkages between line items in the balance sheet with positions included in the traded and non-traded market risk disclosures.	146
23	Provide breakdowns of significant trading and non trading market risk factors.	146-151
24	Describe significant market risk measurement model limitations, assumptions and validation procedures.	146-151, Pillar 3
25	Describe the primary risk management techniques employed to measure and assess the risk of loss beyond reported risk measures and parameters, such as VaR, earnings or economic value scenario results.	146-151, Pillar 3
	Credit risk	
26	Describe the bank's credit risk profile, including any significant credit risk concentrations. Detailing aggregate credit risk exposures that reconciles to the balance sheet, including detailed tables for both retail and corporate portfolios.	124-144, Pillar 3
27	Describe the policies for identifying impaired or non-performing loans, defining impaired or non-performing, restructured and returned-to-performing (cured) loans as well as explanations of loan forbearance policies.	124-129, 189-190
28	A reconciliation of the opening and closing balances of non-performing or impaired loans in the period and the allowance for loan losses.	130, 211
29	Provide analysis of the bank's counterparty credit risk that arises from its derivatives transactions.	131, 267
30	Discuss credit risk mitigation, including collateral held for all sources of credit risk.	124-126
	Other	
31	Describe 'other risk' types and discuss how each one is identified, governed, measured and managed.	145, 152-153, 166-169
32	Discuss publicly known risk events related to other risks.	145, 152-153, 166-169

Subsidiaries and related undertakings

In compliance with Section 409 of the Companies Act 2006, the following comprises a list of all related undertakings of the Group, as at 31 December 2016. The list includes each undertaking's registered office and the percentage of the class(es) of shares held by the immediate parent company. Where different, the ultimate percentage of the class of shares held by the Group is given in brackets. All shares held are ordinary shares unless indicated otherwise.

Subsidiary undertakings

The Group holds a majority of the voting rights of the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)		Notes	
25 Gresham Finance Ltd	100%		1	
A G Finance Ltd	100%		7	ii #
A.C.L. Ltd	100%		1	
ACL Autolease Holdings Ltd	100%		1	
ADF No.1 Pty Ltd	100%		8	
Alex Lawrie Factors Ltd	100%		9	
Alex Lawrie Receivables Financing Ltd	100%		9	
Amberdate Ltd	100%		1	
	100%			iv
AN Vehicle Finance Ltd	100%		1	
Anglo Scottish Utilities Partnership 1	n/a		+	*
Aquilus Ltd	100%		1	
Automobile Association Personal Finance Ltd	100%		4	
Bank of Scotland (B.G.S) London Nominees Ltd	n/a		5	*
Bank of Scotland (Stanlife) London Nominees Ltd	n/a		5	*
Bank of Scotland Branch Nominees Ltd	100%		5	
Bank of Scotland Capital Funding (Jersey) Ltd	100%		10	
Bank of Scotland Capital Funding L.P.	100%		10	
Bank of Scotland Central Nominees Ltd	n/a		5	*
Bank of Scotland Edinburgh Nominees Ltd	n/a		5	*
Bank of Scotland Equipment Finance Ltd	100%		2	
Bank of Scotland Hong Kong Nominees Ltd	n/a		11	*
Bank of Scotland Insurance Services Ltd	99.99%	(100%)	5	
Bank of Scotland Leasing Ltd	100%		2	
Bank of Scotland LNG Leasing (No 1) Ltd	100%		1	
Bank of Scotland London Nominees Ltd	n/a		5	*
Bank of Scotland Nominees (Unit Trusts) Ltd	n/a		5	*
Bank of Scotland P.E.P. Nominees Ltd	n/a		5	*
Bank of Scotland plc	99.99%	(100%)	5	
	0%	(100%)		iv
Bank of Scotland Structured Asset Finance Ltd	100%		1	
Bank of Scotland Transport Finance 1 Ltd	100%		2	
Bank of Wales Ltd	100%		2	
Barbirolli Square Limited Partnership	n/a		3	*
Barents Leasing Ltd	100%		1	
Barnwood Mortgages Ltd	100%		12	
Bavarian Mortgages No. 5 Ltd (in liquidation)	99.998%	(100%)	13	
Birchcrown Finance Ltd	100%		1	iv
	100%			vi
Birmingham Midshires Asset Management Ltd	100%		4	
Birmingham Midshires Financial Services Ltd	100%		4	
Birmingham Midshires Land Development Ltd	100%		4	
Birmingham Midshires Mortgage Services Ltd	100%		4	
Birmingham Midshires Mortgage Services No.1 Ltd (in strike off)	100%		4	
Black Horse (TRF) Ltd	100%		1	
Black Horse Executive Mortgages Ltd	100%		1	
Black Horse Finance Holdings Ltd	100%		1	i
	100%			ii
Black Horse Finance Management Ltd	100%		1	
Black Horse Group Ltd	100%		1	
	0%	(100%)		iv
Black Horse Ltd	100%		1	
Black Horse Offshore Ltd	100%		6	
Black Horse Property Services Ltd	100%		1	
Boltro Nominees Ltd	100%		1	
BOS (Ireland) Nominees Ltd (in liquidation)	100%		32	
BOS (Ireland) Property Services 2 Ltd	100%		16	
BOS (Ireland) Property Services Ltd	100%		16	
BOS (PB) LLC	100%		14	
BOS (Shared Appreciation Mortgages (Scotland) No. 2) Ltd	100%		4	
BOS (Shared Appreciation Mortgages (Scotland) No. 3) Ltd	100%		4	
BOS (Shared Appreciation Mortgages (Scotland)) Ltd	100%		4	
BOS (Shared Appreciation Mortgages) No. 1 plc	99.99%	(100%)	4	#
BOS (Shared Appreciation Mortgages) No. 2 plc	99.99%	(100%)	4	#
BOS (Shared Appreciation Mortgages) No. 3 plc	99.99%	(100%)	4	#
BOS (Shared Appreciation Mortgages) No. 4 plc	99.99%	(100%)	4	#
BOS (Shared Appreciation Mortgages) No. 5 plc	99.99%	(100%)	4	#
BOS (Shared Appreciation Mortgages) No. 6 plc	99.99%	(100%)	4	#
BOS (Southport) Holding LLC	100%		14	
BOS (USA) Fund Investments Inc.	100%		14	xiii
BOS (USA) Inc.	100%		14	
BOS Edinburgh No 1 Ltd	100%		17	
BOS Mistral Ltd	100%		2	
BOSIC Inc.	100%		18	
BOSSAF Rail Ltd	100%		1	
Britannia Personal Lending Ltd	100%		4	i #
British Linen Leasing (London) Ltd	100%		5	
British Linen Leasing Ltd	100%		5	
British Linen Shipping Ltd	100%		5	
Brooklyn Properties Ltd (in liquidation)	100%		32	i #
	100%			ii
C&G Financial Services Ltd (in strike off)	100%		12	
C&G Homes Ltd	100%		12	
C&G Estate Agents Ltd	100%		12	
C.T.S.B. Leasing Ltd	100%		1	
Capital 1945 Ltd	100%		2	
Capital Bank Insurance Services Ltd	100%		4	
Capital Bank Leasing 1 Ltd	100%		2	
Capital Bank Leasing 2 Ltd	100%		2	
Capital Bank Leasing 3 Ltd	100%		2	
Capital Bank Leasing 4 Ltd	100%		2	
Capital Bank Leasing 5 Ltd	100%		2	
Capital Bank Leasing 6 Ltd	100%		2	
Capital Bank Leasing 7 Ltd	100%		2	
Capital Bank Leasing 8 Ltd	100%		17	
Capital Bank Leasing 9 Ltd	100%		2	
Capital Bank Leasing 10 Ltd	100%		2	
Capital Bank Leasing 11 Ltd	100%		2	
Capital Bank Leasing 12 Ltd	100%		5	
Capital Bank Property Investments (3) Ltd	100%		2	
Capital Bank Property Investments (6) Ltd (in liquidation)	100%		13	
Capital Bank Vehicle Management Ltd	100%		2	
Capital Leasing (Edinburgh) Ltd	100%		17	
Capital Leasing Ltd	100%		17	
Capital Personal Finance Ltd	100%		4	
Car Ownership Finance Ltd	100%		1	
Cardnet Merchant Services Ltd	97.85%	(100%)	1	ii, #
	0%	(100%)		iii ^
Carlease Ltd	100%		1	
Cartwright Finance Ltd	100%		2	viii
	0.08%			vii #
Cashfriday Ltd	100%		9	
Cashpoint Ltd	100%		1	
Castle Baynard Funding Ltd (in liquidation)	100%		13	
Caveminster Ltd	100%		1	
CBRail S.A.R.L.	100%		19	
Cedar Holdings Ltd	100%		1	
Central Mortgage Finance Ltd	100%		12	
CF Asset Finance Ltd	100%		2	
Chariot Finance Ltd	100%		1	
Chartered Trust (Nominees) Ltd	100%		1	
Charterhall (No. 1) Ltd (in liquidation)	100%		1	
Charterhall (No. 2) Ltd	100%		1	
Charterhall (No. 3) Ltd (in strike off)	100%		1	
Cheltenham & Gloucester plc	99.99%	(100%)	12	
Cheshire Holdings Europe Ltd	100%		6	
	100%			xii
Chiswell Stockbrokers Ltd	100%		1	
Clerical Medical (Dartford Number 2) Ltd	100%		20	
Clerical Medical (Dartford Number 3) Ltd	100%		20	
Clerical Medical Finance plc	99.99%	(100%)	20	
Clerical Medical Financial Services Ltd	99.99%	(100%)	20	
Clerical Medical Forestry Ltd	99.99%	(100%)	20	
Clerical Medical International Holdings B.V.	100%		21	
Clerical Medical Investment Fund Managers Ltd	100%		4	
Clerical Medical Managed Funds Ltd	99.99%	(100%)	20	
Clerical Medical Non Sterling Property Company SARL	100%		22	
Clerical Medical Properties Ltd	99.99%	(100%)	20	
Cloak Lane Funding Ltd	100%		6	
	100%			iv
Cloak Lane Investments Ltd	100%		6	
CM Venture Investments Ltd	100%		23	
	100%			iv
CMI Asset Management (Luxembourg) S.A (in liquidation)	99.99%		24	
CMI Insurance (Luxembourg) S.A. (in liquidation)	99.99%	(100%)	24	
Conquest Securities Ltd	100%		1	iv
	100%			vi
Corbiere Asset Investments Ltd	100%		1	i
	0%	(100%)		ii
County Wide Property Investments Ltd (in liquidation)	100%		13	
Create Services Ltd	100%		1	
Dalkeith Corporation	100%		25	
Delancey Rolls UK Ltd	100%		26	i #
Denham Funding Ltd (in liquidation)	100%		13	
Deva Lease 2 Ltd (in liquidation)	100%		13	
Deva Lease 3 Ltd (in liquidation)	100%		13	
Direct LB Ltd	100%		1	
Dunstan Investments (UK) Ltd	100%		1	
Enterprise Car Finance Ltd	100%		7	ii #
Equipment Leasing (No. 3) Ltd (in liquidation)	100%		13	

Subsidiaries and related undertakings continued

Equipment Leasing (No. 6) Ltd (in liquidation)	100%		13	
Eurolead Services Holdings Ltd	100%		9	
Exclusive Finance No. 1 Ltd	100%		1	
	100%			i
Financial Consultants LB Ltd	100%		1	
First Retail Finance (Chester) Ltd	100%		4	
Flexifly Ltd	100%		17	
Fontview Ltd	100%		20	
Forthright Finance Ltd	100%		2	
France Industrial Premises Holding Company	100%		28	
Freeway Ltd	100%		2	
General Leasing (No. 2) Ltd (in liquidation)	100%		13	
General Leasing (No. 4) Ltd	100%		1	
General Leasing (No. 12) Ltd	100%		1	
General Leasing (No. 14) Ltd (in liquidation)	100%		13	
General Leasing (No. 15) Ltd (in liquidation)	100%		13	
General Reversionary and Investment Company	80%	(100%)	20	
GFP Holdings LLC	100%		14	
Glosstrips Ltd	100%		17	
Godfrey Davis (Contract Hire) Ltd	100%		2	
Gresham Nominee 1 Ltd	100%		1	
Gresham Nominee 2 Ltd	100%		1	
Halifax Credit Card Ltd	100%		4	i
	100%			ii
	100%			vii
Halifax Equitable Ltd	100%		4	
Halifax Financial Brokers Ltd	100%		4	
Halifax Financial Services (Holdings) Ltd	100%		4	
Halifax Financial Services Ltd	100%		4	
Halifax General Insurance Services Ltd	100%		4	
Halifax Group Ltd	100%		4	
Halifax Investment Services Ltd	100%		4	
Halifax Leasing (June) Ltd	100%		1	
Halifax Leasing (March No.2) Ltd	100%		1	
Halifax Leasing (September) Ltd	100%		1	
Halifax Life Ltd	100%		4	
Halifax Ltd	99.99%	(100%)	4	
Halifax Loans Ltd	100%		4	
Halifax Mortgage Services (Holdings) Ltd	100%		4	
Halifax Mortgage Services Ltd	100%		4	
Halifax Nominees Ltd	100%		4	
Halifax Pension Nominees Ltd	100%		29	
Halifax Premises Ltd	100%		1	
Halifax Share Dealing Ltd	100%		4	
Halifax Vehicle Leasing (1998) Ltd	100%		4	
HBOS Canada Inc.	100%		18	
HBOS Capital Funding (Jersey) Ltd	100%		10	
HBOS Covered Bonds LLP	n/a		4	*
HBOS Directors Ltd	100%		1	
HBOS Final Salary Trust Ltd	100%		5	
HBOS Financial Services Ltd	100%		20	
HBOS Insurance & Investment Group Ltd	100%		20	
HBOS International Financial Services Holdings Ltd	99.99%	(100%)	20	
HBOS Investment Fund Managers Ltd	100%		4	
HBOS Management (Jersey) Ltd	100%		10	
HBOS plc	99.99%	(100%)	5	
	100%			iv
	100%			vi
HBOS Social Housing Covered Bonds LLP	n/a		2	*
HBOS Treasury Services Ltd	100%		20	
HBOS UK Ltd	99.99%	(100%)	5	
Heidi Finance Holdings (UK) Ltd	100%		1	
High Street Marketing Services S.A. (in liquidation)	100%		30	
Highway Vehicle Management Ltd (in liquidation)	100%		13	
Hill Samuel (USA), Inc.	100%		14	
Hill Samuel Bank Ltd	100%		1	
Hill Samuel Finance Ltd	100%		1	xi
	100%		1	iv
Hill Samuel Leasing (No 2) Ltd (in liquidation)	100%		1	
Hill Samuel Leasing Co. Ltd	100%		1	
Hill Samuel Nominees Asia Private Ltd	100%		31	
HL Group (Holdings) Ltd (in liquidation)	100%		4	
Home Shopping Personal Finance Ltd	100%		4	
Horizon Capital 2000 Ltd	100%		17	
Horizon Capital Ltd	100%		17	
Horizon Hotel Investments Ltd (in liquidation)	100%		78	
Horizon Property Investments Ltd (in liquidation)	100%		78	
Horizon Resources Ltd	100%		17	
Horsham Investments Ltd	100%		6	
Housing Growth Partnership GP LLP	n/a		1	*
Housing Growth Partnership LP	n/a		1	* #
Housing Growth Partnership Ltd	100%		1	i
	100%			ii
Housing Growth Partnership Manager Ltd	100%		1	
HSDL Nominees Ltd	100%		4	
HVF Ltd	100%		2	
Hyundai Car Finance Ltd	100%		7	i
	100%			ii
IAI International Ltd	100%		1	
IBOS Finance Ltd	100%		2	
IBOS Securities	n/a		+	*
ICC Enterprise Partners Ltd (in liquidation)	100%		32	
ICC Equity Partners Ltd (in liquidation)	100%		32	
ICC ESOP Trustee Ltd	100%		33	
ICC Holdings Unlimited Company	99.09%	(100%)	16	
ICC Software Partners Ltd (in liquidation)	100%		33	
IF Covered Bonds Limited Liability Partnership	n/a		4	*
Inchcape Financial Services Ltd	100%		2	i #
Industrial Real Estate (General Partner) Ltd	100%		34	
Industrial Real Estate (Nominee) Ltd	100%		34	
Intelligent Finance Financial Services Ltd	100%		4	
Intelligent Finance Software Ltd	100%		4	
International Motors Finance Ltd	100%		2	i #
IWEB (UK) Ltd (in liquidation)	100%		13	
Kanaalstraat Funding C.V.	n/a		35	*
Kanto Leasing Ltd	100%		1	
Katrine Leasing Ltd	100%		36	
Langbourn Holdings Ltd	99.99%	(100%)	37	
LB Comhold Ltd	100%		1	
LB Healthcare Trustee Ltd	100%		1	
LB Leasing L.P	n/a		38	*
LB Mortgages Ltd	100%		1	
LB Motorent Ltd	100%		1	
LB Quest Ltd	100%		1	
LB Share Schemes Trustees Ltd	100%		1	
LBCF Ltd	100%		9	
LBG Capital Holdings Ltd	100%		1	
LBG Capital No. 2 plc	100%		1	
LBG Capital No. 1 plc	100%		1	
LBI Leasing Ltd	100%		1	
LDC (Asia) Ltd (in liquidation)	100%		39	
LDC (General Partner) Ltd	100%		40	
LDC (Managers) Ltd	100%		40	
LDC (Nominees) Ltd	100%		40	
LDC Carry VI LP	n/a		41	*
LDC Equity VI LP	n/a		41	*
LDC GP LLP	n/a		41	*
LDC I LP	n/a		41	*
LDC II LP	n/a		41	*
LDC III LP	n/a		41	*
LDC IV LP	n/a		41	*
LDC Parallel (Nominees) Ltd	100%		40	
LDC Parallel VI LP	n/a		41	*
LDC Ventures Carry Ltd	100%		40	
LDC Ventures Trustees Ltd	100%		40	
LDC V LP	n/a		41	*
LDC VI LP	n/a		41	*
Leasing (No. 2) Ltd	100%		1	
Legacy Renewal Company Ltd	99.99%	(100%)	5	
Lex Autolease (CH) Ltd	100%		1	
Lex Autolease (FMS) Ltd (in liquidation)	100%		1	
Lex Autolease (Shrewsbury) Ltd (in liquidation)	100%		13	
	100%			iv
	100%			v
Lex Autolease (VC) Ltd	100%		1	
Lex Autolease (VL) Ltd (in liquidation)	100%		13	
Lex Autolease Carselect Ltd	100%		1	
Lex Autolease Ltd	100%		1	
Lex Vehicle Finance 2 Ltd	100%		2	
Lex Vehicle Finance 3 Ltd	100%		2	
Lex Vehicle Finance Ltd	100%		2	
Lex Vehicle Leasing (Holdings) Ltd	100%		2	i
	100%			ii
	100%			x
Lex Vehicle Leasing Ltd	100%		2	
Lex Vehicle Partners (1) Ltd	100%		2	
Lex Vehicle Partners (2) Ltd	100%		2	
Lex Vehicle Partners (3) Ltd	100%		2	
Lex Vehicle Partners (4) Ltd	100%		2	
Lex Vehicle Partners Ltd	100%		2	
Lime Street (Funding) Ltd	100%		1	
Lloyds (FDC) Company	99%	(100%)	1	
Lloyds (General Partner) Ltd	100%		6	
Lloyds (Gresham) Ltd	100%		1	
	100%			x
Lloyds (Gresham) No. 1 Ltd	100%		1	
Lloyds (Nimrod) Leasing Industries Ltd (in liquidation)	100%		1	
Lloyds (Nimrod) Specialist Finance Ltd	100%		1	
Lloyds America Securities Corporation	100%		14	
Lloyds Asset Leasing Ltd	100%		1	
Lloyds Bank (BLSA)	50%	(100%)	1	
Lloyds Bank (Branches) Nominees Ltd	100%		1	
Lloyds Bank (Colonial & Foreign) Nominees Ltd	100%		1	
Lloyds Bank (Fountainbridge 1) Ltd	100%		5	
Lloyds Bank (Fountainbridge 2) Ltd	100%		5	
Lloyds Bank (Gibraltar) Ltd	100%		42	
Lloyds Bank (I.D.) Nominees Ltd	100%		1	
Lloyds Bank (PEP Nominees) Ltd	100%		1	
Lloyds Bank (Stock Exchange Branch) Nominees Ltd	100%		1	
Lloyds Bank Asset Finance Ltd	100%		1	
Lloyds Bank Commercial Finance Ltd	100%		9	
Lloyds Bank Commercial Finance Scotland Ltd	100%		43	
Lloyds Bank Corporate Asset Finance (HP) Ltd	100%		1	
Lloyds Bank Corporate Asset Finance (No.1) Ltd	100%		1	
Lloyds Bank Corporate Asset Finance (No. 2) Ltd	100%		1	
Lloyds Bank Corporate Asset Finance (No.3) Ltd	100%		1	

Lloyds Bank Corporate Asset Finance (No.4) Ltd	100%		1	
Lloyds Bank Covered Bonds LLP	n/a		44	*
Lloyds Bank Equipment Leasing (No. 1) Ltd	100%		1	
Lloyds Bank Equipment Leasing (No. 2) Ltd (in liquidation)	100%		13	
Lloyds Bank Equipment Leasing (No. 5) Ltd	100%		1	
Lloyds Bank Equipment Leasing (No. 7) Ltd	100%		1	
Lloyds Bank Equipment Leasing (No. 9) Ltd	100%		1	
Lloyds Bank Equipment Leasing (No. 10) Ltd	100%		1	
Lloyds Bank Equipment Leasing (No. 11) Ltd	100%		1	
Lloyds Bank Financial Advisers Ltd	100%		1	i
	100%			ii
Lloyds Bank Financial Services (Holdings) Ltd	99.99%	(100%)	1	
	0%	(100%)		iv
Lloyds Bank General Insurance Holdings Ltd	100%		45	
Lloyds Bank General Insurance Ltd	100%		1	
Lloyds Bank General Leasing (No. 1) Ltd (in liquidation)	100%		1	
Lloyds Bank General Leasing (No. 3) Ltd	100%		1	
Lloyds Bank General Leasing (No. 5) Ltd	100%		1	
Lloyds Bank General Leasing (No. 9) Ltd (in liquidation)	100%		13	
Lloyds Bank General Leasing (No. 11) Ltd	100%		1	
Lloyds Bank General Leasing (No. 17) Ltd	100%		1	
Lloyds Bank General Leasing (No. 18) Ltd	100%		1	
Lloyds Bank General Leasing (No. 20) Ltd	100%		1	
Lloyds Bank GF (Holdings) Ltd (in liquidation)	100%		13	
Lloyds Bank Hill Samuel Holding Company Ltd	100%		1	
Lloyds Bank Insurance Services (Direct) Ltd	100%		1	
Lloyds Bank Insurance Services Ltd	100%		1	
Lloyds Bank International Ltd	100%		6	
Lloyds Bank Leasing (No. 3) Ltd	100%		1	
Lloyds Bank Leasing (No. 4) Ltd	100%		1	
Lloyds Bank Leasing (No. 6) Ltd	100%		1	
Lloyds Bank Leasing (No. 7) Ltd (in liquidation)	100%		1	
Lloyds Bank Leasing (No. 8) Ltd	100%		1	
Lloyds Bank Leasing Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 2) Ltd (in liquidation)	100%		1	
Lloyds Bank Maritime Leasing (No. 3) Ltd (in liquidation)	100%		13	
Lloyds Bank Maritime Leasing (No. 8) Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 10)Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 12)Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 13)Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 15)Ltd	100%		1	
Lloyds Bank Maritime Leasing (No.16) Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 17)Ltd	100%		1	
Lloyds Bank Maritime Leasing (No. 18)Ltd	100%		1	
Lloyds Bank Maritime Leasing Ltd	100%		1	
Lloyds Bank Mtch Ltd	100%		1	
Lloyds Bank Nominees Ltd	100%		1	
Lloyds Bank Offshore Pension Trust Ltd	91%	(100%)	6	
Lloyds Bank Pension ABCS (No. 1) LLP	n/a		1	*
Lloyds Bank Pension ABCS (No. 2) LLP	n/a		1	*
Lloyds Bank Pension Trust (No. 1) Ltd	100%		1	
Lloyds Bank Pension Trust (No. 2) Ltd	100%		1	
Lloyds Bank Pensions Property (Guernsey) Ltd	100%		37	i
	100%			ii
Lloyds Bank plc	99.99%	(100%)	1	^
	100%			^ x
	100%			^ x
Lloyds Bank Private Banking Ltd	100%		1	
Lloyds Bank Properties Ltd	100%		1	
Lloyds Bank Property Company Ltd	100%		1	
Lloyds Bank S.F. Nominees Ltd	100%		1	
Lloyds Bank Subsidiaries Ltd	100%		1	
	100%			iv
Lloyds Bank Trust Company (International) Ltd	100%		1	
Lloyds Bank Trustee Services Ltd	100%		1	
Lloyds Banking Group Pensions Trustees Ltd	100%		1	
Lloyds Capital 2 L.P	n/a		6	*
Lloyds Commercial Leasing Ltd	100%		1	
Lloyds Commercial Properties Ltd	100%		1	
Lloyds Commercial Property Investments Ltd	100%		1	
Lloyds Corporate Services (Jersey) Ltd	100%		6	
Lloyds Development Capital (Holdings) Ltd	100%		40	
Lloyds Engine Capital (No.1) U.S LLC	100%		14	
Lloyds Far East Ltd	100%		46	
Lloyds Financial Leasing Ltd (in liquidation)	100%		1	
Lloyds General Leasing Ltd	100%		1	
Lloyds Group Holdings (Jersey) Ltd	99.4%	(100%)	47	i #
	100%			ii
	100%			vii
Lloyds Holdings (Jersey) Ltd	100%		6	
Lloyds Industrial Leasing Ltd	100%		1	
Lloyds International Pty Ltd	100%		8	
Lloyds Investment Bonds Ltd	100%		1	
Lloyds Investment Fund Managers Ltd	100%		6	
Lloyds Investment Securities No.5 Ltd	100%		1	
Lloyds Leasing (North Sea Transport) Ltd	100%		1	
Lloyds Leasing Developments Ltd	100%		1	
Lloyds Merchant Bank Asia Ltd	100%		31	
	100%			iv

Lloyds Nominees (Guernsey) Ltd	98%	(100%)	37	
Lloyds Offshore Global Services Private Ltd	99.99%	(100%)	48	
Lloyds Participacoes Ltda	99.99%	(100%)	49	
Lloyds Plant Leasing Ltd	100%		1	
Lloyds Portfolio Leasing Ltd	100%		1	
Lloyds Premises Investments Ltd	100%		1	
Lloyds Project Leasing Ltd	100%		1	
Lloyds Property Investment Company Ltd (in liquidation)	100%		13	
Lloyds Property Investment Company No. 3 Ltd	100%		1	
Lloyds Property Investment Company No. 4 Ltd	100%		1	
Lloyds Property Investment Company No.5 Ltd	100%		1	
Lloyds Secretaries Ltd	100%		1	
Lloyds Securities Inc.	100%		50	
Lloyds Trade & Project Finance Ltd (in strike off)	100%		1	
Lloyds Trust Company (Gibraltar) Ltd	100%		42	
Lloyds TSB Fomento Comercial Ltda	100%		49	
Lloyds TSB Pacific Ltd	99.99%	(100%)	51	
Lloyds TSB Rail Capital Inc.	100%		14	
Lloyds UDT Asset Leasing Ltd	100%		1	
Lloyds UDT Asset Rentals Ltd	100%		1	
Lloyds UDT Business Development Ltd	100%		1	
Lloyds UDT Business Equipment Ltd	100%		1	
Lloyds UDT Hiring Ltd	100%		1	
Lloyds UDT Leasing Ltd	100%		1	
Lloyds UDT Ltd	100%		1	
Lloyds UDT Rentals Ltd (in liquidation)	100%		52	
Lloyds Your Tomorrow Trustee Ltd	100%		1	
London Taxi Finance Ltd	100%		1	i
	100%			ii
London Uberior (L.A.S. Group) Nominees Ltd	n/a		5	*
Lothian Road LLC	100%		25	
Lotus Finance Ltd	100%		81	i #
LTGP Limited Partnership Incorporated	n/a		37	*
Lovat Funding Holdings Ltd (in liquidation)	100%		13	
Maritime Leasing (No.7) Ltd (in liquidation)	100%		13	
Maritime Leasing (No.11) Ltd (in liquidation)	100%		13	
Maritime Leasing (No. 19) Ltd	100%		1	
Meadowfield Investments Ltd	100%		5	
Membership Services Finance Ltd	100%		4	
Mitre Street Funding Ltd	100%		6	
Moor Lane Holdings Ltd	100%		6	
Moray Investments Ltd	100%		20	
Morrison Street LLC	100%		25	
Murrayfield LLC	100%		25	
Nevis Leasing Ltd	74%		36	#
Newfont Ltd	100%		20	
NFU Mutual Finance Ltd	100%		2	i #
	100%			vii
Nominees (Jersey) Ltd	100%		6	
Nordic Leasing Ltd	100%		1	
NWS 2	n/a		+	*
NWS Trust Ltd	100%		5	
Ocean Leasing (July) Ltd	100%		1	
Ocean Leasing (No 1) Ltd	100%		1	
Ocean Leasing (No 2) Ltd	100%		1	
Omnistone Ltd (in liquidation)	100%		32	i
	100%			ii
	98%	(100%)		vii
Oystercatcher LP	n/a		20*	
Oystercatcher Nominees Ltd	100%		20	
Oystercatcher Residential Ltd	100%		20	
Pacific Leasing Ltd	100%		1	
Pensions Management (S.W.F.) Ltd	100%		54	
Peony Eastern Leasing Ltd	100%		1	
Peony Leasing Ltd	100%		1	
Peony Western Leasing Ltd	100%		1	
Perry Nominees Ltd	100%		1	
PIPS Asset Investments Ltd	100%		1	i
	0%	(100%)		ii
Portland Funding Ltd	100%		1	
Prestonfield Investments Ltd	100%		5	
Prestonfield P1 Ltd	100%		5	
Prestonfield P2 Ltd	100%		5	
Prestonfield P3 Ltd	100%		5	
Proton Finance Ltd	99.99%	(100%)	7	ii #
Quion 6 BV	100%		55	
R.F. Spencer And Company Ltd	100%		2	
Ranelagh Nominees Ltd	100%		1	
Retail Revival (Burgess Hill) Investments Ltd	100%		1	
Saint Michel Holding Company No1	100%		28	
Saint Michel Investment Property	99%	(100%)	28	
Saint Witz 2 Holding Company No1	100%		28	
Saint Witz 2 Investment Property	99%	(100%)	28	
Saleslease Purchase Ltd	100%		17	
Savban Leasing Ltd	100%		1	
Scotland International Finance B.V.	100%		21	
Scotland International Finance No. 2 B.V. (in liquidation)	100%		21	
Scotmar Commercial Equipment Finance Ltd	100%		2	i #
Scottish Widows (Port Hamilton) Ltd	100%		54	
Scottish Widows Active Management Fund	n/a		3	*
Scottish Widows Administration Services Ltd	100%		1	
Scottish Widows Annuities Ltd	100%		3	
Scottish Widows Bank plc	100%		3	
Scottish Widows Financial Services Holdings	100%		54	

Subsidiaries and related undertakings continued

Scottish Widows Fund and Life Assurance Society	n/a		54	*
Scottish Widows Fund Management Ltd	100%		54	
Scottish Widows Group Ltd	100%		3	i
	0%	(100%)		ii
	100%			iv
	0%	(100%)		x
Scottish Widows Industrial Properties Europe B.V.	100%		56	
Scottish Widows Ltd	100%		1	
Scottish Widows Pension Trustees Ltd	100%		3	
Scottish Widows Property Management Ltd	100%		54	
Scottish Widows Services Ltd	100%		3	
Scottish Widows Trustees Ltd	100%		54	
Scottish Widows Unit Funds Ltd	100%		3	
Scottish Widows Unit Trust Managers Ltd	100%		45	
Seabreeze Leasing Ltd	100%		1	
Seadance Leasing Ltd (in liquidation)	100%		13	
Seaforth Maritime (Highlander) Ltd	100%		17	
Seaforth Maritime (Jarl) Ltd	100%		17	
Seaspirit Leasing Ltd	100%		1	
Seaspray Leasing Ltd	100%		1	
Services LB (No. 2) Ltd (in liquidation)	100%		1	
	100%			iv
Services LB (No. 3) Ltd (in strike off)	100%		1	
Services LB (No. 4) Ltd (in strike off)	100%		1	
	100%			iv
Share Dealing Nominees Ltd	100%		4	
Shibden Dale Ltd (in liquidation)	100%		13	
Shogun Finance Ltd	100%		7	ii #
Silentdale Ltd	100%		1	iv
	100%			vi
	100%			vi
St Andrew's Group Ltd	99.99%	(100%)	20	
St Andrew's Insurance plc	99.99%	(100%)	20	
St Andrew's Life Assurance plc	99.99%	(100%)	20	
St. Mary's Court Investments	100%		1	
Standard Property Investment (1987) Ltd	100%		17	i
	100%			ii
Standard Property Investment Ltd	60.34%		57	#
Starfort Ltd	100%		20	
Sussex County Homes Ltd	100%		4	
Suzuki Financial Services Ltd	100%		81	i #
SW No.1 Ltd	100%		3	
SWAMF (GP) Ltd	100%		20	
SWAMF Nominee (1) Ltd	100%		20	
SWAMF Nominee (2) Ltd	100%		20	
SW Funding plc	99.99%	(100%)	3	#
SWUF Nominee 1 Ltd	100%		47	
SWUF Nominee 2 Ltd	100%		47	
SWUF Nominee 3 Ltd	100%		47	
SWUF Nominee 4 Ltd	100%		47	
Tantallon Investments, Inc.	100%		50	
Target Corporate Services Ltd	100%		1	
The Agricultural Mortgage Corporation plc	99.99%	(100%)	45	
The British Linen Company Ltd	99.98%	(100%)	5	
The Mortgage Business plc	99.99%	(100%)	4	
Thistle Leasing	n/a		+	*
Three Copthall Avenue Ltd	99%	(100%)	1	
Tower Hill Property Investments (7) Ltd	90%		2	#
Tower Hill Property Investments (10) Ltd	90%		2	#
Tranquility Leasing Ltd	100%		1	
Uberior (Moorfield) Limited	100%		17	
Uberior Canada LP Ltd	100%		60	
Uberior Co-Investments Ltd	100%		17	
Uberior ENA Ltd	100%		17	
Uberior Equity Ltd	100%		17	
Uberior Europe Ltd	100%		5	
Uberior Fund Investments Ltd	100%		17	
Uberior Infrastructure Investments Ltd	100%		17	
Uberior Infrastructure Investments (No.2) Ltd	100%		1	
Uberior Investments Ltd	99%	(100%)	17	
Uberior ISAF CIP 2007 L.P	n/a		61	*
Uberior Nominees Ltd	n/a		5	*
Uberior Trading Ltd	99%	(100%)	17	
Uberior Trustees Ltd	n/a		5	*
Uberior Ventures Australia Pty Ltd	100%		8	
Uberior Ventures Ltd	100%		5	
UDT Autolease Ltd	100%		1	
UDT Budget Leasing Ltd	100%		1	
UDT Ltd	100%		1	
UDT Sales Finance Ltd	100%		1	
United Dominions Leasing Ltd	100%		1	
United Dominions Trust Ltd	100%		1	
Upsaala Ltd	100%		16	
Vehicle Leasing (1) Ltd	100%		2	
Vehicle Leasing (2) Ltd	100%		2	
Vehicle Leasing (3) Ltd	100%		2	
Vehicle Leasing (4) Ltd	100%		2	
Ward Nominees (Abingdon) Ltd	100%		1	
Ward Nominees (Birmingham) Ltd	100%		1	
Ward Nominees (Bristol) Ltd	100%		1	
Ward Nominees Ltd	100%		1	
Warwick Leasing Ltd	100%		2	
Waverley – BOCA LLC	100%		25	
Waverley – Fund II Investor LLC	100%		25	
Waverley – Fund III Investor LLC	100%		25	
Waverley – Wilshire Rodeo LLC	100%		25	
Waymark Asset Investments Ltd	100%		1	i
	0%	(100%)		ii
WCS Ltd	100%		62	
West Craigs Ltd	100%		17	
Western Trust & Savings Holdings Ltd	100%		4	
Western Trust Holdings Ltd	100%		4	
Whitestar Securities Ltd (in liquidation)	100%		1	ii
	100%			xi
Wood Street Leasing Ltd	100%		1	

Subsidiary undertakings (continued)

The Group has determined that it has the power to exercise control over the following entities without having the majority of the voting rights of the undertakings. Unless otherwise stated, the undertakings do not have share capital or the Group does not hold any shares.

Name of undertaking	Notes
Addison Social Housing Holdings Ltd	63
ARKLE Finance Trustee Ltd	10
ARKLE Funding (No. 1) Ltd	64
ARKLE Holdings Ltd	64
ARKLE Master Issuer plc	64
ARKLE PECOH Holdings Ltd	64
ARKLE PECOH Ltd	64
Cancara Asset Securitisation Ltd	65
Candide Financing 2006 BV	66
Candide Financing 2007 NHG BV	66
Candide Financing 2008-1 BV	66
Candide Financing 2008-2 BV	66
Candide Financing 2011-1 BV	66
Candide Financing 2012-1 BV	66
Celsius European Lux 2 SARL	24
Chepstow Blue Holdings Ltd	44
Chepstow Blue plc	44
Clerical Medical Non Sterling Arts FSA	67
Clerical Medical Non Sterling Arts LSA	67
Clerical Medical Non Sterling Guadalix Hold Co BV	68
Clerical Medical Non Sterling Guadalix Spanish Prop Co SL	69
Clerical Medical Non Sterling Megapark Hold Co BV	68
Clerical Medical Non Sterling Megapark Prop Co SA	69
Computershare Trustees (Jersey) Ltd	47
Coral Palm Ltd	83
Craig Financing Holdings Ltd	44
Deva Financing Holdings Ltd	44
Deva Financing plc	44
Dewcrown Ltd	83
Edgbaston RMBS 2010-1 plc	44
Edgbaston RMBS Holdings Ltd	44
Farnham Funding Ltd	82
Fontwell Securities 2016 Ltd	63
Gresham Receivables (No. 1) Ltd	65
Gresham Receivables (No. 3) Ltd	65
Gresham Receivables (No. 10) Ltd	65
Gresham Receivables (No.11) UK Ltd	71
Gresham Receivables (No. 12) Ltd	65
Gresham Receivables (No. 13) UK Ltd	71
Gresham Receivables (No. 14) UK Ltd	71
Gresham Receivables (No. 15) UK Ltd	71
Gresham Receivables (No. 16) UK Ltd	71
Gresham Receivables (No. 19) UK Ltd	71
Gresham Receivables (No. 20) Ltd	65
Gresham Receivables (No. 21) Ltd	65
Gresham Receivables (No. 22) Ltd	65
Gresham Receivables (No. 23) Ltd	65
Gresham Receivables (No. 24) Ltd	65
Gresham Receivables (No. 25) UK Ltd	71
Gresham Receivables (No. 26) UK Ltd	71
Gresham Receivables (No.27) UK Ltd	71
Gresham Receivables (No. 28) Ltd	65
Gresham Receivables (No. 29) Ltd	65
Gresham Receivables (No. 30) UK Ltd	71
Gresham Receivables (No. 31) UK Ltd	71
Gresham Receivables (No. 32) UK Ltd	71
Gresham Receivables (No. 33) UK Ltd	71
Gresham Receivables (No. 34) UK Ltd	71
Gresham Receivables (No. 35) Ltd	65
Gresham Receivables (No.36) UK Ltd	71
Gresham Receivables (No.37) UK Ltd	71
Gresham Receivables (No.38) UK Ltd	71
Gresham Receivables (No.39) UK Ltd	71
Gresham Receivables (No.40) UK Ltd	71
Gresham Receivables (No.41) UK Ltd	71
Gresham Receivables (No.42) Ltd	65
Gresham Receivables (No.44) UK Ltd	71
Gresham Receivables (No.45) UK Ltd	71
Gresham Receivables (No.46) UK Ltd	71
Guildhall Asset Purchasing Company (No 3) Ltd	65
Guildhall Asset Purchasing Company (No.11) UK Ltd	71
Hart 2014-1 Ltd	63
Headingley RMBS 2011-1 Holdings Ltd	44
Leicester Securities 2014 Ltd	73

Lingfield 2014 I Holdings Ltd	44
Lingfield 2014 I plc	44
Lloyds Bank Covered Bonds (Holdings) Ltd	44
Lloyds Bank Covered Bonds (LM) Ltd	44
Molineux RMBS 2016-1 plc	44
Molineux RMBS Holdings Ltd	44
Penarth Asset Securitisation Holdings Ltd	44
Penarth Funding 1 Ltd	63
Penarth Funding 2 Ltd	63
Penarth Master Issuer plc	44
Penarth Receivables Trustee Ltd	63
Permanent Funding (No. 1) Ltd	44
Permanent Funding (No. 2) Ltd	44
Permanent Holdings Ltd	44
Permanent Master Issuer plc	44
Permanent Mortgages Trustee Ltd	44
Permanent PECOH Holdings Ltd	44
Permanent PECOH Ltd	44
Salisbury Securities 2015 Ltd	63
Salisbury II Securities 2016 Ltd	63
Sandown 2012-2 Holdings Ltd	44
Sandown 2012-2 plc	44
Sandown Gold 2011-1 Holdings Ltd	44
Sandown Gold 2011-1 plc	44
Sandown Gold 2012-1 Holdings Ltd	44
Sandown Gold 2012-1 plc	44
Sandown Gold plc	72
SARL Coliseum	77
SARL Fonciere De Rives	77
SARL Hiram	77
SAS Compagnie Fonciere De France,	77
SCI Astoria Invest	77
SCI De L'Horloge	77
SCI Equinoxe	77
SCI Mercury Invest	77
SCI Millenium AP1	77
SCI Norli	77
SCI Rambuteau CFF	77
Stichting Candide Financing Holdings	66
Swan Funding 2 Ltd	63
The Hual Carolita Limited Partnership	74
The SAFA 0494 Limited Partnership (to be placed into liquidation)	75
Thistle Investments (AMC) Ltd	44
Thistle Investments (ERM) Ltd	44
Trinity Financing Holdings Ltd	44
Trinity Financing plc	44
Lloyds Bank Foundation for England & Wales •	79
The Halifax Foundation for Northern Ireland •	15
Lloyds Bank Foundation for the Channel Islands •	79
Lloyds TSB Foundation for Scotland •	80
Bank of Scotland Foundation •	5

• A charitable foundation funded but not owned by Lloyds Banking Group

Associated undertakings

The Group has a participating interest in the following undertakings.

Name of undertaking	% of share class held by immediate parent company (or by the Group where this varies)	Registered office address (UK unless stated otherwise)	Notes
Aceso Healthcare Group Holdings Ltd	27.5%	Sherwood House, Cartwright Way, Forest Business Park, Brandon Hill, Coalville, LE67 1UB	
Addison Social Housing Holdings Ltd	20%	35 Great St Helen's, London, EC3A 6AP	
Adler & Allan Group Ltd	43.6%	80 Station Parade, Harrogate, HG1 1HQ	
A-Gas (Orb) Ltd	55.2%	Baynard Road, Portbury, Bristol, BS20 7XH	&
Agora Shopping Centres Ltd (in receivership)	50%	Hill House, 1 Little New Street, London, EC4A 3TR	ii
Airline Services And Components Group Ltd	46.2%	Canberra House, Robeson Way, Sharston Green Business Park, Manchester, M22 4SX	
Angus International Safety Group Ltd	48.1%	Station Road, High Bentham, Near Lancaster, LA2 7NA	
Antler Ltd	49.1%	Northdown House, 11-21 Northdown Street, London, N1 9BN	
Applied Composites Group Ltd	49.5%	Victoria Works, Thrumpton Lane, Retford, DN22 6HH	
Aqualisa Holdings (International) Ltd	72.5%	Westerham Trade Centre, The Flyers Way, Westerham, TN16 1DE	&
Aspin Group Holdings Ltd	35.6%	Nexus House Boundary Way, Hemel Hempstead Industrial Estate, Hemel Hempstead, England, HP2 7SJ	
Aspire Oil Services Ltd	28.4%	Union Plaza, 6th Floor, 1 Union Wynd, Aberdeen, AB10 1DQ	
Atcore Technology Group Ltd	71.2%	353 Buckinghamshire Avenue, Slough, Berkshire, SL1 4PF	&
Australand Apartments No.6 Pty Ltd	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
Australand Residential Investments Pty Ltd	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
Australand Residential Trust	50%	Level 3, 1 Chomebush Bay Drive, Rhodes, NSW 2138, Australia	
AVJBOS Nominees Proprietary Ltd	50%	Ground Floor, 1 Lakeside Drive, Burwood East, VIC 3151, Australia	
Bacchus Newco Ltd	52.7%	The Grange, Harnett Drive, Wolverton Mill, Milton Keynes, Buckinghamshire, MK12 5NE	&
Bergamot Ventures Ltd	45%	6th Floor 25 Farringdon Street, London, EC4A 4AB	ii
Bluestone Consolidated Holdings Ltd	88.4%	Newnham Mill, Newnham Road, Cambridge, CB3 9EY	&
BoS Mezzanine Partners Fund LP	n/a	7 Melville Crescent, Edinburgh, EH3 7JA	*
Brington North Holdco Ltd	50%	25 Gresham Street, London, EC2V 7HN	&
Business Growth Fund plc	24.3%	13-15 York Buildings, London, England, WC2N 6JU	
Bybox Group Holdings Ltd	47.3%	1-2 Cherry Barn, High Street, Harwell, Oxford, OX11 0EY	
Capital Economics Research Ltd	31.2%	100 Victoria Street, London, England, SW1E 5JL	
Cary Towne Parke Holdings LLC	98%	Jeffrey Cohen, 1066 Woodward Avenue, Detroit, MI 48226, United States	
Cary Towne Parke LLC	100%	National Registered Agents Inc., 150 Fayetteville Street, Raleigh, NC 2782, United States	
Caspian Media Holdings	88.4%	Unit G4, Harbour Yard, Chelsea Harbour, London, SW10 0DX	&
CIPHR Group Ltd	40.2%	Abbey House, Chapel Street, Marlow, SL7 1DD	
City & General Securities Ltd	100%	10 Upper Berkeley Street, London, W1H 7PE	ii
Citysprint (UK) Holdings Ltd	30.8%	Ground Floor, Redcentral, 60 High Street, Redhill, RH1 1SH	
Clifford Thames (Topco) Ltd	50.3%	Springfield Lyons House, Chelmsford Business Park, Chelmsford, CM2 5TH	&
CMS Acquisitions Company Ltd	36.7%	Caisteal Road, Castlecary, Cumbernauld, Glasgow, G68 0FS	
Cobaco Holdings Ltd	50.3%	Cobaco House, North Florida Road, Haydock Industrial Estate, Merseyside, WA11 9TP	&
Connect Managed Holdings Ltd	58.8%	Abbey Place, 24-28 Easton Street., High Wycombe, HP11 1NT	&
Connery Ltd	20%	44 Esplanade St Helier Jersey JE4 9WG	
Continental Shelf 225 Ltd (in liquidation)	100%	4 Mount Ephraim Road, Tunbridge Wells, Kent, TN1 1EE	i
Continental Shelf 291 Ltd (in liquidation)	100%	4 Mount Ephraim Road, Tunbridge Wells, Kent, TN1 1EE	i
Craig Finance Ltd	20%	35 Great St. Helen's, London, EC3A 6AP	
CTI Holdings Ltd	53.6%	47 Esplanade St Helier Jersey JE1 0BD	&
Cuts Ice Holdings Ltd	32.1%	Level 1, Devonshire House, Mayfair Place, London, W1J 8AJ	
D.U.K.E Real Estate Ltd	100%	1st Floor, Exchange Place, 3 Semple Street, Edinburgh, EH3 8BL	i
Dale Erskine Power Solutions Ltd	74.3%	Eastfield Industrial Estate, Salter Road, Scarborough, North Yorkshire, YO11 3DU	&
Delancey Arnold UK Ltd (in liquidation)	50%	105 St Peters Street, St Albans, AL1 3EJ	
Devonshire Homes (Cullompton) Ltd	25%	Devonshire House, Lowman Green, Tiverton, Devon, EX16 4LA	i
Devonshire Homes (Landkey) Limited	25%	Devonshire House, Lowman Green, Tiverton, Devon, EX16 4LA	
Dino Newco Ltd	34.5%	Unit 2, Orchard Place, Nottingham Business Park, Nottingham, NG8 6PX	
Duchy Homes (Penistone) Ltd	21.5%	Middleton House, Westland Road, Leeds, West Yorkshire, LS11 5UH	
Duchy Homes (Scawthorpe) Ltd	21.5%	Middleton House, Westland Road, Leeds, West Yorkshire, LS11 5UH	
EDM Business Services Holdings Ltd	65.3%	Queens House, 8-9 Queen Street, London, EC4N 1SP	&
Eley Group Ltd	70.8%	Selco Way, Off First Avenue, Minworth Industrial Estate, Minworth, Sutton Coldfield, B76 1BA	&
Ellis Whittam (Holdings) Ltd	40.2%	Woodhouse, Aldford, Chester, CH3 6JD	
EPI-V Equity LP	n/a	1st Floor 67 Leigh Road, Eastleigh, SO50 9DF	*
EPI-V Equity Investments LP	n/a	1st Floor 67 Leigh Road, Eastleigh, SO50 9DF	*
Equiom Holdings Ltd	51.1%	Jubilee Buildings, Victoria Street, Douglas, Isle of Man, IM 1 2SH	&

Subsidiaries and related undertakings continued

Europa Property Company (Northern) Ltd	100%	Europa House, 20 Esplanade, Scarborough, North Yorkshire, YO11 2AQ	vii
European Property Fund (Holdings) Ltd SARL	24.9%	1 Allee Scheffer, Luxembourg, I-25250, Luxembourg	ii
Express Engineering (Group) Ltd	37.4%	Kingsway North, Team Valley Trading Estate, Gateshead, NE11 0EG	
FDL Salterns Ltd	25%	2 Poole Road, Bournemouth, BH2 5QY	
Fern Bay Seaside Village Ltd (in liquidation)	34.48%	Septimus Roe Square, Level 8, 256 Adelaide Terrace, Perth, WA 6000, Australia	
FHR European Ventures LLP	n/a	CMS Cameron Mckenna LLP, 78 Cannon Street, London, EC4N 6AF	*
Forest Holidays Group Ltd	59.3%	Bath Yard, Bath Lane, Moira, Swadlincote, Derbyshire, DE12 6BA	&
Giacom Holdings Ltd	40.6%	1 Priory Court, Saxon Way, Hessle, East Yorkshire, HU13 9PB	
Golfview Apartment Holdings LLC	43.758%	Jeffrey Cohen, 1066 Woodward Avenue, Detroit, MI 48226, United States	
Golfview Apartments LLC	88%	300 South Orange Avenue, Suite 100, Orlando, FL 32801, United States	
Great Wigmore Property Ltd	100%	33 Cavendish Square, London, W1G 0PW	&
HBOS Capital Funding LP,	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 1 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 3 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Capital Funding No. 4 LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Euro Finance (Jersey) LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
HBOS Sterling Finance (Jersey) LP	n/a	Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT	*
Hedge End Place (Durkan) LLP	n/a	4 Elstree Gate, Elstree Way, Borehamwood, Hertfordshire, WD6 1JD	*
Hedge End Place Hold Co Ltd	50%	25 Gresham Street, London, EC2V 7HN	&
Helsinki Topco Ltd	16.1%	Granville House, Gatton Park Business Centre, Redhill, Surrey, RH1 3AS	&
ICB Brands Holdings Ltd	58.5%	4 Sceptre House, Hornbeam Square, Hornbeam Business Park, Harrogate, North Yorkshire, HG2 2PB	&
Iglufastnet Ltd	41.9%	2nd Floor, 165 The Broadway, Wimbledon, London, SW19 1NE	
Ingleby (1884) Ltd	76%	Fontana House, Works Road, Letchworth Garden City, SG6 1LD	&
Ingleby (2016) Ltd	41.5%	Unit 22, Lodge Way, Lodge Farm Industrial Estate, Northampton, NN5 7US	
Inprova Group Ltd	21.1%	Unit 2, Olympic Park, Woolston Grange Avenue, Warrington, Cheshire, WA2 0YL	
Kee Safety Group Ltd	20.9%	Unit A2, Cradley Business Park, Overend Road, Cradley Heath, West Midlands, B64 7DW	
Kenmore Capital 2 Ltd (in liquidation)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Kenmore Capital 3 Ltd (in receivership)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Kenmore Capital Ltd (in liquidation)	100%	Grant Thornton UK LLP, 95 Bothwell Street, Glasgow, G2 7JZ	ii
Keoghs Topco Ltd	22.3%	2 The Parklands, Bolton, Lancashire, BL6 4SE	
Kimberly Holdings Ltd	59.1%	13 Hornbeam Square South, Harrogate, North Yorkshire, HG2 8NB	&
LCP Baby Investors LP (in process of disposal)	n/a	International Corporation Services Ltd, Harbour Place, 2nd Floor, 103 South Church Street, George Town, Grand Cayman, KY1106, Cayman Islands*	
Lesprit Ltd	71%	Apollo House 6 Bramley Road, Mount Farm, Milton Keynes, England, MK1 1PT	&
Lighthouse Healthcare Group Ltd	71.96%	2nd Floor Bezant House, Bradgate Park View, Chellaston, Derbyshire, DE73 5UH	v
	59.71%		i
	77.07%		ii
London Topco Ltd	48.7%	Gloucester Road, Cheltenham, Gloucester, GL51 8NR	
Lothian Fifty (150) Ltd (in liquidation)	100%	55 Baker Street, London, W1U 7EU	i
Magicard Holdings Ltd	69.3%	Waverley House, Hampshire Road, Granby Industrial Estate, Weymouth, DT4 9XD	&
Marvel Newco Ltd	44.1%	Paston House, Princess Street, Norwich, Norfolk, NR3 1AZ	
Mini-Cam Enterprise Ltd	38.3%	Unit 4, Yew Tree Way, Golborne, Warrington, WA3 3FN	
Mitrefinch Holdings Ltd	51.9%	Mitrefinch House, Green Lane Trading Estate, Clifton, York, North Yorkshire, YO30 5YY	&
Morston Assets Ltd (in administration)	20%	KPMG LLP, Arlington Business Park, Theale, Reading, Berkshire, RG7 4SD	
Motability Operations Group plc	20% (40%)	City Gate House, 22 Southwark Bridge Road, London, SE1 9HB	
	20% (40%)		iv
Nevada Topco Ltd	73.2%	National Exhibition Centre, Birmingham, B40 1NT	&
Nexinto Ltd	65.3%	55 Baker Street, London, W1U 7EU	&
Northern Edge Ltd	39.4%	The Beacon, 176 St. Vincent Street, Glasgow, G2 5SG	ii
Omnium Leasing Company	39%	N/A	+
Onapp (Topco) II Ltd	70.1%	The Old Truman Brewery, 91 Brick Lane, London, EC20 2AX	&
Onapp (Topco) Ltd	56.3%	The Old Truman Brewery, 91 Brick Lane, London, EC20 2AX	&
Osprey Aviation Services (UK) Ltd	65.5%	Blackwood House, Union Grove Lane, Aberdeen, AB10 6XU	&
Pacific Shelf 1809 Ltd	66.9%	Seabrook House, Duncombe Street, Bradford, West Yorkshire, BD8 9AJ	&
Panther Partners Ltd	61.4%	16 Kirby Street, London, EC1N 8TS	&
Paw Topco Ltd	46.9%	Birkbecks, Water Street, Skipton, North Yorkshire, BD23 1PB	
PEI Group Topco Ltd	34.9%	140 London Wall, London, EC2Y 5DN	
Personal Touch Holdings Ltd	18.9%	3 Trinity Park, Solihull, West Midlands, B37 7ES	&
Pertemps Network Group Ltd	27.2%	Meriden Hall, Main Road, Meriden, Coventry	
PIHL Equity Administration Ltd	100%	Cavendish House, 18 Cavendish Square, London, W1G 0PJ	ii
PIMCO (Holdings) Ltd	61.9%	Dearing House, 1 Young Street, Sheffield, S1 4UP	&
Power Topco Ltd	54.9%	Roundhouse Road, Faverdale Industrial Estate, Darlington, County Durham DL3 0UR	&
Prestbury 1 Limited Partnership	n/a	Cavendish House, 18 Cavendish Square, London, W1G 0PJ	*
Prestbury Hotel Holdings Ltd (in liquidation)	100%	15 Canada Square, London, E14 5GL	vii
Prestbury Wentworth Holdings Ltd (in liquidation)	100%	KPMG LLP Arlington Business Park, Theale, Reading, RG7 4SD	vii
Prism Medical Healthcare Ltd	65.1%	Unit 4, Jubilee Business Park, Jubilee Way, Grange Moor, West Yorkshire, WF4 4TD	&
Quantel Holdings Ltd	83.1%	Turnpike Road, Newbury, Berkshire, RG14 2NX	&
Ramco Acquisition Ltd	60%	Blackwood House, Union Grove Lane, Aberdeen, AB10 6XU	&
Rectory (Aston Clinton) Ltd	23.5%	Rectory House, Thame Road, Haddenham, Aylesbury, Buckinghamshire, HP17 8DA	
Rolls Development UK Ltd (in liquidation)	50%	105 St Peters Street, St Albans, AL1 3EJ	ii
Sapphire Retail Fund Ltd (in liquidation)	50%	Grant Thornton UK LLP, 30 Finsbury Square, London, EC2P 2YU	ii
SHOO 788AA Ltd	73.2%	21-22 Balena Close, Poole, Dorset, BH17 7DX	&
Southport Green Acquisition LLC	50%	1095 Avenue of the Americas, New York, NY 10036, United States	
Specialist People Services Group Ltd	51.6%	7 Bradford Business Park, Kingsgate, Bradford, BD1 4SJ	&
SSP Topco Ltd	54.2%	2nd Floor, G Mill, Dean Clough, Halifax, HX3 5AX	&
Stewart Milne (Glasgow) Ltd	100%	Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE	i
Stewart Milne (West) Ltd	100%	Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE	i
Stratus (Holdings) Ltd	66.6%	Old Truman Brewery, 91 Brick Lane, London , EC20 2AX	&
Stroma Group Ltd	36.4%	Unit 4, Pioneer Way, Castleford, West Yorkshire, WF10 5QU	
Tantallon Acquisition LLC	100%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Tantallon Austin Hotel LLC	100%	National Registered Agents Inc., 160 Greentree Drive, Suite 101, Dover, DE19904, United States	
Tantallon Austin LLC	100%	National Registered Agents Inc., 160 Greentree Drive, Suite 101, Dover, DE19904, United States	
Tantallon LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Team 17 Holdings Ltd	29%	Castleview House, Calder Island Way, Wakefield, West Yorkshire, WF2 7AW	
Test Equipment Asset Management Ltd	64%	Unit 1 Waverley Industrial Estate, Hailsham Drive, Harrow, Middlesex, HA1 4TR	&
The Exceed Partnership LP	n/a	Cavendish House, 39-41 Waterloo Street, Birmingham, B2 5PP	*
The Great Wigmore Partnership (G.P.) Ltd	50%	33 Cavendish Square, London, W1G 0PW	
The Great Wigmore Partnership	n/a	33 Cavendish Square, London, W1G 0PW	*
The Moment Content Group Ltd	60.3%	3 Bush Park, Estover, Plymouth, PL6 7RG	&
The Pallet Network Group Limited	35.7%	Prologis Park, Midpoint Way, Minworth, Sutton Coldfield, West Midlands, B76 9EH	
The Scottish Agricultural Securities Corporation plc (in liquidation)	33.33%	Titanium, 1 Kings Inch Place, Renfrew, PA4 8WF	
The Training Grp Holdings Ltd	40.9%	2nd Floor, Waterloo House, Fleets Corner, Waterloo Road, Poole, Dorset, BH17 0HL	
Thistlerow Ltd	25%	Radleigh House 1 Golf Road, Clarkston, Glasgow, G76 7HU	

Thread Real Estate Cary Towne Park LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Thread Real Estate Golfview LLC	50%	Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States	
Travellers Cheque Associates Ltd	36%	Belgrave House, 76 Buckingham Palace Road, London, SW1W 9AX	
Tropical Marine Centre (2012) Ltd	35%	Tropical Marine Centre, Solesbridge Lane, Chorleywood, Herts, WD3 5SX	
United House Group Holdings Ltd	41.5%	26 Kings Hill Avenue, Kings Hill, West Malling, Kent, ME19 4AE	
United Living Group Ltd	70%	Media House, Azalea Drive, Swanley, Kent, BR8 8HU	&
Valad Canadian Partners LP	n/a	44 Chipman Hill, Suite 100, St. John, NB E2L 2A9, Canada	*
Vocalink Holdings Ltd	14.29% (25.11%)	1 Angel Lane, London, EC4R 3AB	
Vulcan Topco Ltd	55.2%	2 Mountview Court, 310 Friern Barnet Lane, Wheststone, London, N20 0YZ	&
Whitefleet Ltd (in liquidation)	100%	1 More London Place, London, SE1 2AF	i &
Willoughby (873) Ltd	47.4%	Parklands Industrial Estate, Forest Road, Denmead, PO7 6TJ	
Willoughby (880) Ltd	64.3%	IMEX, 575-599 Maxted Road, Hemel Hempstead Industrial Estate, Hemel Hempstead, Herts, HP2 7DX	&
WRG Worldwide Ltd	48.3%	36 Great Titchfield Street, London, W1W 8BQ	
York & Becket Nominees Ltd (in liquidation)	50%	25-28 Bedford Row, London, WC1R 4HE	ii
York & Becket Nominees No.3 Ltd (in liquidation)	50%	25-28 Bedford Row, London, WC1R 4HE	ii
York & Becket Nominees No.4 Ltd (in liquidation)	50%	25-28 Bedford Row, London, WC1R 4HE	ii
Zog Brownfield Ventures Ltd (in administration)	50%	1 More London Place, London, SE1 2AF	

Collective investment vehicles

The following comprises a list of the Group's collective investment vehicles.

Name of undertaking	% of fund held by immediate parent (or by the Group where this varies)	Notes
ABERDEEN INVESTMENT ICVC		8
Aberdeen European Property Share Fund	53.21%	
Aberdeen World Government Bond Fund	85.86%	
Aberdeen Sterling Bond Fund	70.16%	
ABERDEEN INVESTMENTS ICVC II		8
Aberdeen Global Emerging Markets Quantitative Equity Fund	73.47%	
ABERDEEN LIQUIDITY FUND (LUX)		7
Sterling Fund	50.93%	
Euro Fund	32.85%	
Ultra Short Duration Sterling Fund	61.62%	
ABERDEEN PRIVATE EQUITY FUND OF FUNDS (2007) PLC	96.80%	3
ABERDEEN PROPERTY ICVC		8
Aberdeen UK Property Fund	31.39%	
ACS POOLED PROPERTY		2
Scottish Widows Pooled Property ACS Fund	99.88% (100%)	
Scottish Widows Pooled Property ACS Fund2	99.80% (100%)	
BLACKROCK BALANCED GROWTH PORTFOLIO FUND	33.74%	9
BLACKROCK UK SMALLER COMPANIES FUND	22.72%	9
BNY MELLON INVESTMENT FUNDS I		10
Newton Managed Income Fund	31.53%	
BNY MELLON INVESTMENT FUNDS		10
Boston Company US Opportunities Fund	20.06%	
Newton Oriental Fund	42.29%	
BNY MELLON INVESTMENTs FUNDS ICVC		10
Insight Global Multi-Strategy Fund	44.12%	
Insight Global Absolute Return Fund	79.08%	
Newton Multi-Asset Growth Fund (formerly Newton Managed Fund)	29.86%	
Newton UK Opportunities Fund	38.66%	
Newton UK Equity Fund (formerly Newton Income Fund)	22.58%	
DEVONSHIRE ASSETS MANAGED FUNDS PLC		20
Devonshire Conservative Real Return Fund	41.37%	
HBOS ACTIVELY MANAGED PORTFOLIO FUNDS ICVC		1
Diversified Return Fund	94.86%	
Absolute Return Fund	94.08%	
Dynamic Return Fund	96.94%	
HBOS INTERNATIONAL INVESTMENT FUNDS ICVC		1
North American Fund	96.86%	
Far Eastern Fund	82.43%	
European Fund	94.39%	
International Growth Fund	54.44%	
Japanese Fund	96.61%	
HBOS SPECIALISED INVESTMENT FUNDS ICVC	1	
Cautious Managed Fund	53.45%	
Ethical Fund	83.78%	
Fund of Investment Trusts	41.28%	
Smaller Companies Fund	66.75%	
Special Situations Fund	52.55%	
HBOS UK INVESTMENT FUNDS ICVC		1
UK Equity Income Fund	63.13%	
UK Growth Fund	63.04%	
UK FTSE All-Share Index Tracking Fund	59.39%	
HBOS PROPERTY INVESTMENT FUNDS ICVC		1
UK Property Fund	40.23%	
HLE ACTIVE MANAGED PORTFOLIO KONSERVATIV	31.06%	18
HLE ACTIVE MANAGED PORTFOLIO DYNAMISCH	51.95%	18
HLE ACTIVE MANAGED PORTFOLIO AUSGEWOGEN	56.45%	18
INSIGHT INVESTMENT FUND OF FUNDS II ICVC		11
Absolute Insight Fund	48.14%	
INVESCO PERPETUAL FAR EASTERN INVESTMENT SERIES		12
Invesco Perpetual Asian Equity Income Fund	25.95%	
JP MORGAN FUND II ICVC		13
JP Morgan Balanced Managed Fund	68.99%	
LDI SOLUTIONS PLUS PLC		19
IIFIG Government Liquidity Fund	29.19%	
MULTI MANAGER ICVC		2
Multi Manager UK Equity Growth Fund	70.69%	
Multi Manager UK Equity Income Fund	24.87%	
Multi Manager UK Equity Focus Fund	23.47%	
Multi Manager Global Real Estate Fund	21.32%	
NORDEA 1		14
Nordea 1 SICAV-GBP Diversified Return Return Fund	45.68%	
RUSSELL INVESTMENT COMPANY PLC		15
Russell Euro Fixed Income Fund	25.73%	
Russell Sterling Bond Fund	27.52%	
Russell U.S. Bond Fund	53.59%	
SCHRODER GILT AND FINXED INTEREST FUND	24.15%	16
SCOTTISH WIDOWS INCOME AND GROWTH FUNDS ICVC		2
UK Index Linked Gilt Fund	100%	
Corporate Bond PPF Fund	100%	
SW Corporate Bond Tracker	100%	
Scottish Widows GTAA 1	82.92%	
Corporate Bond 1 Fund	100%	
Balanced Growth Fund	27.47%	
Adventurous Growth Fund	71.25%	
SCOTTISH WIDOWS INVESTMENT SOLUTIONS FUNDS ICVC		2
Balanced Solution	48.46%	
Cautious Solution	40.82%	
Discovery Solution	48.05%	
Strategic Solution	56.95%	
Dynamic Solution	58.83%	
Defensive Solution	73.86%	
Adventurous Solution	77.50%	
European (ex UK) Equity Fund	95.90%	
Asia Pacific (ex Japan) Equity Fund	98.32%	
Japan Equities Fund	94.44%	
US Equities Fund	99.69%	
Fundamental Index UK Equity Fund	85.40%	
Fundamental Index Global Equity Fund	96.35%	
Fundamental Index Emerging Markets Equity Fund	95.52%	
Fundamental Low Volatility Index Global Equity	100.00%	
Fundamental Low Volatility Index Emerging Markets Equity	95.57%	
Fundamental Low Volatility Index UK Equity	91.08%	
SCOTTISH WIDOWS MANAGED INVESTMENT FUNDS ICVC		2
International Equity Tracker Fund	98.50%	
Balanced Portfolio Fund	82.10%	
Progressive Portfolio Fund	73.17%	
Cautious Portfolio Fund	60.14%	
Cash Fund	98.68%	
Opportunities Portfolio Fund	92.61%	
SCOTTISH WIDOWS OVERSEAS GROWTH INVESTMENT FUNDS ICVC		2
Global Growth Fund	52.39%	
European Growth Fund	89.24%	
American Growth Fund	88.68%	
Pacific Growth Fund	36.36%	
Japan Growth Fund	98.58%	
SCOTTISH WIDOWS TRACKER AND SPECIALIST INVESTMENT FUNDS ICVC		2
UK All Share Tracker Fund	91.56%	
International Bond Fund	65.88%	
UK Smaller Companies Fund	28.20%	
UK Tracker Fund	47.43%	
UK Fixed Interest Tracker Fund	97.98%	
Emerging Markets Fund	90.34%	
UK Index-Linked Tracker Fund	90.22%	
Overseas Fixed Interest Tracker Fund	98.99%	
SCOTTISH WIDOWS UK AND INCOME INVESTMENT FUNDS ICVC		2
UK Corporate Bond Fund	53.65%	
UK Growth Fund	63.32%	
Gilt Fund	96.72%	
High Income Bond Fund	25.32%	
Safety Plus ® Fund	72.01%	
Strategic Income Fund	61.80%	
Environmental Investor Fund	68.92%	
Ethical Fund	71.41%	
SSGA ASIA PACIFIC TRACKER FUND	84.66%	4
SSGA EUROPE (EX UK)	96.00%	4
SSGA UK EQUITY TRACKER FUND	91.64%	4

Subsidiaries and related undertakings continued

SSGA NORTH AMERICAN EQUITY FUND	100%	4
SWIP EUROPEAN BALANED PROPERTY FUND	83.988%	5
UNIVERSE, THE CMI GLOBAL NETWORK		6
CMIG GA 70 Flexible	100%	
CMIG GA 80 Flexible	100%	
CMIG GA 90 Flexible	100%	
European Enhanced Equity	100%	
CMIG Access 80%	100%	
Continental Euro Equity	97.54%	
UK Equity	73.27%	
US Enhanced Equity	86.78%	
Japan Enhanced Equity	96.76%	
Pacific Enhanced Basin	78.73%	
Euro Bond	66.52%	
US Bond	93.81%	
US Currency Reserve	78.99%	
Euro Currency Reserve	98.57%	
CMIG Focus Euro Bond	99.97%	
INVESTMENT PORTFOLIO ICVC		2
IPS Growth	20.42%	
THE TM LEVITAS FUNDS		21
TM Levitas A Fund	42.39%	
TM Levitas B Fund	32.86%	
UBS INVESTMENT FUNDS ICVC		17
UBS Global Optimal Fund	27.40%	
UBS UK Opportunities Fund	49.87%	

Principal place of business for collective investment vehicles

(1) Trinity Road, Halifax West Yorkshire, HX1 2RG
(2) 15 Dalkeith Road Edinburgh EH16 5WL
(3) 39/40 Upper Mount Street, Dublin, Ireland
(4) 20 Churchill Place, Canary Wharf, London E14 5HJ
(5) 80 route d'Esch, L-1470 Luxembourg
(6) Lemanik Asset Management S.A 106 route d'Arlon, L-8210 Mamer Luxembourg
(7) 35a avenue John F. Kennedy, L-1855, Luxembourg
(8) ABERDEEN ASSET MANAGERS LTD, 1 BREAD STREET, BOW BELLS HOUSE, LONDON EC4M 9HH
(9) BlackRock Fund Managers Limited, 12 Throgmorton Avenue, London EC2N 2DL
(10) BNY MELLON INVESTMENT FUNDS, BNY MELLON CENTRE, 160 QUEEN VICTORIA STREET, LONDON EC4V 4LA
(11) INSIGHT INVESTMENT MGMT GLOBAL, 160 QUEEN VICTORIA STREET, LONDON EC4V 4LA
(12) Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire, RG9 1HH
(13) JP Morgan Funds Limited, 3 Lochside View, Edinburgh Park, Edinburgh, EH12 9DH
(14) Nordea Investment Funds S.A., 562 rue de Neudorf, L-2220 Luxembourg
(15) 78 SIR JOHN ROGERSON'S QUAY, DUBLIN 2, IRELAND
(16) SCHRODER UNIT TRUSTS LIMITED, 31 GRESHAM STREET, LONDON, EC2V 7QA
(17) UBS INVESTMENT FUNDS ICVC, 21 LOMBARD STREET, LONDON, EC3V 9AH
(18) Oppenheim Asset Management Services S.à r.l. , 2, Boulevard Konrad Adenauer, L-1115 Luxemburg
(19) LDI Solutions Plus plc, 2nd Floor, Beaux Lane House, Mercer Street Lower, Dublin 2, Ireland
(20) GEORGE'S COURT, 54 -62 TOWNSEND STREET, DUBLIN 2, IRELAND
(21) Thesis Unit Trust Management Limited, Exchange Building, St. John's Street, Chichester, West Sussex PO19 1UP

* The undertaking does not have share capital
+ The undertaking does not have a registered office
# In relation to Subsidiary Undertakings, an undertaking external to the Group holds shares
^ Shares held directly by Lloyds Banking Group plc
& The Group holds voting rights of between 20% and 49.9%

(i) A Ordinary shares
(ii) B Ordinary shares
(iii) Deferred shares
(iv) Preference shares
(v) Preferred ordinary shares
(vi) Non-voting shares
(vii) C Ordinary shares
(viii) N Ordinary shares
(ix) Callable preference shares
(x) Redeemable preference shares
(xi) Ordinary limited voting shares
(xii) Redeemable ordinary shares
(xiii) Common stock

Registered office addresses

(1) 25 Gresham Street, London, EC2V 7HN
(2) Charterhall House, Charterhall Drive, Chester, CH88 3AN
(3) Port Hamilton, 69 Morrison Street, Edinburgh, EH3 8YF
(4) Trinity Road, Halifax, HX1 2RG
(5) The Mound, Edinburgh, EH1 1YZ
(6) 25 New Street, St. Helier, Jersey, JE4 8RG
(7) 116 Cockfosters Road, Barnet, Hertfordshire, EN4 0DY
(8) Minter Ellison, Governor Macquire Tower, Level 40, 1 Farrer Place, Sydney, NSW 2000, Australia
(9) 1 Brookhill Way, Banbury, Oxon, OX16 3EL
(10) Sanne Group, 13 Castle Street, St. Helier, Jersey, JE4 5UT
(11) 26th Floor, Oxford House, Taikoo Place, Quarry Bay, Hong Kong
(12) Barnett Way, Gloucester, GL4 3RL
(13) 1 More London Place, London, SE1 2AF
(14) 1095 Avenue of the America's, 34th Floor, New York, NY 10036, United States
(15) 2nd Floor, 14 Cromac Place, Gasworks, Belfast, BT7 2JB
(16) Rineanna House, Shannon Free Zone, Co. Clare, Ireland
(17) Level 1, Citymark, 150 Fountainbridge, Edinburgh, EH3 9PE
(18) Cox and Palmer, Suite 400, 371 Queen Street, Phoenix Square, Fredericton, NB E3B 4Y9, Canada
(19) 4 Rue Alphonse Weicker, L-2721, Luxembourg
(20) 33 Old Broad Street, London, EC2N 1HZ
(21) Prins Bernhardplein 200, 1097 JB, Amsterdam, Netherlands
(22) Citco REIF Services, 20 Rue de Poste, L-2346, Luxembourg
(23) RL360 House, Cooil Road, Douglas, Isle of Man, IM2 2SP
(24) Centre Orchimont, 36 Rangwee, L-2412, Luxembourg
(25) Corporation Service Company, Suite 400, 2711 Centre Road, Wilmington, DE 19805, United States
(26) 105 St Peters Street, St. Albans, AL1 3EJ
(27) 1 Allee Scheffer, Luxembourg, L-2520, Luxembourg
(28) SAB Formalities, 23 Rue de Roule, Paris, 75001, France
(29) Rockspring, 166 Sloane Street, London, SW1X 9QF
(30) Tronador 4890, 9th Floor, Buenos Aires, 1430, Argentina
(31) 138 Market Street, #27-01/02, Capita Green, 048946, Singapore
(32) McStay Luby, Dargan House, 21-23 Fenian Street, Dublin 2, Ireland
(33) 124-127 St. Stephen's Green, Dublin 2, Ireland
(34) 21 St. Thomas Street, Bristol, BS1 6JS
(35) De Entrée 254, 1101 EE, Amsterdam, Netherlands
(36) 47 Esplanade, St. Helier, Jersey, JE1 0BD
(37) Sarnia House, Le Truchot, St. Peter Port, Guernsey, GY1 4EF
(38) 1 Rodney Square, 10th Floor, Tenth and King Street, Wilmington, DE 19801, United States
(39) Bank of China, Tower 1, Garden Road Central, Hong Kong
(40) 1 Vine Street, London, W1J 0AH
(41) 39 Queens Road, Aberdeen, AB15 4ZN
(42) Royal Ocean Plaza, Ocean Village, GX11 1AA, Gibraltar
(43) 110 St. Vincent Street, Glasgow, G2 4QR
(44) 35 Great St. Helen's, London, EC3A 6AP
(45) Charlton Place, Charlton Road, Andover, SP10 1RE
(46) 22 Grenville Street, St. Helier ,Jersey, JE4 8PX
(47) Queensway House, Hilgrove Street, St. Helier, Jersey, JE4 1ES
(48) Unit 2, Level 2, Bagmane Tridib B-Wing, Bagmane Technology Park, Bangalore, 560093, India
(49) Av. Jurubatuba 73, 8th Floor, Sao Paulo, Brazil
(50) Corporation Trust Centre, 1209 Orange Street, Wilmington, DE 19801, United States
(51) 18th Floor, United Centre, 95 Queensway, Hong Kong
(52) Finance House, Orchard Brae, Edinburgh
(53) 55 Baker Street, London, W1U 7EU
(54) 15 Dalkeith Road, Edinburgh, EH16 5BU
(55) Lichtenauerlann 170, 3062ME, Rotterdam, Netherlands
(56) Weena 340, 3012 NJ, Rotterdam, Netherlands
(57) Caledonian Exchange, 19A Canning Street, Edinburgh, EH3 8HE
(60) 44 Chipman Hill, Suite 100, St. John, NB E2L 2A9, Canada
(61) 155 Bishopsgate, London, EC2M 3YB
(62) 12 Peveril Buildings, Peveril Square, Douglas, Isle of Man, IM99 1JJ
(63) 44 Esplanade, St. Helier, Jersey, JE4 9WG
(64) Asticus Building 2nd Floor, 21 Palmer Street, London, SW1H 0AD
(65) 26 New Street St Helier Jersey JE2 3RA
(66) Fred. Roeskestraat 123, 1076 EE, Amsterdam, Netherlands
(67) Avenue Louise 331-333, 1050 Brussels, Belgium
(68) Naritaweg 165, 1043 BW, Amsterdam, Netherlands
(69) Calle Pinar 7, 5ºIzquierda, 28006, Madrid, Spain
(70) 2nd Floor Beaux Lane House, Mercer Street Lower, Dublin 2, Ireland
(71) Wilmington Trust Sp Services (London) Limited, Third Floor, 1 King's Arms Yard, London, EC2R 7AF
(72) 40a Station Road, Upminster, Essex, RM14 2TR
(73) 1st Floor, 1-2 Victoria Buildings, Haddington Road, Dublin 4, Ireland
(74) Black Horse House, Bentalls, Basildon, Essex, SS14 3BY
(75) Maples and Calder, P.O. Box 309, Ugland House, South Church Street, George Town, Grand Cayman, KY1-1104, Cayman Islands
(76) 106 Goring Road, Goring By Sea, Worthing, West Sussex, BN12 4AA
(77) 8 Avenue Hoche, 75008, Paris, France
(78) 10 George Street, Edinburgh, EH2 2DZ
(79) Pentagon House, 52-54 Southwark Street, London, SE1 1UN
(80) Riverside House, 502 Gorgie Road, Edinburgh, EH11 3AF
(81) St William House, Tresillian Terrace, Cardiff, CF10 5BH
(82) Walker House, Mary Street, PO Box 908GT, South Church Street, George Town, Grand Cayman, Cayman Islands
(83) Tower House, Charterhall Drive, Chester, CH88 3AN

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www.merchantcantos.com

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