

Lloyds Banking Group plc  
Form 20-F  
March 08, 2016

**As filed with the Securities and Exchange Commission on 8 March 2016**

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

**FORM 20-F**

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

OR

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

For the fiscal year ended 31 December 2015

OR

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

OR

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

**Commission file number 001-15246**

**LLOYDS BANKING GROUP plc**

(previously Lloyds TSB Group plc)

(Exact name of Registrant as Specified in Its Charter)

**Scotland**

(Jurisdiction of Incorporation or Organization)

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

(Address of Principal Executive Offices)

**Malcolm Wood, Company Secretary  
Tel +44 (0) 20 7356 1274, Fax +44 (0) 20 7356 1808  
25 Gresham Street  
London EC2V 7HN  
United Kingdom**

(Name, telephone, e-mail and/or facsimile number and address of Company contact person)

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

| <b>Title of each class</b>  | <b>Name of each exchange on which registered</b> |
|---|--|
| Ordinary shares of nominal value 10 pence each, represented by American Depositary Shares | The New York Stock Exchange                      |
| \$1,250,000,000 3.5% Senior Notes due 2025  | The New York Stock Exchange                      |
| \$1,000,000,000 4.5% Subordinated Securities due 2024                                     | The New York Stock Exchange                      |
| \$2,500,000,000 6.375% Senior Notes due 2021  | The New York Stock Exchange                      |
| \$1,000,000,000 2.7% Senior Notes due 2020  | The New York Stock Exchange                      |
| \$1,000,000,000 2.4% Senior Notes due 2020  | The New York Stock Exchange                      |
| \$1,000,000,000 2.35% Senior Notes due 2019   | The New York Stock Exchange                      |
| \$1,000,000,000 2.3% Senior Notes due 2018  | The New York Stock Exchange                      |
| \$700,000,000 2% Senior Notes due 2018  | The New York Stock Exchange                      |
| \$300,000,000 Floating Rate Notes due 2018  | The New York Stock Exchange                      |
| \$1,250,000,000 1.75% Senior Notes due 2018   | The New York Stock Exchange                      |
| \$400,000,000 Floating Rate Notes due 2018  | The New York Stock Exchange                      |
| \$1,000,000,000 1.75% Senior Notes due 2018   | The New York Stock Exchange                      |
| \$500,000,000 Floating Rate Notes due 2018  | The New York Stock Exchange                      |
| \$1,500,000,000 4.20% Senior Notes due 2017   | The New York Stock Exchange                      |
| \$2,250,000,000 4.875% Senior Notes due 2016  | The New York Stock Exchange                      |

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

**None**

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

7.50% Fixed Rate Reset Additional Tier 1 Perpetual Subordinated Contingent Convertible Securities

The number of outstanding shares of each of Lloyds Banking Group plc's classes of capital or common stock as of 31 December 2015 was:

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|   |                |
|---|----------------|
| Ordinary shares, nominal value 10 pence each        | 71,373,735,357 |
| Limited voting shares, nominal value 10 pence each  | 80,921,051     |
| Preference shares, nominal value 25 pence each      | 412,204,151    |
| Preference shares, nominal value 25 cents each      | 1,206,888      |
| Preference shares, nominal value 25 euro cents each | Nil            |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

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

Yes  No

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

Yes  No

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-Accelerated filer

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

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

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

Item 17  Item 18

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

Yes  No

## TABLE OF CONTENTS

|   |     |
|---|-----|
| <u>Presentation of information</u>  | 1   |
| <u>Business overview</u>  | 2   |
| <u>Selected consolidated financial data</u>                               | 3   |
| <u>Exchange rates</u>   | 4   |
| <u>Business</u>   | 4   |
| <u>Operating and financial review and prospects</u>                       | 12  |
| <u>Management and employees</u>   | 125 |
| <u>Compensation</u>   | 129 |
| <u>Corporate governance</u>   | 156 |
| <u>Major shareholders and related party transactions</u>                  | 183 |
| <u>Regulation</u>   | 187 |
| <u>Listing information</u>  | 191 |
| <u>Dividends</u>  | 194 |
| <u>Memorandum and articles of association of Lloyds Banking Group plc</u> | 195 |
| <u>Exchange controls</u>  | 200 |
| <u>Taxation</u>   | 201 |
| <u>Where you can find more information</u>                                | 204 |
| <u>Enforceability of civil liabilities</u>                                | 204 |
| <u>Risk factors</u>   | 205 |
| <u>Forward looking statements</u>   | 221 |
| <u>Lloyds Banking Group structure</u>                                     | 222 |
| <u>Index to the consolidated financial statements</u>                     | F-1 |
| <u>Glossary</u>   | 223 |
| <u>Form 20-F cross-reference sheet</u>                                    | 225 |
| <u>Exhibit index</u>  | 227 |
| <u>Signatures</u>   | 228 |

## PRESENTATION OF INFORMATION

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

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

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

Lloyds Banking Group publishes its consolidated financial statements expressed in British pounds ('pounds sterling', 'sterling' or '£'), the lawful currency of the UK. In this annual report, references to 'pence' and 'p' are to one-hundredth of one pound sterling; references to 'US dollars', 'US\$' or '\$' are to the lawful currency of the United States (the US); references to 'cent' or 'c' are to one-hundredth of one US dollar; references to 'euro' or '€' are to the lawful currency of the member states of the European Union (EU) that have adopted a single currency in accordance with the Treaty establishing the European Communities, as amended by the Treaty of European Union; references to 'euro cent' are to one-hundredth of one euro; and references to 'Japanese yen', 'Japanese ¥' or '¥' are to the lawful currency of Japan. Solely for the convenience of the reader, this annual report contains translations of certain pounds sterling amounts into US dollars at specified rates. These translations should not be construed as representations by Lloyds Banking Group that the pounds sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated or at any other rate. Unless otherwise stated, the translations of pounds sterling into US dollars have been made at the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) in effect on 31 December 2015, which was \$1.4746 = £1.00. The Noon Buying Rate on 31 December 2015 differs from certain of the actual rates used in the preparation of the consolidated financial statements, which are expressed in pounds sterling, and therefore US dollar amounts appearing in this annual report may differ significantly from actual US dollar amounts which were translated into pounds sterling in the preparation of the consolidated financial statements in accordance with IFRS.

## BUSINESS OVERVIEW

Lloyds Banking Group is a leading provider of financial services to individual and business customers in the UK. At 31 December 2015, total Lloyds Banking Group assets were £806,688 million and Lloyds Banking Group had 75,306 employees (on a full-time equivalent basis). Lloyds Banking Group plc's market capitalisation at that date was £52,153 million. The Group reported a profit before tax for the 12 months to 31 December 2015 of £1,644 million, and its capital ratios at that date were 21.5 per cent for total capital, 16.4 per cent for tier 1 capital and 12.8 per cent for common equity tier 1 capital.

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

|                                       | 2015     | 2014      | 2013      |
|---------------------------------------|----------|-----------|-----------|
|                                       | £m       | £m        | £m        |
| Net interest income                   | 11,318   | 10,660    | 7,338     |
| Other income                          | 11,832   | 19,232    | 30,647    |
| Total income                          | 23,150   | 29,892    | 37,985    |
| Insurance claims                      | (5,729 ) | (13,493 ) | (19,507 ) |
| Total income, net of insurance claims | 17,421   | 16,399    | 18,478    |
| Operating expenses                    | (15,387) | (13,885)  | (15,322)  |
| Trading surplus                       | 2,034    | 2,514     | 3,156     |
| Impairment                            | (390 )   | (752 )    | (2,741 )  |
| Profit before tax                     | 1,644    | 1,762     | 415       |

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

At 31 December 2015, the Group's four primary operating divisions, which are also reporting segments, were: Retail; Commercial Banking; Consumer Finance and Insurance. Retail provides banking, mortgages and other financial services to personal and small business customers in the UK. Commercial Banking provides banking and related services to business clients, from SMEs to large corporates. Consumer Finance provides a range of products including motor finance, credit cards, and European mortgages and deposit taking. Insurance provides long-term savings, protection and investment products as well as general insurance products in the UK.

Profit before tax is analysed on pages 15 to 18 on a statutory basis and, in order to provide a more comparable representation of business performance of the Group's segments, on pages 26 to 36 on an underlying basis. The key principles adopted in the preparation of this basis of reporting are described on page 26. The Group Executive Committee, which is the chief operating decision maker for the Group, reviews the Group's internal reporting based around these segments (which reflect the Group's organisational and management structures) in order to assess

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performance and allocate resources; this reporting is on an underlying basis. IFRS 8, *Operating Segments* requires that the Group presents its segmental profit before tax on the basis reviewed by the chief operating decision maker that is most consistent with the measurement principles used in measuring the Group's statutory profit before tax.

Accordingly, the Group presents its segmental underlying basis profit before tax in note 4 to the financial statements in compliance with IFRS 8. The table below shows the results of Lloyds Banking Group's segments in the last three fiscal years, and their aggregation. Further information on non-GAAP measures and the reconciliations required by the Securities and Exchange Commission's Regulation G are set out on pages F-23 to F-26.

|                                      | 2015  | 2014  | 2013   |
|--------------------------------------|-------|-------|--------|
|                                      | £m    | £m    | £m     |
| Retail                               | 3,514 | 3,228 | 3,015  |
| Commercial Banking                   | 2,431 | 2,206 | 1,890  |
| Consumer Finance                     | 1,005 | 1,010 | 965    |
| Insurance                            | 962   | 922   | 1,088  |
| Other                                | 200   | 390   | (792 ) |
| Profit before tax – underlying basis | 8,112 | 7,756 | 6,166  |

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



## SELECTED CONSOLIDATED FINANCIAL DATA

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

|  | 2015      | 2014      | 2013      | 2012      | 2011      |
|--|-----------|-----------|-----------|-----------|-----------|
| Income statement data for the year ended 31 December (£m)      |           |           |           |           |           |
| Total income, net of insurance claims                          | 17,421    | 16,399    | 18,478    | 20,517    | 20,802    |
| Operating expenses   | (15,387 ) | (13,885 ) | (15,322 ) | (15,974 ) | (13,259 ) |
| Trading surplus  | 2,034     | 2,514     | 3,156     | 4,543     | 7,543     |
| Impairment losses  | (390 )    | (752 )    | (2,741 )  | (5,149 )  | (8,094 )  |
| Profit (loss) before tax                                       | 1,644     | 1,762     | 415       | (606 )    | (551 )    |
| Profit (loss) for the year                                     | 956       | 1,499     | (802 )    | (1,387 )  | (554 )    |
| Profit (loss) for the year attributable to equity shareholders | 466       | 1,125     | (838 )    | (1,471 )  | (627 )    |
| Dividends for the year <sup>2,3</sup>                          | 1,962     | 535       | –         | –         | –         |
| Balance sheet data at 31 December (£m)                         |           |           |           |           |           |
| Share capital  | 7,146     | 7,146     | 7,145     | 7,042     | 6,881     |
| Shareholders' equity   | 41,234    | 43,335    | 38,989    | 41,896    | 45,506    |
| Other equity instruments                                       | 5,355     | 5,355     | –         | –         | –         |
| Customer deposits  | 418,326   | 447,067   | 439,467   | 426,216   | 413,906   |
| Subordinated liabilities                                       | 23,312    | 26,042    | 32,312    | 34,092    | 35,089    |
| Loans and advances to customers                                | 455,175   | 482,704   | 492,952   | 516,764   | 565,638   |
| Total assets <sup>1</sup>                                      | 806,688   | 854,896   | 842,380   | 933,064   | 970,609   |
| Share information  |           |           |           |           |           |
| Basic earnings (loss) per ordinary share                       | 0.8p      | 1.7p      | (1.2 )p   | (2.1 )p   | (0.9 )p   |
| Diluted earnings (loss) per ordinary share                     | 0.8p      | 1.6p      | (1.2 )p   | (2.1 )p   | (0.9 )p   |
| Net asset value per ordinary share                             | 57.9p     | 60.7p     | 54.6p     | 59.5p     | 66.1p     |
| Dividends per ordinary share <sup>2,4</sup>                    | 2.75p     | 0.75p     | –         | –         | –         |
| Equivalent cents per share <sup>2,4,5</sup>                    | 3.91c     | 1.16c     | –         | –         | –         |
| Market price per ordinary share (year end)                     | 73.1p     | 75.8p     | 78.9p     | 47.9p     | 25.9p     |
| Number of shareholders (thousands)                             | 2,563     | 2,626     | 2,681     | 2,733     | 2,770     |
| Number of ordinary shares in issue (millions) <sup>6</sup>     | 71,374    | 71,374    | 71,368    | 70,343    | 68,727    |
| <b>Financial ratios (%)<sup>7</sup></b>                        |           |           |           |           |           |
| Dividend payout ratio <sup>8</sup>                             | 359.3     | 45.1      | –         | –         | –         |
| Post-tax return on average shareholders' equity                | 1.3       | 2.9       | (2.0 )    | (3.3 )    | (1.4 )    |
| Post-tax return on average assets                              | 0.11      | 0.17      | (0.09 )   | (0.14 )   | (0.06 )   |
| Average shareholders' equity to average assets                 | 5.1       | 4.7       | 4.7       | 4.6       | 4.5       |
| Cost:income ratio <sup>9</sup>                                 | 88.3      | 84.7      | 82.9      | 77.9      | 63.7      |
| <b>Capital ratios (%)<sup>10,11,12</sup></b>                   |           |           |           |           |           |
| Total capital  | 21.5      | 22.0      | 20.8      | 17.3      | 15.6      |
| Tier 1 capital   | 16.4      | 16.5      | 14.5      | 13.8      | 12.5      |
| Common equity tier 1 capital/Core tier 1 capital               | 12.8      | 12.8      | 14.0      | 12.0      | 10.8      |

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- 1 Restated, where appropriate, in 2013 for IAS 19 (Revised) and IFRS 10.
- 2 Annual dividends comprise both interim and final dividend payments. The total dividend for the year represents the  
interim dividend paid during the year and the final dividend, which is paid and accounted for in the following year.
- 3 Dividends for the year in 2015 include a recommended special dividend totalling £357 million.
- 4 Dividends per ordinary share in 2015 include a recommended special dividend of 0.5 pence.  
Translated into US dollars at the Noon Buying Rate on the date each payment was made, with the exception of the  
5 final and special dividends in respect of 2015, which have been translated at the Noon Buying Rate on 26 February  
2016.
- 6 This figure excludes the limited voting ordinary shares owned by the Lloyds Bank Foundations.
- 7 Averages are calculated on a monthly basis from the consolidated financial data of Lloyds Banking Group.
- 8 Total dividend for the year divided by earnings attributable to ordinary shareholders adjusted for tax relief on  
distributions to other equity holders.
- 9 The cost:income ratio is calculated as total operating expenses as a percentage of total income (net of insurance  
claims).
- 10 Capital ratios for 2012 and earlier years were not restated to reflect the adoption of IAS 19 (Revised) in 2013.
- 11 Capital ratios for 2013 and earlier years are in accordance with modified Basel II framework as implemented by the  
PRA.
- 12 Capital ratios for 2014 are in accordance with the CRD IV rules implemented by the PRA on 1 January 2014.

## EXCHANGE RATES

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

|                                | 2016<br>January | 2015<br>December | 2015<br>November | 2015<br>October | 2015<br>September | 2015<br>August |
|--------------------------------|-----------------|------------------|------------------|-----------------|-------------------|----------------|
| US dollars per pound sterling: |                 |                  |                  |                 |                   |                |
| High                           | 1.47            | 1.52             | 1.54             | 1.55            | 1.56              | 1.57           |
| Low                            | 1.42            | 1.47             | 1.50             | 1.52            | 1.51              | 1.54           |

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

|                                | 2015 | 2014 | 2013 | 2012 | 2011 |
|--------------------------------|------|------|------|------|------|
| US dollars per pound sterling: |      |      |      |      |      |
| Average                        | 1.53 | 1.65 | 1.57 | 1.59 | 1.61 |

On 26 February 2016, the latest practicable date, the US dollar Noon Buying Rate was \$1.39 = £1.00. Lloyds Banking Group makes no representation that amounts in pounds sterling have been, could have been or could be converted into US dollars at that rate or at any of the above rates.

## BUSINESS

**HISTORY AND DEVELOPMENT OF LLOYDS BANKING GROUP**

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

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

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

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

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

Pursuant to two placing and open offers which were completed by the Company in January and June 2009 and the Rights Issue completed in December 2009, the UK Government acquired 43.4 per cent of the Company's issued ordinary share capital. As announced, at 4 December 2015 UKFI held approximately 6.6 billion shares in the Group representing a stake of approximately 9.2 per cent, following a sale of 4,282 million shares on 20 September 2013, a further sale of 5,555 million shares on 31 March 2014, the effects of a trading plan with Morgan Stanley & Co. International plc (Morgan Stanley) that was announced on 17 December 2014 and extended on both 1 June 2015 and 4 December 2015, and the effects of issues of ordinary shares. The trading plan provides Morgan Stanley with full discretion to effect a measured and orderly sell down of shares in the Group on behalf of the UK Government above a share price of 73.6 pence. The trading plan will terminate no later than 30 June 2016. The plan may be stopped earlier than 30 June 2016, for example to ensure that HMT retains sufficient shares for the proposed retail offer, which was originally expected to be launched in Spring 2016 but has been delayed following recent market volatility. The UK Government has instructed Morgan Stanley that up to but no more than 15 per cent of the aggregate total trading volume in the Group is to be sold over the duration of the trading plan. Although the UK government may have sold shares since its last notification (approximately 9.2 per cent) on 4 December 2015 its holding remains above 9 per cent.

Pursuant to its decision approving state aid to the Group, the European Commission required the Group to dispose of a retail banking business meeting minimum requirements for the number of branches, share of the UK personal current accounts market and proportion of the Group's mortgage assets. Following disposals in 2014, the Group retained an interest of approximately 50 per cent in TSB as at 31 December 2014. The Group sold its remaining interest in TSB to

Banco de Sabadell (Sabadell) in 2015, with the acquisition becoming unconditional in all respects on 30 June 2015 following the receipt of all relevant regulatory clearances.

4

## BUSINESS

### **STRATEGY OF LLOYDS BANKING GROUP**

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

The Group operates a simple, low-risk, customer focused retail and commercial banking business primarily in the UK. The Group's corporate strategy is built around being the best bank for individual and business customers across the UK and creating value by investing in areas that make a real difference to these customers.

Following the successful delivery of the Group's 2011 strategy that underpinned the Group's low cost, low risk, customer focused, UK retail and commercial banking business model, the Group outlined the next phase of its strategy in October 2014. The Group's strategy is focused upon delivering value and high quality experiences for customers alongside superior and sustainable financial performance within a prudent risk and conduct framework. This will be achieved through three strategic priorities which will be consistently applied across all divisions:

### **CREATING THE BEST CUSTOMER EXPERIENCE**

The Group's ambition is to create the best customer experience through its multi brand, multi channel approach, combining comprehensive online and mobile capabilities with face to face services. This involves transforming the Group's digital presence while sustaining extensive customer reach through a branch network focused on delivering high quality service and the right outcomes for customers.

### **BECOMING SIMPLER AND MORE EFFICIENT**

The Group is focused on creating operational capability which is simpler and more efficient than today and will become more responsive to changing customer expectations while maintaining its cost leadership amongst UK high street banks. This includes a second phase of the Simplification programme to achieve run-rate savings of £1 billion per annum by the end of 2017. In order to achieve these savings, the Group will invest around £1.6 billion over three years on initiatives to simplify processes and increase automation.

## **DELIVERING SUSTAINABLE GROWTH**

As the UK economy continues to recover, the Group will seek Group-wide growth opportunities whilst maintaining its prudent risk appetite. This will be achieved by maintaining market leadership in its retail business lines while also focusing on areas where the Group is currently under represented.

## **SUMMARY**

The Group is creating a simpler, more agile, efficient and responsive customer focused organisation which operates sustainably and responsibly and Helps Britain Prosper. The achievement of our strategy could not happen without the support of our colleagues. We are therefore committed to 'building the best team' to create a high performance organisation. The Group believes that the successful execution of the next phase of its strategy will enable delivery of superior and sustainable returns for shareholders.

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

At 31 December 2015 the Group's activities were organised into four financial reporting segments: Retail; Commercial Banking; Consumer Finance and Insurance.

Further information on the Group's segments is set out on pages 26 to 36 and in note 4 to the financial statements.

## **MATERIAL CONTRACTS**

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

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

BUSINESS

**ENVIRONMENTAL MATTERS**

The Group’s 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 the Group’s stakeholders and its own operations.

The Group recognises the global challenge posed by these wider issues, and its responsibility to reduce the environmental impacts of its business operations. The Group is committed to managing its direct environmental impacts in a responsible manner and reducing its greenhouse gas emissions. The Group does this through its Environmental Action Plan, through which it aims to maximise the opportunity to create business value and minimise business risk in relation to its direct environmental impact.

The Group’s approach towards managing its environmental impact is set out in its Environmental Statement, available on the Responsible Business section of the Group’s corporate website.

**Greenhouse gas emissions**

The Group has voluntarily reported greenhouse gas emissions and environmental performance since 2009, and since 2013 this has been in line with the requirements of the Companies Act 2006. Deloitte LLP has reviewed a selection of non-financial KPIs, indicated by providing limited assurance using the International Standard on Assurance Engagements (ISAE) 3000 (Revised). Their full, independent assurance statement is available online at [www.lloydsbankinggroup.com/RBdownloads](http://www.lloydsbankinggroup.com/RBdownloads).

**CO<sub>2</sub>e emissions (tonnes)**

|                         | Oct 2014 –<br>Sept 2015 | Oct 2013 –<br>Sept 2014 |
|-------------------------|-------------------------|-------------------------|
| Total CO <sub>2</sub> e | 398,191                 | 441,703                 |
| Total scope 1           | 57,761                  | 60,019                  |
| Total scope 2           | 241,008                 | 264,252                 |
| Total scope 3           | 99,422                  | 117,432                 |

Restated 2013/2014 emissions data to improve the accuracy of reporting, using actual data to replace estimations and the re-categorisation of the emissions from the Group’s owned vehicles.



Emissions in tonnes CO<sub>2</sub>e in line with the GHG Protocol Corporate Standard revised issue (2004). Criteria used to measure and report Scope 1, 2, 3 emissions is provided in the Lloyds Banking Group criteria statement available online at [www.lloydsbankinggroup.com/ResponsibleBusiness](http://www.lloydsbankinggroup.com/ResponsibleBusiness)

Indicator is subject to limited ISAE 3000 (Revised) assurance by Deloitte LLP for the 2015 Annual Responsible Business Reporting. Deloitte LLP's 2015 assurance statement and the 2015 Reporting Criteria are available online at [www.lloydsbankinggroup.com/RBdownloads](http://www.lloydsbankinggroup.com/RBdownloads)

## Methodology

The Group follows the principles of the Greenhouse Gas (GHG) Protocol Corporate Accounting and Reporting Standard to calculate its Scope 1, 2 and 3 emissions from its worldwide operations.

The reporting period is 1 October 2014 to 30 September 2015, which is different to that of the Group's Directors' Report (January 2015 – December 2015). 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. Reported Scope 3 emissions relate to business travel undertaken by colleagues and emissions associated with the extraction and distribution of each of the Group's energy sources – electricity, gas and oil. A detailed definition of these emissions can be found in the Group's 2015 Reporting Criteria online at [www.lloydsbankinggroup.com/RBdownloads](http://www.lloydsbankinggroup.com/RBdownloads).

## Intensity ratio

An intensity ratio of GHG gases per £m of underlying income has been selected.

|   | Oct 2014 – Oct 2013–<br>Sept 2015 | Sep 2014 |
|---|-----------------------------------|----------|
| GHG emissions per unit of underlying income | 22.3                              | 24.0     |

## Omissions

Emissions associated with joint ventures and investments are not included in this disclosure as they fall outside the scope of the Group's 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 its reporting.

## BUSINESS

### PROPERTIES

At 31 December 2015, Lloyds Banking Group occupied 2,388 properties in the UK. Of these, 696 were held as freeholds and 1,692 as leasehold. The majority of these properties are retail branches, widely distributed throughout England, Scotland, Wales and Northern Ireland. Other buildings include the Lloyds Banking Group's head office in the City of London with other customer service and support centres located to suit business needs but clustered largely in eight core geographic conurbations – London, Edinburgh, Glasgow, Midlands (Birmingham), Northwest (Chester and Manchester), West Yorkshire (Halifax and Leeds), South (Brighton and Andover) and Southwest (Bristol and Cardiff).

In addition, there are 122 properties which are either sub-let or vacant. There are also a number of ATM units situated throughout the UK, the majority of which are held as leasehold. The Group also has business operations elsewhere in the world, primarily holding property on a leasehold basis.

### LEGAL ACTIONS AND REGULATORY MATTERS

During the ordinary course of business the Group is subject to threatened or actual legal proceedings and regulatory reviews and investigations both in the UK and overseas. Set out below is a summary of the more significant matters. Further details are included in notes 39 and 49 to the financial statements.

### INTERCHANGE FEES

With respect to multi-lateral interchange fees (MIFs), the Group is not directly involved in the on-going 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, and their outcome remains uncertain. It is also possible that new claims may be issued.

On 2 November 2015, Visa Inc announced its proposed acquisition of Visa Europe, which remains subject to completion. As set out in the announcement by the Group on 2 November, the Group's share of the sale proceeds will comprise upfront consideration of cash (the amount of which remains subject to adjustment prior to completion) and preferred stock. The preferred stock will be convertible into Class A Common Stock of Visa Inc or its equivalent upon 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 how liabilities will be allocated between the parties should the litigation referred to above result in Visa Inc being liable for damages payable by Visa Europe. Visa Inc may only have recourse to the LSA once €1 billion of damages have been applied to the value of the UK preferred stock received by Visa UK members (including the Group) as part of the consideration to the transaction. The value of the preferred stock will be reduced (by making a downward adjustment to the conversion rate) in an amount equal to any covered losses. The maximum amount of liability to which the Group may be subject under the LSA is capped at the cash consideration to be received by the Group. 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.

The ultimate impact on the Group of the above investigations and the litigation against Visa and MasterCard cannot be known before the conclusion of these matters.

## **PAYMENT PROTECTION INSURANCE**

The Group increased the provision for PPI costs by a further £4,000 million in 2015, bringing the total amount provided to £16,025 million. This included an additional £2,100 million in the fourth quarter, largely to reflect the impact of our interpretation of the proposals contained within the Financial Conduct Authority's (FCA) consultation paper regarding a potential time bar and the Plevin case. As at 31 December 2015, £3,458 million or 22 per cent of the total provision, remained unutilised with £2,950 million relating to reactive complaints and associated administration costs.

The volume of reactive PPI complaints has continued to fall, with an 8 per cent reduction in 2015 compared with 2014, to approximately 8,000 complaints per week. Whilst direct customer complaint levels fell 30 per cent year-on-year, those from Claims Management Companies (CMCs) have remained broadly stable and as a result, CMCs now account for over 70 per cent of complaints.

On 26 November 2015, the FCA published a consultation paper (CP15/39: Rules and guidance on payment protection insurance complaints) proposing (i) the introduction of a deadline by which consumers would need to make their PPI complaints including an FCA led communications campaign, and (ii) rules and guidance about how firms should handle PPI complaints in light of the Supreme Court's decision in *Plevin v Paragon Personal Finance Limited* [2014] UKSC 61 (Plevin).

## Edgar Filing: Lloyds Banking Group plc - Form 20-F

Based on recent trends, and in light of the proposals from the FCA, the Group now expects a higher level of complaints than previously assumed including those related to Plevin. As a result the Group has increased the total expected reactive complaint volumes to 4.7 million with approximately 1.3 million still expected to be received. This is equivalent to approximately 10,000 net complaints per week on average through to the proposed time bar of mid-2018.

Monthly complaints trends could vary significantly throughout this period, given they are likely to be impacted by a number of factors including the potential impact of the FCA's proposed communication campaign as well as changes in the regulation of CMCs.

7

## BUSINESS

The provision includes an estimate to cover redress that would be payable under the FCA's proposed new rules and guidance in light of Plevin.

| Quarter | Average<br>monthly<br>reactive<br>complaint<br>volume | Quarter<br>on<br>quarter<br>% | Year<br>on<br>year<br>% |
|---------|---|-------------------------------|-------------------------|
| Q1 2013 | 61,259  | (28 %)                        |                         |
| Q2 2013 | 54,086  | (12 %)                        |                         |
| Q3 2013 | 49,555  | (8 %)                         |                         |
| Q4 2013 | 37,457  | (24 %)                        |                         |
| Q1 2014 | 42,259  | 13 %                          | (31 %)                  |
| Q2 2014 | 39,426  | (7 %)                         | (27 %)                  |
| Q3 2014 | 40,624  | 3 %                           | (18 %)                  |
| Q4 2014 | 35,910  | (12 %)                        | (4 %)                   |
| Q1 2015 | 37,791  | 5 %                           | (11 %)                  |
| Q2 2015 | 36,957  | (2 %)                         | (6 %)                   |
| Q3 2015 | 37,586  | 2 %                           | (7 %)                   |
| Q4 2015 | 33,998  | (10 %)                        | (5 %)                   |

The Group continues to progress the re-review of previously handled cases and expects this to be substantially complete by the end of the first quarter of 2016. During the year the scope has been extended by 0.5 million to 1.7 million cases relating largely to previously redressed cases, in addition to which, higher overturn rates and average redress have been experienced. At the end of January 2016, 77 per cent of cases had been reviewed and 77 per cent of all cash payments made.

The Group has completed its Past Business Review (PBR) where it has been identified that there was a risk of potential mis-sale for certain customers, albeit monitoring continues. No further change has been made to the amount provided.

The Group expects to maintain the PPI operation on its current scale for longer than previously anticipated given the update to volume related assumptions and the re-review of previously handled cases continuing into the first quarter of 2016. The estimate for administrative expenses, which comprise complaint handling costs and costs arising from cases subsequently referred to the FOS, is included in the provision increase outlined above.

## Sensitivities

The Group estimates that it has sold approximately 16 million policies since 2000. These include policies that were not mis-sold. Since the commencement of the PPI redress programme in 2011 the Group estimates that it has contacted, settled or provided for almost 49 per cent of the policies sold since 2000, covering both customer-initiated complaints and actual and PBR mailings undertaken by the Group.

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 materially 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 FCA media campaign and CMC and customer activity in the lead up to the proposed time bar.

Key metrics and sensitivities are highlighted in the table below:

| Sensitivities <sup>1</sup>                                       | To date unless<br>noted | Future | Sensitivity   |
|--|-------------------------|--------|---------------|
| Customer initiated complaints since origination (m) <sup>2</sup> | 3.4                     | 1.3    | 0.1 = £200m   |
| Average uphold rate per policy <sup>3</sup>                      | 76%                     | 89%    | 1% = £35m     |
| Average redress per upheld policy <sup>4</sup>                   | £1,810                  | £1,400 | £100 = £170m  |
| Administrative expenses (£m)                                     | 2,710                   | 665    | 1 case = £450 |

<sup>1</sup> All sensitivities exclude claims where no PPI policy was held.

<sup>2</sup> Sensitivity includes complaint handling costs. Future volume includes complaints falling into the Plevin rules and guidance. As a result, the sensitivity per 100,000 complaints includes cases where the average redress would be lower than historical trends.

<sup>3</sup> The percentage of complaints where the Group finds in favour of the customer excluding PBR. The 76 per cent uphold rate per policy is based on the six months to 31 December 2015. Future uphold rate and sensitivities are influenced by a proportion of complaints falling under the Plevin rules and guidance which would otherwise be defended.

<sup>4</sup> The amount that is paid in redress in relation to a policy found to have been mis-sold, comprising, where applicable, the refund of premium, compound interest charged and interest at 8 per cent per annum. Actuals are based on the six months to 31 December 2015. Future average redress is influenced by expected compensation payments for complaints falling under the Plevin rules and guidance.

## **INVESTIGATIONS AND LITIGATION RELATING TO INTERBANK OFFERED RATES, AND OTHER REFERENCE 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. 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, have been dismissed by the US Federal Court for Southern District of New York (the District Court). That court's

8

## BUSINESS

dismissal of plaintiffs' anti-trust claims has been appealed to the New York Federal Court of Appeal. The OTC and Exchange – Based plaintiffs' claims were dismissed in November 2015 for lack of personal jurisdiction against the Group.

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.

## **CUSTOMER CLAIMS IN RELATION TO INSURANCE BRANCH BUSINESS IN GERMANY**

The Group has received a number of claims from customers relating to policies issued by Clerical Medical Investment Group Limited (recently renamed Scottish Widows Limited) but sold by independent intermediaries in Germany, principally during the late 1990s and early 2000s. Following decisions in July 2012 from the Federal Court of Justice (FCJ) in Germany the Group recognised provisions totalling £520 million during the period to 31 December 2014. Recent experience has been slightly adverse to expectations and the Group has noted decisions of the FCJ in 2014 and 2015 involving German insurers in relation to a German industry-wide issue regarding notification of contractual 'cooling off' periods. Accordingly, a provision increase of £25 million has been recognised giving a total provision of £545 million. The remaining unutilised provision as at 31 December 2015 is £124 million (31 December 2014: £199 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 only be known once all relevant claims have been resolved.

## **INTEREST RATE HEDGING PRODUCTS**

In June 2012, a number of banks, including the Group, reached agreement with the FSA (now FCA) to carry out a review of sales made since 1 December 2001 of interest rate hedging products (IRHP) to certain small and medium-sized businesses. As at 31 December 2015 the Group had identified 1,735 sales of IRHPs to customers within scope of the agreement with the FCA which have opted in and are being reviewed and, where appropriate, redressed.



The Group agreed that it would provide redress to any in-scope customers where appropriate. The Group continues to review the remaining cases within the scope of the agreement with the FCA and has met all of the regulator's requirements to date.

During 2015, the Group has charged a further £40 million in respect of redress and related administration costs, increasing the total amount provided for redress and related administration costs for in-scope customers to £720 million (31 December 2014: £680 million). As at 31 December 2015, the Group has utilised £652 million (31 December 2014: £571 million), with £68 million (31 December 2014: £109 million) of the provision remaining.

## **FCA REVIEW OF COMPLAINT HANDLING**

On 5 June 2015 the FCA announced a settlement with the Group totalling £117 million following its investigation into aspects of the Group's PPI complaint handling process during the period March 2012 to May 2013. The FCA did not find that the Group acted deliberately. The Group has reviewed all customer complaints fully defended during the Relevant Period. The remediation costs of reviewing these affected cases are not materially in excess of existing provisions.

## **PROVISIONS FOR 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. During 2015, the Group charged an additional £655 million (2014: £430 million), including £225 million (2014: £nil) in response to complaints concerning packaged bank accounts and £282 million (2014: £318 million) in respect of other matters within the Retail division. In addition, the Group has charged a further £148 million (2014: £112 million) in respect of a number of product rectifications primarily in Insurance and Commercial Banking.

At 31 December 2015, provisions for other legal actions and regulatory matters of £813 million (31 December 2014: £521 million) remained unutilised, principally in relation to the sale of bancassurance products and packaged bank accounts and other Retail provisions.

## **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 fiduciary and tortious 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 2015, the end of the latest FSCS scheme year, the principal balance outstanding on these loans was £15,797 million (31 March 2014: £16,591 million). Although 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

## BUSINESS

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; 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 has indicated that it will issue a Consultation Paper in relation to industry practice in this area in February 2016. 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 FINANCIAL CONDUCT AUTHORITY'S ANNOUNCEMENT ON TIME-BARRING FOR PPI COMPLAINTS AND PLEVIN V PARAGON PERSONAL FINANCE LIMITED

On 26 November 2015 the FCA issued a Consultation Paper on the introduction of a deadline by which consumers would need to make their PPI complaints or else lose their right to have them assessed by firms or the Financial Ombudsman Service, and proposed rules and guidance concerning the handling of PPI complaints in light of the Supreme Court's decision in Plevin v Paragon Personal Finance Limited [2014] UKSC 61 (Plevin). The Financial Ombudsman Service is also considering the implications of Plevin for PPI complaints. The implications of potential time-barring and the Plevin decision in terms of the scope of any court proceedings or regulatory action remain uncertain.

## CONTINGENT LIABILITIES IN RESPECT OF 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.

10

## BUSINESS

### COMPETITIVE ENVIRONMENT

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

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

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

*See Risk Factors – Business and Economic Risks – The Group’s businesses are conducted in competitive environments, with increased competition scrutiny, and the Group’s financial performance depends upon management’s ability to respond effectively to competitive pressures.*

*See Regulation – Competition Regulation.*

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

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

## TABLE OF CONTENTS

|  |     |
|--|-----|
| <u>Overview and trend information</u>                            | 13  |
| <u>Critical accounting policies</u>                              | 14  |
| <u>Future accounting developments</u>                            | 14  |
| <u>Results of operations – 2015, 2014 and 2013</u>               | 15  |
| <u>Line of business information</u>                              | 26  |
| <u>Average balance sheet and net interest income</u>             | 37  |
| <u>Changes in net interest income – volume and rate analysis</u> | 39  |
| <u>Risk overview</u>   | 40  |
| <u>Risk management</u>   | 46  |
| <u>Risk governance</u>   | 53  |
| <u>Credit risk</u>   | 56  |
| <u>Loan portfolio</u>  | 80  |
| <u>Risk elements in the loan portfolio</u>                       | 89  |
| <u>Conduct risk</u>  | 93  |
| <u>Market risk</u>   | 94  |
| <u>Operational risk</u>  | 101 |
| <u>Funding and liquidity risk</u>                                | 103 |
| <u>Capital risk</u>  | 111 |
| <u>Regulatory and legal risk</u>                                 | 117 |
| <u>Insurance risk</u>  | 117 |
| <u>People risk</u>   | 118 |
| <u>Financial reporting risk</u>                                  | 119 |
| <u>Governance risk</u>   | 120 |

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OVERVIEW AND TREND INFORMATION**

**GIVEN THE GROUP'S UK FOCUS, ITS FINANCIAL PERFORMANCE IS INEXTRICABLY LINKED TO THE PERFORMANCE OF THE UK ECONOMY AND ITS REGULATORY AND COMPETITIVE ENVIRONMENT**

**UK ECONOMIC TRENDS**

**RESILIENCE IN THE FACE OF A FRAGILE GLOBAL ECONOMY**

Initial estimates indicate that the UK economy grew by 2.2 per cent in 2015, close to its 25-year average, at a time when global growth slowed. UK economic growth was the second strongest of the G7 countries, only marginally behind the US. Eurozone growth improved during 2015, back to its 25-year average, but at 1.5 per cent it remains significantly slower than the UK.

Leadership of global growth is shifting back to developed economies as they emerge from a period of private sector debt reduction, government cuts and tax increases. The slowdown in emerging markets as their credit cycle turns is pushing inflation down across the world as their currencies and commodity prices fall. UK inflation has hovered close to zero throughout 2015, and as a result, consumers' inflation-adjusted incomes have increased, ending a seven year period in which they had been broadly flat. That has boosted consumer spending growth to an eight year high in 2015, and helped push unemployment down to pre-crisis levels.

Low inflation and risks from the slowdown in emerging markets are complicating central banks' setting of interest rates. The US increased rates in December 2015 for the first time since 2006, much later than had been expected at the start of the year. And the UK hasn't yet raised rates, contrary to consensus expectations at the start of 2015 of two increases during that year. Low interest rates, along with limited supply, have boosted property prices with UK house prices up 10 per cent during 2015, surpassing their 2007 peak, and commercial property prices up 7.8 per cent.

**MARKET GROWTH**

Growth in the markets in which the Group operates has improved but in aggregate remains much weaker than pre-crisis. Mortgage volumes for house purchases rose 4.7 per cent to a post-crisis high, and their value rose by 10.7 per cent, pushing growth in balances up from 1.6 per cent in 2014 to 2.6 per cent in 2015, its strongest since 2008. Growth in consumer unsecured borrowing balances rose from 4.1 per cent in 2014 to 6.0 per cent in 2015, the strongest since 2005. Small and medium-sized companies (SMEs) have started to increase borrowing from banks again in 2015 for the first time since 2008, while companies' deposits continued to

grow rapidly, up 11.5 per cent in 2015 after an average of 9.3 per cent across 2013-14. Consumer deposits growth fell back slightly from 4.3 per cent in 2014 to 3.8 per cent in 2015, but this was mainly due to the government's launch of pensioner bonds.

## **MARGIN PRESSURE**

Competition and the delay in Bank Rate increases are keeping banks' margins under pressure. The spread between average lending and deposit rates has held fairly flat in 2015 close to its pre-crisis level, having improved from the very low level of 2011-12 when wholesale funding costs were exceptionally high. Lending rates have fallen to a record low in 2015, and whilst deposit rates have fallen during the year they are still higher than short term financial-market rates, opposite to pre-crisis. Mortgage pricing has been particularly aggressive in 2015, with spreads on new loans over market funding costs falling around 50 basis points through the year.

## **LOW LEVEL IMPAIRMENT**

Improving indebtedness, along with the continued low interest rate environment, is continuing to reduce impairments which are below expected through-the-cycle levels. The share of highly indebted consumers has fallen further in 2015, and consumers' concerns over their level of debt and mortgage payments are back to pre-crisis lows. Personal and corporate insolvency rates are low, both around half their 2009-10 peaks. Rising property prices have also sharply reduced potential losses from defaults on property lending.

## **OUTLOOK FOR 2016**

Despite challenges from slowing emerging markets and rising US interest rates, the most likely outlook for the UK in 2016 is another year similar to 2015. Consensus expectations are for gdp growth of 2.2 per cent, CPI inflation rising to 1.1 per cent by the end of the year, house prices up 5 per cent, and another year without a rise in Bank Rate. As the recovery matures, borrowing is rising and domestic consumption will be the primary driver of economic growth. Lending has been subdued for five years and corporate and household balance sheets have strengthened, so that credit has room to grow without threatening macroeconomic stability. Low inflation will keep real household incomes growing, sustaining economic growth despite headwinds from the elevated level of sterling, weak manufacturing activity, tightening benefit payments and uncertainty over the future of the UK's membership of the EU.



There are, however, risks to those expectations, stemming from the deflationary impact of the slowdown in emerging markets, the associated recent volatility in financial markets that might weaken consumer and business confidence; and the referendum on UK membership of the EU which, if the vote is to leave, may create a period of uncertainty and impact companies' investment plans. Crystallisation of any of these risks could impact the UK economy, which in turn would have a negative impact on the Group's income, funding costs and impairment charges.

## **GROWTH IN THE GROUP'S MARKETS**

(yearly % change in UK market balances)

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CRITICAL ACCOUNTING POLICIES**

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

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

**FUTURE ACCOUNTING DEVELOPMENTS**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## RESULTS OF OPERATIONS – 2015, 2014 AND 2013

## SUMMARY

|  | 2015     | 2014     | 2013     |
|--|----------|----------|----------|
|  | £m       | £m       | £m       |
| Net interest income                                      | 11,318   | 10,660   | 7,338    |
| Other income   | 11,832   | 19,232   | 30,647   |
| Total income   | 23,150   | 29,892   | 37,985   |
| Insurance claims   | (5,729 ) | (13,493) | (19,507) |
| Total income, net of insurance claims                    | 17,421   | 16,399   | 18,478   |
| Operating expenses                                       | (15,387) | (13,885) | (15,322) |
| Trading surplus  | 2,034    | 2,514    | 3,156    |
| Impairment   | (390 )   | (752 )   | (2,741 ) |
| Profit before tax  | 1,644    | 1,762    | 415      |
| Taxation   | (688 )   | (263 )   | (1,217 ) |
| Profit (loss) for the year                               | 956      | 1,499    | (802 )   |
| Profit (loss) attributable to ordinary shareholders      | 466      | 1,125    | (838 )   |
| Profit attributable to other equity holders <sup>1</sup> | 394      | 287      | –        |
| Profit (loss) attributable to equity holders             | 860      | 1,412    | (838 )   |
| Profit attributable to non-controlling interests         | 96       | 87       | 36       |
| Profit (loss) for the year                               | 956      | 1,499    | (802 )   |

<sup>1</sup> The profit after tax attributable to other equity holders of £394 million (2014: £287 million; 2013: £nil) is partly offset in reserves by a tax credit attributable to ordinary shareholders of £80 million (2014: £62 million; 2013: £nil).

## 2015 COMPARED WITH 2014

During the year ended 31 December 2015, the Group recorded a profit before tax of £1,644 million compared with a profit before tax in 2014 of £1,762 million. The result in 2015 included provisions in respect of redress to customers relating to both past sales of Payment Protection Insurance and other matters of £4,837 million compared to a charge of £3,125 million in the year ended 31 December 2014; 2014 also included a past service pension credit of £822 million and a loss of £1,362 million in relation to the exchange and repurchase of Enhanced Capital Notes, neither of which were repeated in 2015. Excluding these items from both years, profit before tax was £1,054 million, or 19 per cent, higher at £6,481 million in the year ended 31 December 2015 compared to £5,427 million in the previous year, reflecting a significant reduction in expenditure in relation to the Group's Simplification programme and lower impairment charges.

The comparison of results for 2015 to 2014 is also impacted by the sale of TSB Banking Group plc (TSB), which ceased to be consolidated in March 2015, with the sale of the Group's remaining holding becoming unconditional on

30 June 2015. The Group recognised a net loss of £660 million in 2015, relating to both the disposal of its shareholding and commitments under agreements entered into with TSB (see also note 55 on page F-104).

Total income decreased by £6,742 million, or 23 per cent, to £23,150 million in 2015 compared with £29,892 million in 2014, comprising a £7,400 million decrease in other income partly offset by an increase in net interest income.

Net interest income was £11,318 million in 2015; an increase of £658 million, or 6 per cent compared to £10,660 million in 2014. There was a positive impact of £358 million in 2015 from a decrease in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group, particularly in relation to fixed income securities; the change in population of consolidated OEICs in 2015 compared to 2014 caused an increase of £27 million in this interest expense. After adjusting for this, net interest income was £300 million, or 3 per cent, higher at £11,562 million in 2015 compared to £11,262 million in 2014 reflecting an improvement in margin in the Group's banking operations, driven by a combination of lower deposit and wholesale funding costs, partly offset by continued pressure on asset prices. Average interest-earning assets fell as a result of the sale of TSB and the continued run down of the portfolio of assets which are outside of the Group's risk appetite.

Other income was £7,400 million, or 38 per cent, lower at £11,832 million in 2015 compared to £19,232 million in 2014. Fee and commission income was £407 million, or 11 per cent, lower at £3,252 million compared to £3,659 million in 2014. Fee and commission expense increased by £40 million, or 3 per cent, to £1,442 million compared with £1,402 million in 2014. The decrease in net fee and commission income largely reflects the disposals of TSB and Scottish Widows Investment Partnership. Net trading income decreased by £6,445 million, or 63 per cent, to £3,714 million in 2015 compared to £10,159 million in 2014; this decrease reflected a reduction of £6,146 million in gains on policyholder investments held within the insurance business as a result of market conditions over 2015 relative to those in 2014. The reduction in trading income within the insurance business was coupled with a small decrease of £266 million in the Group's other operations. Insurance premium income was £2,333 million, or 33 per cent, lower at £4,792 million in 2015 compared with £7,125 million in 2014; there was a decrease of £2,334 million in life insurance premiums and a £1 million increase in general insurance premiums. Premium income in 2015 has been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group; excluding this item life insurance premium income was £375 million, or 6 per cent, lower at £5,880 million in 2015 compared to £6,255 million in 2014. Other operating income was £1,825 million higher at £1,516 million in 2015 compared to a deficit of £309 million in 2014. Other operating income includes the results of liability management from which the Group incurred a loss of £28 million in 2015 compared to a loss of £1,386 million in 2014, which was principally in relation to exchange and repurchase transactions in respect of the Group's Enhanced Capital Notes. Excluding the impact of liability management activities, other operating income was £467 million, or 43 per cent, higher at £1,544 million in 2015 compared to £1,077 million in 2014; in part reflecting a reduction in the losses arising from the movement in the value of in-force insurance business.

Insurance claims expense was £7,764 million, or 58 per cent, lower at £5,729 million in 2015 compared to £13,493 million in 2014. The insurance claims expense in respect of life and pensions business was £7,804 million, or 59 per cent, lower at £5,359 million in 2015 compared to £13,163 million in 2014;

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

this decrease was matched by a similar decline in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £40 million or 12 per cent, higher at £370 million in 2015 compared to £330 million in 2014.

Operating expenses increased by £1,502 million, or 11 per cent to £15,387 million in 2015 compared with £13,885 million in 2014; the main reasons for the increase being the £1,712 million increase in charges for redress payments to customers in respect of PPI and other conduct related matters from £3,125 million in 2014 to £4,837 million in 2015, a charge of £665 million in 2015 in relation to the disposal of TSB and a net past service pension credit of £822 million in 2014 which was not repeated in 2015. Excluding these items from both years, operating expenses were £1,697 million, or 15 per cent, lower at £9,885 million in 2015 compared to £11,582 million in 2014. On this basis staff costs were £890 million, or 16 per cent, lower at £4,677 million in 2015 compared with £5,567 million in 2014; annual pay rises being more than offset by the impact of headcount reductions resulting from business disposals and the Group's rationalisation programmes and a reduction in severance costs as this phase of the Simplification programme draws to a close. Premises and equipment costs were £176 million or 20 per cent, lower at £715 million in 2015 compared with £891 million in 2014. Other expenses, excluding the charges in respect of customer redress provisions and the charge relating to the TSB disposal, were £808 million, or 25 per cent, lower at £2,381 million in 2015 compared with £3,189 million in 2014 as a result of lower levels of technology spend, advertising and professional fees, in particular relating to Simplification and the costs of TSB separation in 2014. Depreciation and amortisation costs were £177 million, or 9 per cent, higher at £2,112 million in 2015 compared to £1,935 million in 2014.

Impairment losses decreased by £362 million, or 48 per cent, to £390 million in 2015 compared with £752 million in 2014. Impairment losses in respect of loans and advances to customers were £292 million, or 40 per cent, lower at £443 million in 2015 compared with £735 million in 2014. The overall performance of the portfolio reflects a significant reduction in lending which is outside of the Group's risk appetite and improvements in all divisions. The net charge has also benefited from significant provision releases but at lower levels than seen in 2014. There was a credit of £55 million in respect of undrawn commitments in 2015, compared to a charge of £10 million in 2014, a result of improvements in credit quality in a number of corporate relationships.

In 2015, the Group recorded a tax charge of £688 million compared to a tax charge of £263 million in 2014, an effective tax rate of 42 per cent, which was higher than the standard UK corporation tax rate of 20.25 per cent; principally as a result of the disallowance of a substantial proportion of the Group's charge in respect of PPI and other conduct risk issues. The tax charge of £263 million in 2014 arose on a profit before tax of £1,762 million; this tax charge reflected tax exempt gains on the sale of businesses.

On the balance sheet, total assets were £48,208 million, or 6 per cent, lower at £806,688 million at 31 December 2015 compared to £854,896 million at 31 December 2014, largely due to the disposal of TSB. Loans and advances to customers were £27,529 million, or 6 per cent, lower at £455,175 million at 31 December 2015 compared to £482,704 million at 31 December 2014, with £21,643 million of the reduction being due to the sale of TSB, the continued

reduction in the portfolio of assets which are outside of the Group's risk appetite and a £5,148 million reduction in reverse repurchase agreement balances have more than offset growth in the UK consumer finance business. An increase of £7,925 million in cash and balances at central banks has been more than offset by an £11,395 million reduction in trading and other financial assets at fair value through profit or loss and a £6,661 million reduction in derivative assets. Total liabilities were £45,285 million, or 6 per cent, lower at £759,708 million at 31 December 2015 compared to £804,993 million at 31 December 2014, again largely due to the sale of TSB. Customer deposits were £28,741 million, or 6 per cent, lower at £418,326 million at 31 December 2015 compared to £447,067 million at 31 December 2014 with £24,625 million of the reduction being due to the sale of TSB. Decreases of £10,239 million in trading and other financial liabilities at fair value through profit or loss and £11,095 million in insurance and investment contract liabilities have been partly offset by increases of £6,038 million in deposits by banks and £5,823 million in debt securities in issue as the Group took advantage of favourable funding opportunities. Total equity was £2,923 million, or 6 per cent, lower at £46,980 million at 31 December 2015 compared to £49,903 million at 31 December 2014; this reflected the fact that retained profit for the year has been more than offset by negative reserve movements in respect of available-for-sale revaluation and cash flow hedging reserves, dividends paid and the adjustment to non-controlling interests on the deconsolidation of TSB.

The Group has maintained its capital position, with a common equity tier 1 (CET1) ratio of 12.8 per cent, (31 December 2014: 12.8 per cent) as the impact of the lower capital base (as a result of reduced levels of equity) has been offset by a reduction in risk-weighted assets.

Risk-weighted assets reduced by £16,986 million, or 7 per cent, to £222,747 million, at 31 December 2015 compared to £239,734 million at 31 December 2014, primarily driven by the sale of TSB, reductions in the portfolio of assets which are outside of the Group's risk appetite and continued improvements in credit quality offset by targeted lending growth.

The Group's liquidity position remains good, with liquidity coverage ratio (LCR) eligible assets of £123 billion. LCR eligible assets represent almost 5.7 times the Group's money-market funding with a maturity of less than one year and were in excess of total wholesale funding at 31 December 2015 thus providing a buffer in the event of market dislocation. The Group's LCR ratio already exceeds regulatory requirements and is greater than 100 per cent.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**2014 COMPARED WITH 2013**

During the year ended 31 December 2014, the Group recorded a profit before tax of £1,762 million compared with a profit before tax in 2013 of £415 million. The result in 2014 included provisions in respect of redress to customers relating to past sales of Payment Protection Insurance and other issues of £3,125 million compared to a charge of £3,455 million in the year ended 31 December 2013; and 2014 also includes a past service pension credit of £822 million, compared to a charge of £104 million in 2013. Excluding these items from both years, profit before tax was £91 million, or 2 per cent, higher at £4,065 million in the year ended 31 December 2014 compared to £3,974 million in the previous year.

Total income decreased by £8,093 million, or 21 per cent, to £29,892 million in 2014 compared with £37,985 million in 2013, comprising an £11,415 million decrease in other income partly offset by an increase of £3,322 million in net interest income.

Net interest income was £10,660 million in 2014; an increase of £3,322 million, or 45 per cent compared to £7,338 million in 2013. There was a positive impact of £2,489 million in 2014 from a decrease in the amounts payable to unit holders in those Open-Ended Investment Companies (OEICs) included in the consolidated results of the Group. After adjusting for this, net interest income was £833 million, or 8 per cent, higher at £11,262 million in 2014 compared to £10,429 million in 2013 reflecting the continued improvement in margins and loan growth in targeted customer segments, partly offset by the effect of disposals and the reduced portfolio of assets which are outside of the Group's risk appetite. The net interest margin benefited from improved deposit pricing and lower funding costs, partly offset by continued pressure on asset prices.

Other income was £11,415 million, or 37 per cent, lower at £19,232 million in 2014 compared to £30,647 million in 2013. Fee and commission income was £460 million, or 11 per cent, lower at £3,659 million compared to £4,119 million in 2013. Fee and commission expense increased by £17 million, or 1 per cent, to £1,402 million compared with £1,385 million in 2013. The decrease in net fee and commission income largely reflects the impact of business disposals. Net trading income decreased by £6,308 million, or 38 per cent, to £10,159 million in 2014 compared to £16,467 million in 2013; this decrease reflected a reduction of £7,384 million in gains on policyholder investments held within the insurance business as a result of movements in financial markets. The reduction in trading income within the insurance business was partly offset by an increase of £1,076 million in the Group's other operations, principally because of an improvement of £610 million in valuation gains on the equity conversion feature embedded in the Group's Enhanced Capital Notes. Insurance premium income was £1,072 million, or 13 per cent, lower at £7,125 million in 2014 compared with £8,197 million in 2013; there was a decrease of £945 million in life insurance premiums and a £127 million decrease in general insurance premiums. Other operating income was £3,558 million lower at a deficit of £309 million in 2014 compared to £3,249 million in 2013. Other operating income includes gains and losses on disposal of available-for-sale financial assets which were £498 million, or 79 per cent, lower at £131 million in 2014 compared to £629 million in 2013 following the completion of the repositioning of the Group's government bond portfolio. Other operating income also includes gains and losses on liability management

from which the Group incurred a loss of £1,362 million in 2014 in relation to exchange and repurchase transactions in respect of its Enhanced Capital Notes. Excluding gains and losses on sale of available-for-sale financial assets and the impact of liability management activities, other operating income was £1,816 million lower at £946 million in 2014 compared to £2,762 million in 2013; income in 2013 included the gains of £540 million from the sales of shares in St James's Place and £538 million following the sale of the Group's portfolio of US Residential Mortgage-Backed Securities.

Insurance claims expense was £6,014 million, or 31 per cent, lower at £13,493 million in 2014 compared to £19,507 million in 2013. The insurance claims expense in respect of life and pensions business was £5,988 million, or 31 per cent, lower at £13,163 million in 2014 compared to £19,151 million in 2013; this decrease in claims was matched by a similar decline in net trading income, reflecting the relative performance of policyholder investments. Insurance claims in respect of general insurance business were £26 million, or 7 per cent, lower at £330 million in 2014 compared to £356 million in 2013.

Operating expenses decreased by £1,437 million, or 9 per cent to £13,885 million in 2014 compared with £15,322 million in 2013; the main reasons for the decrease being the £330 million reduction in charges for regulatory provisions from £3,455 million in 2013 to £3,125 million in 2014 and, a net past service pension credit of £822 million compared to a charge of £104 million in 2013. Excluding these items from both years, operating expenses were £181 million, or 2 per cent, lower at £11,582 million in 2014 compared to £11,763 million in 2013. On this basis staff costs were £170 million, or 3 per cent, lower at £5,567 million in 2014 compared with £5,737 million in 2013; annual pay rises being more than offset by the impact of headcount reductions resulting from business disposals and the Group's rationalisation programmes. Premises and equipment costs were £79 million, or 8 per cent, lower at £891 million in 2014 compared with £970 million in 2013. Other expenses excluding the charges in respect of payment protection insurance and other regulatory provisions were £73 million, or 2 per cent, higher at £3,189 million in 2014 compared with £3,116 million in 2013. Depreciation and amortisation costs were £5 million lower at £1,935 million in 2014 compared to £1,940 million in 2013.

Impairment losses decreased by £1,989 million, or 73 per cent, to £752 million in 2014 compared with £2,741 million in 2013. Impairment losses in respect of loans and advances to customers were £1,990 million, or 73 per cent, lower at £735 million in 2014 compared with £2,725 million in 2013. The overall performance of the portfolio reflects a significant reduction in lending which is outside of the Group's risk appetite and improvements in all divisions. The improvements reflect lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment. The net charge has also benefited from significant provision releases but at lower levels than seen in 2013. The impairment charge in respect of debt securities classified as loans and receivables was a charge of £2 million in 2014 compared to a charge of £1 million in 2013 and the impairment charge in respect of available-for-sale financial assets was £10 million lower at £5 million in 2014 compared to £15 million in 2013.

In 2014, the Group recorded a tax charge of £263 million compared to a tax charge of £1,217 million in 2013. The tax charge in 2014 was £116 million lower than the charge that would arise at the standard UK corporation tax rate of 21.5 per cent; principally as a result of a tax exempt gains on sales of businesses and a lower deferred tax liability in respect of the value of in-force assets for the life business partially offset by the effect of non-deductible expenses. The tax charge of £1,217 million in 2013 arose on a profit before tax of £415 million; this tax charge reflected a



£594 million charge arising from the reduction in the corporation tax rate, a £348 million write-off of deferred tax assets following the sale of the Group's Australian operations and a £251 million policyholder tax charge.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

On the balance sheet, total assets were £12,516 million, or 1 per cent, higher at £854,896 million at 31 December 2014 compared to £842,380 million at 31 December 2013. Loans and advances to customers were £10,248 million, or 2 per cent, lower at £482,704 million at 31 December 2014 compared to £492,952 million at 31 December 2013 as the impact of focused growth in mortgages, unsecured personal lending and the small to medium-sized businesses sector has been more than offset by the continuing reduction in the portfolio of assets which are outside of the Group's credit risk appetite, including the disposal of tranches of lending in Ireland. Available-for-sale financial assets were £12,517 million, or 28 per cent, higher at £56,493 million at 31 December 2014 compared to £43,976 million at 31 December 2013 as the Group continues to build up its holding of high quality government and other securities for liquidity purposes. Trading assets were £11,144 million higher at £48,494 million as a result of an increase in reverse repo activity. Deposits by banks were £3,095 million, or 22 per cent, lower at £10,887 million at 31 December 2014 compared to £13,982 million at 31 December 2013 and debt securities in issue were £10,869 million, or 12 per cent, lower at £76,233 million at 31 December 2014 compared to £87,102 million at 31 December 2013 as the Group reduced its reliance on wholesale funding; however, customer deposits was £7,600 million, or 2 per cent, higher at £447,067 million at 31 December 2014 compared to £439,467 million at 31 December 2013 following growth in relationship deposits. Total equity was £10,567 million, or 27 per cent, higher at £49,903 million at 31 December 2014 compared to £39,336 million at 31 December 2013; this reflected the issue of £5,355 million of other equity instruments, retained profit and positive movements in cash flow hedging and available-for-sale reserves.

The Group continued to strengthen its capital position, with a common equity tier 1 (CET1) ratio of 12.8 per cent, driven by a combination of retained profit, further dividends from the Insurance business, changes to and improved valuations of the Group's defined benefit pension arrangements, and a reduction in risk-weighted assets. The positive effect of these items was partly offset by the impact of the recommended dividend of 0.75 pence per share.

Risk-weighted assets reduced in the year, to £239,734 million, primarily due to asset reductions in the portfolio of assets which are outside of the Group's risk appetite, active portfolio management in Commercial Banking and improvements in economic conditions.

The Group's liquidity position remained strong, with primary liquid assets of £109.3 billion (31 December 2013: £89.3 billion). Primary liquid assets represented almost six times the Group's money-market funding with a maturity of less than one year, and just under three times the Group's total short-term wholesale funding, in turn providing a substantial buffer in the event of market dislocation. In addition to primary liquid assets, the Group had significant secondary liquidity holdings of £99.2 billion (31 December 2013: £105.4 billion). Total liquid assets represented approximately five times the Group's short-term wholesale funding with primary liquid assets broadly equivalent to total wholesale funding.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**NET INTEREST INCOME**

|   | 2015    | 2014    | 2013    |
|---|---------|---------|---------|
| Net interest income £m                                | 11,318  | 10,660  | 7,338   |
| Average interest-earning assets £m                    | 614,917 | 634,910 | 661,793 |
| Average rates:  |         |         |         |
| Gross yield on interest-earning assets % <sup>1</sup> | 2.86    | 3.03    | 3.20    |
| Interest spread % <sup>2</sup>                        | 1.67    | 1.52    | 0.88    |
| Net interest margin % <sup>3</sup>                    | 1.84    | 1.68    | 1.11    |

<sup>1</sup> Gross yield is the rate of interest earned on average interest-earning assets.

<sup>2</sup> Interest spread is the difference between the rate of interest earned on average interest-earning assets and the rate of interest paid on average interest-bearing liabilities.

<sup>3</sup> The net interest margin represents the interest spread together with the contribution of interest-free liabilities. It is calculated by expressing net interest income as a percentage of average interest-earning assets.

**2015 COMPARED WITH 2014**

Net interest income was £11,318 million in 2015 an increase of £658 million, or 6 per cent, compared to £10,660 million in 2014. Net interest income in 2015 includes a charge of £244 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2014 of £602 million; the change in population of consolidated OEICs in 2015 compared to 2014 caused an increase of £27 million in this interest expense. After adjusting for this, net interest income was £300 million, or 3 per cent, higher at £11,562 million in 2015 compared to £11,262 million in 2014.

Average interest-earning assets were £19,993 million, or 3 per cent, lower at £614,917 million in 2015 compared to £634,910 million in 2014. The reduction reflected the sale of TSB (leading to a year-on-year reduction of £17,309 million) and the continuing run-off of assets which are outside of the Group's risk appetite.

Average interest-earning assets in Retail were £1,766 million lower at £315,801 million in 2015 compared to £317,567 million in 2014 and average interest-earning assets in Commercial Banking were £3,854 million lower at £89,299 million in 2015 compared to £93,153 million in 2014. Average interest-earning assets across the rest of the

Group were £14,373 million, or 6 per cent, lower at £209,817 million in 2015 compared to £224,190 million in 2014. The main driver for this reduction being the decrease of £17,309 million resulting from the sale of TSB and in the portfolio of assets which are outside of the Group's risk appetite, partly offset by growth in Consumer Finance and in non-relationship balances.

The net interest margin was 16 basis points higher at 1.84 per cent in 2015 compared to 1.68 per cent in 2014, however adjusting net interest income for the amounts allocated to unitholders in Open-Ended Investment Companies, the net interest margin was 11 basis points higher at 1.88 per cent in 2015 compared to 1.77 per cent in 2014. Margins in Retail increased, driven by improved deposit margin and mix, more than offsetting reduced lending rates; however margins in Consumer Finance were down due to the acquisition of lower risk but lower margin new business and the impact of the planned reduction in deposits in line with Group's funding strategy. Margins on relationship lending and similar interest-earning assets in Commercial Banking increased due to disciplined pricing on new lending and deposits, with a reduction in wholesale funding costs led by continued progress in attracting high quality deposits.

### **2014 COMPARED WITH 2013**

Net interest income was £10,660 million in 2014 an increase of £3,322 million, or 45 per cent, compared to £7,338 million in 2013. Net interest income in 2014 includes a charge of £602 million in respect of amounts payable to unitholders in consolidated Open-Ended Investment Companies compared to a charge in 2013 of £3,091 million. After adjusting for this, net interest income was £833 million, or 8 per cent, higher at £11,262 million in 2014 compared to £10,429 million in 2013.

Average interest-earning assets were £26,883 million, or 4 per cent, lower at £634,910 million in 2014 compared to £661,793 million in 2013. The reduction reflected the continuing run-off of assets which were outside of the Group's risk appetite, including business disposals, more than offsetting the impact of focused new lending.

Average interest-earning assets in Retail were £1,371 million higher at £317,567 million in 2014 compared to £316,196 million in 2013 and average interest-earning assets in Commercial Banking were £207 million lower at £93,153 million in 2014 compared to £93,360 million in 2013. Average interest-earning assets across the rest of the Group were £28,047 million, or 11 per cent lower at £224,190 million in 2014 compared to £252,237 million in 2013. The main driver for this reduction was the continuing run-down of the portfolio of assets which are outside of the Group's risk appetite, average interest-earning assets in respect of which were £27,711 million at 48 per cent lower at £29,921 million in 2014 compared to £57,632 million in 2013.

The net interest margin was 57 basis points higher at 1.68 per cent in 2014 compared to 1.11 per cent in 2013, however adjusting net interest income for the amounts paid to unitholders in Open-Ended Investment Companies, the net interest margin was 19 basis points higher at 1.77 per cent in 2014 compared to 1.58 per cent in 2013. Margins in Retail improved, driven by further improvements in deposit mix, more than offsetting reduced lending rates however margins in Consumer Finance fell as a result of business growth being focused on higher quality, but lower margin,

lending on the new vehicle market and credit card balances, more than offsetting favourable deposit repricing. Margins on relationship lending and similar interest-earning assets in Commercial Banking improved as a result of disciplined pricing of new lending, deposit repricing and a reduction in funding costs.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER INCOME**

|  | 2015     | 2014     | 2013     |
|--|----------|----------|----------|
|  | £m       | £m       | £m       |
| Fee and commission income:                           |          |          |          |
| Current account fees                                 | 804      | 918      | 973      |
| Credit and debit card fees                           | 918      | 1,050    | 984      |
| Other  | 1,530    | 1,691    | 2,162    |
|  | 3,252    | 3,659    | 4,119    |
| Fee and commission expense                           | (1,442 ) | (1,402 ) | (1,385 ) |
| Net fee and commission income                        | 1,810    | 2,257    | 2,734    |
| Net trading income                                   | 3,714    | 10,159   | 16,467   |
| Insurance premium income                             | 4,792    | 7,125    | 8,197    |
| Gains on sale of available-for-sale financial assets | 51       | 131      | 629      |
| Liability management                                 | (28 )    | (1,386 ) | (142 )   |
| Other  | 1,493    | 946      | 2,762    |
| Other operating income                               | 1,516    | (309 )   | 3,249    |
| Total other income                                   | 11,832   | 19,232   | 30,647   |

**2015 COMPARED WITH 2014**

Other income was £7,400 million, or 38 per cent, lower at £11,832 million in 2015 compared to £19,232 million in 2014.

Fee and commission income was £407 million, or 11 per cent, lower at £3,252 million in 2015 compared with £3,659 million in 2014. Current account fees were £114 million, or 12 per cent, lower at £804 million in 2015 compared to £918 million in 2014, with £75 million of the reduction being a result of the sale of TSB. A decrease of £132 million, or 13 per cent, in credit and debit card fees from £1,050 million in 2014 to £918 million in 2015 resulted from the sale of TSB (£51 million of the decrease) and reduced interchange income due to changes in regulation. Other fees and commissions receivable were £161 million, or 10 per cent lower at £1,530 million in 2015 compared with £1,691 million in 2014; again partly reflecting the sale of TSB and also Scottish Widows Investment Partnership in 2014.

Fee and commission expense was £40 million, or 3 per cent, higher at £1,442 million in 2015 compared to £1,402 million in 2014; despite a £63 million decrease as a result of the sale of TSB and Scottish Widows Investment Partnership; the underlying increase reflects increased levels of fees payable in respect of transactions in Commercial Banking and for asset management services in Insurance.

Net trading income was £6,445 million, or 63 per cent, lower at £3,714 million in 2015 compared with £10,159 million in 2014. Net trading income within the insurance businesses was £6,146 million, or 69 per cent, lower at £2,774 million in 2015 compared to £8,920 million in 2014, which reflects lower levels of returns on policyholder investments as a result of market conditions over 2015 relative in those in 2014. However this decrease, along with the decrease in long-term insurance premium income, was largely offset by the decrease in insurance claims expense and the £358 million decrease in the amounts payable to unit holders in those Open-Ended Investment Companies consolidated into the Group's results within net interest income. Net trading income within the Group's banking activities was £299 million, or 24 per cent, lower at £940 million in 2015 compared to £1,239 million in 2014; in particular this decrease reflected a charge of £101 million for the movement in fair value of the equity conversion feature of the Group's Enhanced Capital Notes, compared to a gain of £401 million in the year ended 31 December 2014.

Insurance premium income was £4,792 million in 2015 compared with £7,125 million in 2014; a decrease of £2,333 million, or 33 per cent. Premium income in 2015 has been reduced by a charge of £1,959 million relating to the recapture by a third party insurer of a portfolio of policies previously reassured with the Group. Excluding this item earned premiums in respect of the Group's long-term life and pensions business were £375 million, or 6 per cent, lower at £5,880 million in 2015 compared to £6,255 million in 2014 with the impact of regulatory and market change more than offsetting income from the new bulk annuities business. General insurance earned premiums were little changed, just £1 million higher at £871 million in 2015 compared with £870 million in 2014 reflecting competitive market conditions and the run-off of products closed to new customers.

Other operating income was £1,825 million higher at £1,516 million in 2015 compared to a deficit of £309 million in 2014. In April 2014, the Group had completed exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities and a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash; a loss of £1,362 million was recognised in relation to these exchange and tender transactions in the year ended 31 December 2014. Excluding this item, other operating income was £463 million, or 44 per cent, higher at £1,516 million in 2015 compared to £1,053 million in 2014; this reflected a £266 million improvement in the movement in value of in-force insurance business and a £39 million increase in operating lease rental income.

## **2014 COMPARED WITH 2013**

Other income was £11,415 million, or 37 per cent, lower at £19,232 million in 2014 compared to £30,647 million in 2013.

Fee and commission income was £460 million, or 11 per cent, lower at £3,659 million in 2014 compared with £4,119 million in 2013. Current account fees were £55 million, or 6 per cent, lower at £918 million in 2014 compared to £973 million in 2013. An increase of £66 million, or 7 per cent, in credit and debit card fees from £984 million in 2013 to £1,050 million in 2014 resulted from increased customer activity and merchanting charges. Other fees and commissions receivable were £471 million, or 22 per cent lower at £1,691 million in 2014 compared with £2,162 million in 2013; this reduction principally reflects the disposal of St James's Place plc in March 2013 and the

sale of Scottish Widows Investment Partnership during the first half of 2014.

Fee and commission expense was £17 million, or 1 per cent, higher at £1,402 million in 2014 compared to £1,385 million in 2013.

Net trading income was £6,308 million, or 38 per cent, lower at £10,159 million in 2014 compared with £16,467 million in 2013. Net trading income within the insurance businesses was £7,384 million, or 45 per cent, lower at £8,920 million in 2014 compared to £16,304 million in 2013, which reflects relatively lower returns on policyholder investments. However this decrease, along with the decrease in long-term insurance premium income, was largely offset



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

by the decrease in insurance claims expense and the £2,489 million decrease in the amounts payable to unit holders in those Open-Ended Investment Companies consolidated into the Group's results within net interest income. Net trading income within the Group's banking activities was £1,076 million higher at £1,239 million in 2014 compared to £163 million in 2013. The principal reason for this was a £610 million improvement in the mark-to-market movement in the embedded derivative related to the Group's Enhanced Capital Notes from a loss of £209 million in 2013 to a gain of £401 million in 2014; there was also an improvement in gains recognised on interest rate derivatives and foreign exchange contracts in the banking book not mitigated through hedge accounting.

Insurance premium income was £7,125 million in 2014 compared with £8,197 million in 2013; a decrease of £1,072 million, or 13 per cent. Earned premiums in respect of the Group's long-term life and pensions business were £945 million, or 13 per cent, lower at £6,255 million in 2014 compared to £7,200 million in 2013 following changes in the pensions and annuities markets and lower protection sales through branches. General insurance earned premiums were £127 million, or 13 per cent, lower at £870 million in 2014 compared with £997 million in 2013 due to competitive market conditions.

Other operating income was £3,558 million lower at a deficit of £309 million in 2014 compared to £3,249 million in 2013. In April 2014, the Group completed concurrent Sterling, Euro and Dollar exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities. In addition, the Group completed a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash. The exchange offers completed with the equivalent of £4.0 billion of Sterling and Euro ECNs and approximately US\$1.6 billion of US Dollar ECNs being exchanged for approximately £5.35 billion of AT1 securities. The retail tender offer completed with approximately £58.5 million of ECNs being repurchased for cash. A loss of £1,362 million has been recognised in relation to these exchange and tender transactions in the year ended 31 December 2014. During 2013 the Group incurred liability management losses of £142 million, following a planned exit from repurchase agreement facilities and redemption of a tranche of covered bonds.

During 2013, the Group had recognised a gain of £540 million following the sale of its shareholding in St. James's Place plc and gains of £538 million on the sale of a portfolio of US residential mortgage-backed securities partly offset by a loss of £256 million on the sale of the Group's Spanish retail banking operations and a loss of £382 million related to the sale of the Group's German life assurance business. In 2014 there was a gain of £128 million on the sale of Scottish Widows Investment Partnership which completed during the year.

Other operating income also includes gains and losses on sale of available-for-sale financial assets, which were £498 million, or 79 per cent, lower at £131 million in 2014 compared to £629 million in 2013; of this £787 million in 2013 related to the sale of government securities following the repositioning of the Group's government bond portfolio which substantially completed in the first half of 2013.

## operating and financial review and prospects

## OPERATING EXPENSES

|   | <b>2015</b>   | 2014   | 2013   |
|---|---------------|--------|--------|
|   | <b>£m</b>     | £m     | £m     |
| Administrative expenses:  |               |        |        |
| Staff:  |               |        |        |
| Salaries  | <b>2,808</b>  | 3,178  | 3,331  |
| Performance-based compensation  | <b>409</b>    | 390    | 473    |
| Social security costs   | <b>349</b>    | 398    | 385    |
| Pensions and other post-retirement benefit schemes:                               |               |        |        |
| Past service credits and curtailment gains  | –             | (822 ) | 104    |
| Other   | <b>548</b>    | 596    | 654    |
|   | <b>548</b>    | (226 ) | 758    |
| Restructuring costs   | <b>104</b>    | 264    | 111    |
| Other staff costs   | <b>459</b>    | 741    | 783    |
|   | <b>4,677</b>  | 4,745  | 5,841  |
| Premises and equipment:   |               |        |        |
| Rent and rates  | <b>368</b>    | 424    | 467    |
| Repairs and maintenance   | <b>173</b>    | 221    | 178    |
| Other   | <b>174</b>    | 246    | 325    |
|   | <b>715</b>    | 891    | 970    |
| Other expenses:   |               |        |        |
| Communications and data processing  | <b>893</b>    | 1,118  | 1,169  |
| Advertising and promotion   | <b>253</b>    | 336    | 313    |
| Professional fees   | <b>262</b>    | 481    | 425    |
| UK bank levy  | <b>270</b>    | 237    | 238    |
| TSB disposal  | <b>665</b>    | –      | –      |
| Other   | <b>703</b>    | 1,017  | 971    |
|   | <b>3,046</b>  | 3,189  | 3,116  |
| Depreciation and amortisation:  |               |        |        |
| Depreciation of tangible fixed assets   | <b>1,534</b>  | 1,391  | 1,374  |
| Amortisation of acquired value of in-force non-participating investment contracts | <b>41</b>     | 43     | 54     |
| Amortisation of other intangible assets   | <b>537</b>    | 501    | 512    |
|   | <b>2,112</b>  | 1,935  | 1,940  |
| Total operating expenses, excluding regulatory provisions                         | <b>10,550</b> | 10,760 | 11,867 |
| Regulatory provisions:  |               |        |        |
| Payment protection insurance provision  | <b>4,000</b>  | 2,200  | 3,050  |
| Other regulatory provisions   | <b>837</b>    | 925    | 405    |
|   | <b>4,837</b>  | 3,125  | 3,455  |
| <b>Total operating expenses</b>   | <b>15,387</b> | 13,885 | 15,322 |
| Cost:income ratio (%) <sup>1</sup>  | <b>88.3</b>   | 84.7   | 82.9   |

<sup>1</sup>Total operating expenses divided by total income, net of insurance claims.

**2015 COMPARED WITH 2014**

Operating expenses increased by £1,502 million, or 11 per cent, to £15,387 million in 2015 compared with £13,885 million in 2014. This increase principally reflected the fact that 2014 included a past service pension credit of £822 million and 2015 includes a regulatory provisions charge of £4,837 million, which was £1,712 million, or 54 per cent, higher than the charge of £3,125 million in 2014.

The past service pension credit of £822 million in 2014 followed the Group's decision, announced on 11 March 2014 to reduce the cap on increases in pensionable pay used in calculating the pension benefit to nil with effect from 2 April 2014.

Despite the past service pension credit in 2014, staff costs were £68 million, or 1 per cent, lower in 2015 at £4,677 million compared to £4,745 million in 2014. Excluding the pension credit, staff costs were £890 million, or 16 per cent, lower at £4,677 million in 2015 compared to £5,567 million in 2014 reflecting, in particular, the impact of business disposals and a significant reduction in expenditure in relation to the Group's Simplification programme. As a result, salaries were £370 million, or 12 per cent, lower at £2,808 million in 2015 compared with £3,178 million in 2014; pension costs, excluding the past service pension credit from 2014, were £48 million, or 8 per cent, lower at £548 million in 2015 compared to £596 million in 2014; social security costs were £49 million, or 12 per cent, lower at £349 million in 2015 compared with £398 million in 2014; staff restructuring costs were £160 million, or 61 per cent, lower at £104 million in 2015 compared with £264 million in 2014; and other staff costs were £282 million, or 38 per cent, lower at £459 million in 2015 compared with £741 million in 2014, in particular due to lower levels of agency staff costs in relation to the Simplification programme.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Premises and equipment costs were £176 million, or 20 per cent, lower at £715 million in 2015 compared to £891 million in 2014, again reflecting business disposals and reduced Simplification expenditure. Rent and rates was £56 million, or 13 per cent, lower at £368 million in 2015 compared to £424 million in 2014; repairs and maintenance costs were £48 million, or 22 per cent, lower at £173 million in 2015 compared to £221 million in 2014, in part due to a lower level of dilapidation provisions on vacation of properties in 2015 than in 2014; and other premises and equipment costs decreased by £72 million, or 29 per cent, from £246 million in 2014 to £174 million in 2015, reflecting lower levels of losses on sale of equipment and a reduced level of activity in the property portfolio.

Other expenses, excluding the regulatory provisions charges, were £143 million, or 4 per cent, lower at £3,046 million in 2015 compared with £3,189 million in 2014. Communications and data processing costs were £225 million, or 20 per cent, lower at £893 million in 2015 compared with £1,118 million in 2014 as a result of a significant reduction in Simplification spend on systems and technology; professional fees were £219 million, or 46 per cent, lower at £262 million in 2015 compared to £481 million in 2014, reflecting both the reduced Simplification spend and a lower level of professional fees in respect of TSB; and advertising and promotion costs were £83 million, or 25 per cent, lower at £253 million in 2015 compared with £336 million in 2014 due to spend in relation to TSB in 2014. The cost of the Bank levy was £33 million, or 14 per cent, higher at £270 million in 2015 compared to £237 million in 2014, as a result of the increase in rate with effect from 1 April 2015. In 2015 the Group incurred a charge of £665 million relating to the disposal of TSB, reflecting the net costs of the Transitional Service Agreement between Lloyds and TSB and the contribution to be provided by Lloyds to TSB in moving to alternative IT provision. Other costs were £314 million, or 31 per cent, lower at £703 million in 2015 compared with £1,017 million in 2014.

Depreciation and amortisation costs were £177 million, or 9 per cent, higher at £2,112 million in 2015 compared with £1,935 million in 2014. Charges for the depreciation of tangible fixed assets were £143 million, or 10 per cent, higher at £1,534 million in 2015 compared to £1,391 million in 2014, in line with increased asset balances. The charge for the amortisation of acquired value of in-force non-participating investment contracts was £2 million, or 5 per cent, lower at £41 million in 2015 compared to £43 million in 2014. The charge for the amortisation of other intangible assets was £36 million, or 7 per cent, higher at £537 million in 2015 compared to £501 million in 2014, reflecting increased capitalised software balances.

The Group incurred a regulatory provisions charge in operating expenses of £4,837 million in 2015 compared to £3,125 million in 2014 of which £4,000 million (2014: £2,200 million) related to payment protection insurance. For further details see note 39 to the financial statements.

### **2014 COMPARED WITH 2013**

Operating expenses decreased by £1,437 million, or 9 per cent, to £13,885 million in 2014 compared with £15,322 million in 2013. This decrease principally reflected a past service pension credit of £822 million, compared to a

charge of £104 million in 2013 and the reduced regulatory provisions charge of £3,125 million in 2014, which was £330 million, or 10 per cent, lower than the charge of £3,455 million in 2013.

The past service pension credit of £822 million in 2014 followed the Group's announcement on 11 March 2014 to freeze pensionable pay 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.

As a result of the past service pension credit, staff costs were £1,096 million, or 19 per cent, lower in 2014 at £4,745 million compared to £5,841 million in 2013. Excluding this, staff costs were lower by £170 million, or 3 per cent, at £5,567 million in 2014 compared to £5,737 million in 2013. Salaries were £153 million, or 5 per cent, lower at £3,178 million in 2014 compared with £3,331 million in 2013 as the impact of annual pay rises was more than offset by staff reductions, in part due to business disposals. Pension costs, excluding the past service pension items, were £58 million, or 9 per cent, lower at £596 million in 2014 compared to £654 million in 2013 primarily due to lower current service costs. Social security costs were £13 million, or 3 per cent, higher at £398 million in 2014 compared with £385 million in 2013. Staff restructuring costs were £153 million, higher at £264 million in 2014 compared with £111 million in 2013 reflecting a number of initiatives in the year, and other staff costs were £42 million, or 5 per cent, lower at £741 million in 2014 compared with £783 million in 2013.

Premises and equipment costs were £79 million, or 8 per cent, lower at £891 million in 2014 compared to £970 million in 2013. Rent and rates was £43 million, or 9 per cent, lower at £424 million in 2014 compared to £467 million in 2013 as the Group continues to rationalise its property portfolio, in part through business disposals. Repairs and maintenance costs were £43 million, or 24 per cent, higher at £221 million in 2014 compared to £178 million in 2013 in part reflecting increased dilapidation charges on a number of properties; other premises and equipment costs decreased by £79 million, or 24 per cent, from £325 million in 2013 to £246 million in 2014, partly due to reduced charges in relation to the Group's Simplification programme.

Other expenses excluding the regulatory provisions charges, were £73 million, or 2 per cent, higher at £3,189 million in 2014 compared with £3,116 million in 2013. Communications and data processing costs were £51 million, or 4 per cent, lower at £1,118 million in 2014 compared with £1,169 million in 2013 due to the high level of costs supporting the TSB separation in 2013; professional fees were £56 million, or 13 per cent, higher at £481 million in 2014 compared to £425 million in 2013, in part due to charges in relation to the restructuring of the staff remuneration package and the rationalisation of the Group's overseas presence; and advertising and promotion costs were £23 million, or 7 per cent, higher at £336 million in 2014 compared with £313 million in 2013 due to the promotion of the TSB brand. Other costs were £46 million, or 5 per cent, higher at £1,017 million in 2014 compared with £971 million in 2013.

Depreciation and amortisation costs were £5 million, lower at £1,935 million in 2014 compared with £1,940 million in 2013. Charges for the depreciation of tangible fixed assets were £17 million, or 1 per cent, higher at £1,391 million in 2014 compared to £1,374 million in 2013, in line with increased asset balances. The charge for the amortisation of

acquired value of in-force non-participating investment contracts was £11 million, or 20 per cent, lower at £43 million in 2014 compared to £54 million in 2013 following the sale of St James's Place plc in March 2013. The charge for the amortisation of other intangible assets was £11 million, or 2 per cent, lower at £501 million in 2014 compared to £512 million in 2013, partly as certain core deposit intangibles have become fully amortised.

The Group incurred a regulatory provisions charge of £3,125 million in 2014 compared to £3,455 million in 2013 of which £2,200 million (2013: £3,050 million) related to payment protection insurance. For further details see note 40 to the financial statements.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**IMPAIRMENT**

|   | <b>2015</b>  | 2014 | 2013  |
|---|--------------|------|-------|
|   | <b>£m</b>    | £m   | £m    |
| Impairment losses on loans and receivables:             |              |      |       |
| Loans and advances to customers                         | <b>443</b>   | 735  | 2,725 |
| Debt securities classified as loans and receivables     | <b>(2 )</b>  | 2    | 1     |
| Total impairment losses on loans and receivables        | <b>441</b>   | 737  | 2,726 |
| Impairment of available-for-sale financial assets       | <b>4</b>     | 5    | 15    |
| Other credit risk provisions                            | <b>(55 )</b> | 10   | –     |
| <b>Total impairment charged to the income statement</b> | <b>390</b>   | 752  | 2,741 |

**2015 COMPARED WITH 2014**

Impairment losses decreased by £362 million, or 48 per cent, to £390 million in 2015 compared to £752 million in 2014, largely due to reduced charges in relation to the portfolio of assets which are outside of the Group's risk appetite.

The impairment charge in respect of loans and advances to customers was £292 million, or 40 per cent, lower at £443 million in 2015 compared to £735 million in 2014. In Retail, a reduced impairment charge reflected continued low risk underwriting discipline, strong portfolio management and a favourable credit environment with low unemployment, increasing house prices and continued low interest rates. The improvement in Commercial Banking was driven by lower levels of new impairment as a result of effective risk management, improving UK economic conditions and the continued low interest rate environment; as well as provision releases, but at lower levels than seen during 2014. The Consumer Finance impairment charge reduced, driven by a continued underlying improvement in portfolio quality, supported by an increased level of write-backs from the sale of recoveries assets in the credit card portfolio compared to 2014 due to favourable market conditions. The impairment charge relating to assets which are outside of the Group's risk appetite reduced significantly, reflecting the Group's ongoing exit from these positions.

The impairment charge in respect of debt securities classified as loans and receivables was a credit of £2 million in 2015 compared to a charge of £2 million in 2014. The impairment charge in respect of available-for-sale financial assets was £1 million, or 20 per cent, lower at £4 million in 2015 compared to £5 million in 2014; and there was a credit of £55 million (2014: charge of £10 million) in respect of other credit risk provisions as a result of improved credit quality in a number of corporate relationships.

**2014 COMPARED WITH 2013**

Impairment losses decreased by £1,989 million, or 73 per cent, to £752 million in 2014 compared to £2,741 million in 2013 with a significant reduction in the portfolio of assets which are outside of the Group's risk appetite and improvements in all Divisions. The improvements reflect lower levels of new impairment as a result of effective risk management, improving economic conditions and the continued low interest rate environment. The net charge has also benefited from significant provision releases but at lower levels than seen in 2013.

The impairment charge in respect of loans and advances to customers was £1,990 million, or 73 per cent, lower at £735 million compared to £2,725 million in 2013. In Retail, the impairment charge on unsecured lending reduced in line with lower impaired loan and arrears balances, in part reflecting the sale of a tranche of recoveries balances, and coverage in the secured book improved. The charge in Commercial Banking reduced as a result of the higher quality of recent new lending, the improving economy and continuing low interest rates, and provision releases as the Division progresses with its strategy of building a low-risk commercial bank. The Consumer Finance impairment charge was lower as a result of improving portfolio quality and the Division also had a benefit from the sale of recoveries balances. The impairment charge relating to assets which are outside of the Group's risk appetite fell substantially following successful run-down of the portfolio, and in particular the sale of the majority of the Group's impaired mortgage assets in Ireland.

The impairment charge in respect of debt securities classified as loans and receivables was £2 million in 2014 compared to £1 million in 2013. The impairment charge in respect of available-for-sale financial assets was £10 million, or 67 per cent, lower at £5 million in 2014 compared to £15 million in 2013; and there was a charge of £10 million (2013: £nil) in respect of undrawn commitments.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## TAXATION

|                                       | <b>2015</b>  | 2014  | 2013    |
|---------------------------------------|--------------|-------|---------|
|                                       | <b>£m</b>    | £m    | £m      |
| UK corporation tax:                   |              |       |         |
| Current tax on profits for the year   | <b>(485)</b> | (162) | (226 )  |
| Adjustments in respect of prior years | <b>(90 )</b> | 213   | (205 )  |
|                                       | <b>(575)</b> | 51    | (431 )  |
| Foreign tax:                          |              |       |         |
| Current tax on profits for the year   | <b>(24 )</b> | (39 ) | (60 )   |
| Adjustments in respect of prior years | <b>27</b>    | 3     | 26      |
|                                       | <b>3</b>     | (36 ) | (34 )   |
| <b>Current tax credit (charge)</b>    | <b>(572)</b> | 15    | (465 )  |
| Deferred tax                          | <b>(116)</b> | (278) | (752 )  |
| <b>Taxation charge</b>                | <b>(688)</b> | (263) | (1,217) |

**2015 COMPARED WITH 2014**

In 2015, a tax charge of £688 million arose on the profit before tax of £1,644 million and in 2014 a tax charge of £263 million arose on the profit before tax of £1,762 million. The statutory corporation tax rates were 20.25 per cent for 2015 and 21.5 per cent for 2014.

The tax charge for the 2015 represented an effective tax rate of 42 per cent. The effective tax rate was higher than the UK corporation tax rate largely due to the introduction in 2015 of restrictions on the deductibility of conduct related provisions which resulted in an additional tax charge of £459 million. Adjusting for this charge, the effective tax rate would have been 14 per cent reflecting non-taxable and relieved gains and a number of positive one-off items.

The low tax charge in 2014 was driven by tax exempt gains on sales of businesses and a lower deferred tax liability in respect of the value of in-force assets in the life business.

**2014 COMPARED WITH 2013**

In 2014, a tax charge of £263 million arose on the profit before tax of £1,762 million and in 2013 a tax charge of £1,217 million arose on the profit before tax of £415 million. The statutory corporation tax rates were 21.5 per cent for 2014 and 23.25 per cent for 2013.

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The tax charge for the 2014 represented an effective tax rate of 15 per cent. The effective tax rate was lower than the UK corporation tax rate largely as a result of tax exempt gains on sales of businesses and a lower deferred tax liability in respect of the value of in-force assets for the life business partially offset by the effect of non-deductible expenses.

The high tax charge in 2013 was driven by the write down of deferred tax assets following the changes in corporation tax rates and the sale of the Australian business.

25

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**LINE OF BUSINESS INFORMATION**

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

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

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

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

The Group's activities are organised into four financial reporting segments: Retail; Commercial Banking; Consumer Finance and Insurance.

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

the amortisation of purchased intangible assets and the unwind of acquisition-related fair value adjustments arising from the HBOS acquisition;

the effects of certain asset sales, the impact of liability management actions and the volatility relating to the Group's own debt and hedging arrangements as well as that arising in the insurance businesses and insurance gross up;

Simplification costs, which for 2015 are limited to severance costs relating to the programme announced in October 2014. Costs in 2014 and 2013 included severance, IT and business costs relating to the programme started in 2011;

-TSB build and dual running costs and the loss relating to the TSB sale;

-payment protection insurance provision and other conduct provisions; and

-certain past service pensions charges and credits in respect of the Group's defined benefit pension arrangements.

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

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

|                                     | <b>2015</b>  | 2014  | 2013   |
|-------------------------------------|--------------|-------|--------|
|                                     | <b>£m</b>    | £m    | £m     |
| Retail                              | <b>3,514</b> | 3,228 | 3,015  |
| Commercial Banking                  | <b>2,431</b> | 2,206 | 1,890  |
| Consumer Finance                    | <b>1,005</b> | 1,010 | 965    |
| Insurance                           | <b>962</b>   | 922   | 1,088  |
| Other                               | <b>200</b>   | 390   | (792 ) |
| <b>Underlying profit before tax</b> | <b>8,112</b> | 7,756 | 6,166  |

26

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**Reconciliation of underlying profit to statutory profit (loss) before tax for the year**

|   | Note | 2015<br>£m     | 2014<br>£m | 2013<br>£m |
|---|------|----------------|------------|------------|
| <b>Profit before tax – Underlying basis</b>               |      | <b>8,112</b>   | 7,756      | 6,166      |
| Asset sales   | 1    | <b>54</b>      | 138        | (687 )     |
| Sale of government securities                             | 2    | –              | –          | 787        |
| Liability management                                      | 3    | <b>(28 )</b>   | (1,386)    | (142 )     |
| Own debt volatility                                       | 4    | <b>26</b>      | 398        | (221 )     |
| Other volatile items                                      | 5    | <b>(129 )</b>  | (112 )     | (457 )     |
| Volatility arising in insurance businesses                | 6    | <b>(105 )</b>  | (228 )     | 668        |
| Fair value unwind   | 8    | <b>(192 )</b>  | (529 )     | (228 )     |
| Simplification costs and TSB build and dual running costs | 9    | <b>(255 )</b>  | (1,524)    | (1,517)    |
| Charge relating to TSB disposal                           | 10   | <b>(660 )</b>  | –          | –          |
| Payment protection insurance provision                    | 11   | <b>(4,000)</b> | (2,200)    | (3,050)    |
| Other conduct provisions                                  | 12   | <b>(837 )</b>  | (925 )     | (405 )     |
| Past service pension credit (charge)                      | 13   | –              | 710        | (104 )     |
| Amortisation of purchased intangibles                     | 14   | <b>(342 )</b>  | (336 )     | (395 )     |
| <b>Profit before tax – Statutory</b>                      |      | <b>1,644</b>   | 1,762      | 415        |

**1. Asset sales**

Asset sales comprise the gains and losses on asset disposals (2015: gains of £54 million; 2014: gains of £138 million; 2013: losses of £687 million), principally of assets which were outside of the Group's risk appetite.

**2. Sale of government securities**

These reflected gains on bond sales (2015: £nil; 2014: £nil; 2013: £787 million) as the Group took the opportunity afforded by the continuing low interest rate environment to reposition its holdings of available-for-sale government securities.

**3. Liability management**

In April 2014, the Group completed concurrent Sterling, Euro and Dollar exchange offers with holders of certain series of its Enhanced Capital Notes (ECNs) to exchange the ECNs for new Additional Tier 1 (AT1) securities. In addition the Group completed a tender offer to eligible retail holders outside the United States to sell their Sterling-denominated ECNs for cash. The exchange offers completed with the equivalent of £5.0 billion of ECNs being exchanged for the equivalent of £5.35 billion of AT1 securities, before issue costs. The retail tender offer completed with approximately £58.5 million of ECNs being repurchased for cash. A loss of £1,362 million was recognised in relation to these exchange and tender transactions in the year ended 31 December 2014.

Losses of £28 million (2014: losses of £24 million; 2013: losses of £142 million) arose on other transactions undertaken as part of the Group's management of wholesale funding and capital. The liability management losses were included in other income.

#### **4. Own debt volatility**

Own debt volatility includes a loss of £101 million (2014: gain of £401 million; 2013: loss of £209 million) relating to the change in fair value of the equity conversion feature of the Enhanced Capital Notes, which principally reflects the ongoing amortisation of the value of the conversion feature over its life. Own debt volatility also includes a £114 million gain (2014: gain of £33 million; 2013: gain of £41 million) relating to the change in fair value of the small proportion of the Group's wholesale funding which was designated at fair value at inception.

#### **5. Other volatile items**

Other volatile items include the change in fair value of interest rate derivatives and foreign exchange hedges in the banking book not mitigated through hedge accounting. A charge of £99 million was included in 2015 (2014: charge of £138 million; 2013: charge of £489 million). Also included in 2015 was a negative net derivative valuation adjustment of £30 million (2014: credit of £26 million; 2013: credit of £32 million), reflecting movements in the market implied credit risk associated with customer derivative balances.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**6. Volatility arising in insurance businesses**

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

In 2015, the Group's statutory result before tax included negative insurance and policyholder interests volatility totalling £105 million compared to negative volatility of £228 million in 2014 and positive volatility of £668 million in 2013.

Volatility comprises the following:

|                                   | <b>2015</b>  | 2014  | 2013  |
|-----------------------------------|--------------|-------|-------|
|                                   | <b>£m</b>    | £m    | £m    |
| Insurance volatility              | <b>(303)</b> | (219) | 218   |
| Policyholder interests volatility | <b>87</b>    | 17    | 564   |
| Insurance hedging arrangements    | <b>111</b>   | (26 ) | (114) |
| <b>Total</b>                      | <b>(105)</b> | (228) | 668   |

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

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

- (i) Insurance volatility requires an assumption to be made for the normalised return on equities and other investments; and
- (ii) Insurance volatility impacts on the Group's regulatory capital position, even though it is not included within underlying profit before tax.

Management compensates for the limitations above by:

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

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

*Insurance volatility*

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

The expected gross investment returns used to determine the underlying profit of the business are based on prevailing market rates and published research into historical investment return differentials for the range of assets held. Where appropriate, rates are updated throughout the year to reflect changing market conditions and changes in the asset mix. In 2015 the basis for calculating these expected returns has been enhanced to reflect an average of the 15 year swap rate over the preceding 12 months and rates were updated throughout the year to reflect changing market conditions. The negative insurance volatility during 2015 of £303 million primarily reflects lower equity returns than expected, widening credit spreads and low returns on cash investments.

*Policyholder interests volatility*

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

Accounting standards require that tax on policyholder investment returns should be included in the Group's tax charge rather than being offset against the related income. The result is, therefore, to either increase or decrease profit before tax with a related change in the tax charge. Timing and measurement differences exist between provisions for tax and charges made to policyholders. Consistent with the expected approach taken in respect of insurance volatility, differences in the expected levels of the policyholder tax provision and policyholder charges are adjusted through policyholder interests volatility. In 2015, the statutory results before tax included a credit to other income which relates to policyholder interests volatility totalling £87 million (2014: £17 million) reflecting offsetting movements in equity, bond and gilt returns.



*Insurance hedging arrangements*

The Group purchased put option contracts in 2015 to protect against deterioration in equity market conditions and the consequent negative impact on the value of in-force business on the Group balance sheet. These were financed by selling some upside potential from equity market movements. A gain of £111 million was recognised in relation to these contracts in 2015.

**7. Insurance gross-up**

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

**8. Fair value unwind**

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

### **9. Simplification costs and TSB build and dual-running costs**

Simplification programme costs in 2015 were £170 million (2014: £966 million; 2013: £830 million) relating to the next phase of simplification announced in October 2014. This had delivered annual run-rate cost savings of £373 million by 31 December 2015. The costs in 2014 and 2013 related to phase 1 of the simplification programme which was completed in 2014.

During 2015, the Group completed the European Commission (EC) mandated business disposal of TSB. TSB costs in the year ended 31 December 2015 totalled £85 million (2014: £558 million; 2013: £687 million) relating to dual-running costs. The dual-running costs include the costs of TSB's standalone treasury, finance, human resources and other head office functions.

### **10. Charge relating to TSB disposal**

On 20 March 2015 the Group announced that it had agreed to sell a 9.99 per cent interest in TSB Banking Group plc (TSB) to Banco de Sabadell S.A. (Banco Sabadell) and that it had entered into an irrevocable undertaking to accept Banco Sabadell's recommended cash offer in respect of its remaining 40.01 per cent interest in TSB. The offer by Banco Sabadell was conditional upon, amongst other things, regulatory approval.

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

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

### **11. Payment protection insurance (PPI) provision**

The Group increased the provision for PPI costs by a further £4,000 million in 2015, bringing the total amount provided to £16,025 million. This included an additional £2,100 million in the fourth quarter, largely to reflect the impact of its interpretation of the proposals contained within the Financial Conduct Authority's (FCA) consultation paper regarding a potential time bar and the Plevin case. As at 31 December 2015, £3,458 million or 22 per cent of the total provision, remained unutilised with approximately £2,950 million relating to reactive complaints and associated administration costs.

The volume of reactive PPI complaints has continued to fall, with an 8 per cent reduction in 2015 compared with 2014, to approximately 8,000 complaints per week. Whilst direct customer complaint levels fell 30 per cent year-on-year, those from Claims Management Companies (CMCs) have remained broadly stable and as a result, CMCs now account for over 70 per cent of complaints.

Assuming current FCA proposals are implemented and an average of approximately 10,000 complaints per week, including those related to Plevin, the outstanding provision should be sufficient to cover all future PPI related complaints and associated administration costs through to mid-2018.

Weekly complaint trends could vary significantly throughout this period, given they are likely to be impacted by a number of factors including the potential impact of the FCA's proposed communication campaign as well as changes in the regulation of CMCs.

## **12. Other conduct provisions**

In 2015, the Group incurred a charge of £837 million, of which £302 million was recognised in the fourth quarter relating to a number of non-material items including packaged bank accounts and a number of other product rectifications primarily in Retail, Insurance and Commercial Banking. Within the full year charge, £720 million of provisions related to potential claims and remediation in respect of products sold through the branch network and continuing investigation of matters highlighted through industry wide regulatory reviews, as well as legacy product sales and historical systems and controls such as those governing legacy incentive schemes. This includes a full year charge of £225 million in respect of complaints relating to packaged bank accounts. The full year charge also included the previously announced settlement of £117 million that the Group reached with the FCA with regard to aspects of its PPI complaint handling process during the period March 2012 to May 2013.

## **13. Past service pension credit (charge)**

On 11 March 2014 the Group announced a change to its defined benefit pension arrangements, 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 £133 million relating to the cost of other changes to the pay, benefits and reward offered to employees to give a net credit of £710 million recognised in 2014.

In 2013 the Group recorded a charge of £104 million as a result of changes to early retirement and commutation factors in two of its principal defined benefit schemes.

**14. Amortisation of purchased intangibles**

The Group incurred a charge for the amortisation of intangible assets, recognised on the acquisition of HBOS in 2009, of £342 million (2014: £336 million; 2013: £395 million).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## DIVISIONAL RESULTS

## RETAIL

Retail offers a broad range of financial service products, including current accounts, savings, personal loans and mortgages, to UK personal customers, including Wealth and small business customers. It is also a distributor of insurance, protection and credit cards, 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 real 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.

|                     | <b>2015</b> | 2014    | 2013    |
|---------------------|-------------|---------|---------|
|                     | <b>£m</b>   | £m      | £m      |
| Net interest income | 7,397       | 7,079   | 6,500   |
| Other income        | 1,122       | 1,212   | 1,435   |
| Total income        | 8,519       | 8,291   | 7,935   |
| Operating expenses  | (4,573)     | (4,464) | (4,160) |
| Impairment          | (432 )      | (599 )  | (760 )  |
| Underlying profit   | 3,514       | 3,228   | 3,015   |

## 2015 COMPARED WITH 2014

Underlying profit increased by £286 million, or 9 per cent to £3,514 million in 2015 compared to £3,228 million in 2014, driven by improved margins and reduced impairments.

Net interest income increased £318 million, or 4 per cent, to £7,397 million in 2015 compared to £7,079 million in 2014. Margin performance was strong, increasing 11bps to 2.40 per cent in 2015 compared to 2.29 per cent in 2014, driven by improved deposit mix and margin, more than offsetting reduced lending rates.

Other income decreased £90 million, or 7 per cent, to £1,122 million in 2015 compared to £1,212 million in 2014, driven by current account transaction related income and regulatory changes, in particular, impacting the Wealth business.

Operating expenses increased £109 million, 2 per cent, to £4,573 million in 2015 compared to £4,464 million in 2014. The increase reflects continued business investment and simplification to improve customer experiences and enable staff numbers to be reduced by 7 per cent in 2015.

Impairment reduced by £167 million, or 28 per cent, to £432 million in 2015 compared to £599 million in 2014, driven by continued low risk underwriting discipline, strong portfolio management and a favourable credit environment.

### **2014 COMPARED WITH 2013**

Underlying profit increased by £213 million, or 7 per cent to £3,228 million in 2014 compared to £3,015 million in 2013, driven by improved margins and reduced impairments.

Net interest income increased £579 million, or 9 per cent, to £7,079 million in 2014 compared to £6,500 million in 2013. Margin performance was strong, increasing 20 basis points to 2.29 per cent in 2014 compared to 2.09 per cent in 2013, driven by improved deposit mix and margin, more than offsetting reduced lending rates.

Other income decreased £223 million, or 16 per cent, to £1,212 million in 2014 compared to £1,435 million in 2013, as a result of lower other operating income from protection sales partly due to fewer advised sales roles in branches. Lower Wealth other operating income following the Retail Distribution Review.

Total costs increased £304 million, 7 per cent, to £4,464 million in 2014 compared to £4,160 million in 2013, driven by higher indirect costs previously absorbed within TSB and depreciation costs associated with ongoing investment in the business.

Impairment reduced £161 million, or 21 per cent, to £599 million in 2014 compared to £760 million in 2013, driven by lower write-offs and impaired loans in the unsecured book. Secured coverage strengthened to 37 per cent, resulting in a 13 per cent increase to the impairment charge.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**COMMERCIAL BANKING**

Commercial Banking has been supporting British business for 250 years. It has a client-led, low risk, capital efficient strategy, helping UK-based clients and international clients with a link to the UK. Through its four client facing 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.

|                     | <b>2015</b> | 2014    | 2013    |
|---------------------|-------------|---------|---------|
|                     | <b>£m</b>   | £m      | £m      |
| Net interest income | 2,510       | 2,480   | 2,113   |
| Other income        | 2,066       | 1,956   | 2,259   |
| Total income        | 4,576       | 4,436   | 4,372   |
| Operating expenses  | (2,167)     | (2,147) | (2,084) |
| Impairment          | 22          | (83 )   | (398 )  |
| Underlying profit   | 2,431       | 2,206   | 1,890   |

**2015 COMPARED WITH 2014**

Commercial Banking underlying profit increased by £225 million, or 10 per cent, to £2,431 million in 2015 compared to £2,206 million in 2014 due to lower impairments and increased total underlying income partially offset by higher operating costs.

Net interest income increased by £30 million, or 1 per cent, to £2,510 million in 2015 compared to £2,480 million in 2014 driven by reduced funding costs and higher net interest margin due to disciplined new lending and an increase in deposits.

Other income increased by £110 million, or 6 per cent, to £2,066 million in 2015 compared to £1,956 million in 2014 driven by refinancing support provided to Global Corporate clients and increases in Mid Markets.

Operating expenses increased by £20 million, or 1 per cent, to £2,167 million in 2015 compared to £2,147 million in 2014.

Impairments improved by £105 million to a £22 million release in 2015 compared to an £83 million charge in 2014 reflecting lower gross charges and a number of write-backs and releases.

## **2014 COMPARED WITH 2013**

Commercial Banking underlying profit increased by £316 million, or 17 per cent, to £2,206 million in 2014 compared to £1,890 million in 2013 due to lower impairments and increased net interest income, partially offset by reduced other income and increased operating expenses.

Net interest income increased by £367 million, or 17 per cent, to £2,480 million in 2014 compared to £2,113 million in 2013 driven by reduced funding costs and net interest margin expansion as a result of disciplined pricing of new business.

Other income decreased by £303 million, or 13 per cent, to £1,956 million in 2014 compared to £2,259 million in 2013 reflecting reduced client activity in Debt Capital Markets and Financial Markets in addition to lower revaluation gains within Lloyds Development Capital.

Operating expenses increased by £63 million, or 3 per cent, to £2,147 million in 2014 compared to £2,084 million in 2013 as a result of continued investment in developing product capabilities.

Impairments decreased by £315 million, or 79 per cent, to £83 million in 2014 compared to £398 million in 2013 reflecting lower gross charges, and improved credit quality.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CONSUMER FINANCE

Consumer Finance provides a range of products including motor finance, credit cards, and European mortgages and deposit taking, aiming to deliver sustainable growth within risk appetite. Motor Finance seeks to achieve this through improving customer service by building digital capability and continuing to create innovative propositions. Credit Cards aims to attract customers through better use of Group customer relationships and insight, underpinned by improvements to customer experience.

|                          | <b>2015</b>    | 2014    | 2013    |
|--------------------------|----------------|---------|---------|
|                          | <b>£m</b>      | £m      | £m      |
| Net interest income      | <b>1,287</b>   | 1,290   | 1,333   |
| Other income             | <b>1,358</b>   | 1,364   | 1,359   |
| Total income             | <b>2,645</b>   | 2,654   | 2,692   |
| Operating expenses       | <b>(1,488)</b> | (1,429) | (1,384) |
| Impairment               | <b>(152 )</b>  | (215 )  | (343 )  |
| <b>Underlying profit</b> | <b>1,005</b>   | 1,010   | 965     |

## 2015 COMPARED WITH 2014

Underlying profit was £1,005 million in 2015 compared to £1,010 million in 2014 with growth in better quality but lower margin lending resulting in lower income but lower impairments, offset by increased cost of investment in growth initiatives.

Total income decreased by £9 million to £2,645 million in 2015 compared to £2,654 million in 2014.

Net interest margin decreased by 55 basis points to 5.94 per cent, contributing to a small reduction in net interest income to £1,287 million in 2015 compared to £1,290 million in 2014. Net interest margin was down due to the acquisition of lower risk but lower margin new business, an increased proportion of Cards interest free balance transfer balances and the impact of the planned reduction in deposits in line with the Group's balance sheet funding strategy.

Other income reduced by £6 million to £1,358 million in 2015 compared to £1,364 million in 2014, as higher income from growing the Lex Autolease fleet was offset by the impact of lower interchange income in Cards following the recent EU ruling.

Operating expenses increased by £59 million, or 4 per cent, to £1,488 million in 2015 compared to £1,429 million in 2014 as operating cost savings were offset by continued investment in growth initiatives and increased operating lease depreciation as a result of growth in the Lex Autolease fleet.

The impairment charge reduced by £63 million, or 29 per cent, to £152 million in 2015 compared to £215 million in 2014. This has been driven by a continued underlying improvement in portfolio quality and supported by the sale of recoveries assets in the Credit Cards portfolio. The asset quality ratio improved by 37 basis points.

### **2014 COMPARED WITH 2013**

Underlying profit increased by £45 million to £1,010 million in 2014 compared to £965 million in 2013 primarily due to a reduction of £128 million in impairment charges across the portfolio and growth in total income from Asset Finance partly offset by a fall in total income from Credit Cards and investments for future growth in the businesses.

Total income decreased by £38 million to £2,654 million in 2014 compared to £2,692 million in 2013.

Net interest margin decreased by 45 basis points to 6.49 per cent, resulting in a 3 per cent reduction in net interest income to £1,290 million in 2014 compared to £1,333 million in 2013. New business growth and deposit repricing have been offset by a change in the composition of the portfolio with an increase in higher quality, lower margin lending to the new vehicle market and the impact of the current year's strategic focus on growing the volume of new credit cards. Consistent with the strategy of acquiring high quality new business, the asset quality ratio improved by 71 basis points.

Other income increased by £5 million to £1,364 million in 2014 compared to £1,359 million in 2013 as a result of the growth strategy.

Operating expenses increased by £45 million, or 3 per cent, to £1,429 million in 2014 compared to £1,384 million in 2013 driven by investment in growth initiatives and increased operating lease depreciation as a result of growth in the Lex Autolease fleet, offset by cost savings and increased gains from end of life lease asset sales. In 2014 a further £45 million was invested in improving propositions and customers' digital experience.

The impairment charge reduced by £128 million, or 37 per cent, to £215 million in 2014 compared to £343 million in 2013. This has been driven by a continued underlying improvement of portfolio quality supported by the sale of

recoveries assets in the Credit Cards and Asset Finance portfolios.

32

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**INSURANCE**

Insurance provides a broad range of long term savings, retirement and protection products to retail and corporate customers, either direct or through intermediary networks or through the Group's banking branches .

*Life, Pensions and Investments*

The Life, Pensions and Investments business provides long-term savings, retirement solutions and protection products primarily distributed through intermediaries and direct channels of Scottish Widows.

*General Insurance*

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

|                                       | <b>2015</b> | 2014   | 2013   |
|---------------------------------------|-------------|--------|--------|
|                                       | <b>£m</b>   | £m     | £m     |
| Net interest expense                  | (163 )      | (131 ) | (107 ) |
| Other income                          | 1,827       | 1,725  | 1,864  |
| Total income, net of insurance claims | 1,664       | 1,594  | 1,757  |
| Operating expenses                    | (702 )      | (672 ) | (669 ) |
| Underlying profit                     | 962         | 922    | 1,088  |

**2015 COMPARED WITH 2014**

Underlying profit from insurance was £40 million, or 4 per cent higher at £962 million compared to £922 million in 2014. The increase was driven by bulk annuity deals and the net benefit from a number of assumption updates, partly offset by increased costs reflecting significant investment spend, adverse economics, and reduced general insurance income.

Net interest expense increased by £32 million, or 24 per cent, to £163 million from £131 million in 2014 due to holding increased debt whilst a tranche of subordinated debt was re-financed.

Other income increased by £102 million, or 6 per cent, to £1,827 million from £1,725 million in 2014. The increase was driven by bulk annuity deals and the net benefit from a number of assumption updates, partly offset by adverse economics and reduced general insurance income.

## **2014 COMPARED WITH 2013**

Underlying profit from insurance was £166 million, or 15 per cent, lower at £922 million compared to £1,088 million in 2013. This was impacted by the cost of structural changes in the corporate pensions book, primarily the cap on pension charges and lower life new business and general insurance premiums offset by improved economics and an increase in yields on assets backing annuity business as a result of the strategy to invest in long-term, low risk, higher yielding assets.

Net interest expense increased by £24 million, or 22 per cent, to £131 million from £107 million in 2013, primarily due to higher intra group charges.

Other income decreased by £139 million, or 7 per cent, to £1,725 million from £1,864 million in 2013. This was impacted by lower new business, reduced general insurance income and structural changes in the corporate pensions book, offset by benefits arising from the strategy of acquiring attractive, higher yielding assets to back the annuities business, improved economics and lower weather related claims.

Operating expenses of £672 million increased by £3 million from £669 million in 2013 where increased investment in strategic initiatives has been funded by a reduction in the underlying cost base.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## UNDERLYING PROFIT BY PRODUCT GROUP

|   | 2015                         |                               |                      |                         |             |              | 2014        | 2013        |
|---|------------------------------|-------------------------------|----------------------|-------------------------|-------------|--------------|-------------|-------------|
|   | Pensions & investments<br>£m | Protection & retirement<br>£m | Bulk annuities<br>£m | General insurance<br>£m | Other<br>£m | Total<br>£m  | Total<br>£m | Total<br>£m |
| New business income                         | 168                          | 33                            | 125                  | –                       | –           | 326          | 268         | 423         |
| Existing business income                    | 630                          | 122                           | –                    | –                       | 28          | 780          | 882         | 795         |
| Long-term investment strategy               | –                            | 73                            | 102                  | –                       | –           | 175          | 160         | 118         |
| Assumption changes and experience variances | (208)                        | ) 240                         | 30                   | –                       | (2)         | ) 60         | (134)       | (48)        |
| General insurance income net of claims      | –                            | –                             | –                    | 323                     | –           | 323          | 418         | 469         |
| <b>Total income</b>                         | <b>590</b>                   | <b>468</b>                    | <b>257</b>           | <b>323</b>              | <b>26</b>   | <b>1,664</b> | 1,594       | 1,757       |
| Total costs                                 | (414)                        | ) (133)                       | ) (10)               | ) (145)                 | ) –         | (702)        | (672)       | (669)       |
| <b>Underlying profit 2015</b>               | <b>176</b>                   | <b>335</b>                    | <b>247</b>           | <b>178</b>              | <b>26</b>   | <b>962</b>   | 922         | 1,088       |
| Underlying profit 2014                      | 236                          | 344                           | –                    | 274                     | 68          | 922          |             |             |

## 2015 COMPARED WITH 2014

New business income increased by £58 million to £326 million with the primary driver being the new bulk annuity business. This was offset by a reduction in Protection income, following the removal of face-to-face advice in branch standalone protection sales and reduced annuity income following the introduction of Pensions Freedoms in 2015. Corporate pension income remained robust despite lower sales following the auto enrolment driven increases in 2014.

The £102 million fall in existing business income reflects a reduction in the expected rate of return used to calculate life and pensions income. The rate of return is largely set by reference to an average 15 year swap rate (2.57 per cent in 2015 and 3.48 per cent in 2014).

Long-term investment strategy includes the benefit from the successful acquisition of a further £1.4 billion of higher yielding assets to match long duration annuity liabilities.

Assumption changes and experience variances include an adverse impact of £208 million in Pensions and Investments as a result of the strengthening of lapse assumptions on the pensions book to allow for the impact of the recent pension

reforms. This was more than offset by the £240 million of benefit recognised within Protection and Retirement, primarily as a result of changes to assumptions on longevity. These longevity changes reflect both experience in the annuity portfolio and the adoption of a new industry model reflecting an updated view of future life expectancy.

General Insurance income net of claims has fallen by £95 million. This reflects the run-off of products closed to new customers, the impact of becoming a sole underwriter of the home insurance business (which has resulted in a short term reduction from the loss of commission recognised upfront) and the impact of adverse weather. The anticipated launch in early 2016 of a more flexible Home product is expected to lead to an improvement in general insurance sales going forward.

Total costs were £30 million higher, reflecting significant investment spend as part of an ongoing programme of growth and simplification initiatives. In 2015 this included the launch of Protection to IFAs and the bulk annuities business alongside the Part VII transfer as well as a significant regulatory change agenda in particular to support pensions freedoms and transition to Solvency II. Excluding investment related expenditure, underlying costs fell by 3 per cent during 2015 reflecting ongoing operational efficiencies.

### **2014 COMPARED WITH 2013**

New business income reduced by £155 million to £268 million driven by a reduction in pensions new business income due to lower volumes relative to the spike in 2013 sales (as Retail Distribution Review sales completed). In calculating new business income on auto-enrolment schemes, allowance has been made for low initial contribution levels and does not include future automatic increases in contribution levels. These increases will be reported in future years. In addition protection and retirement new business income has reduced following the 2014 Budget announcement which led to industry wide reductions in annuities volumes following changes to the freedoms consumers have in accessing their pension savings.

Existing business income has increased by £87 million reflecting improved economics benefiting the life and pensions business.

2014 underlying profit in the protection and annuities business included a benefit of £277 million, largely from investing in higher yielding assets to match long duration liabilities and benefits from assumption changes. This was offset by a charge of £219 million in the pensions and investments business driven primarily by assumption changes within the existing book including actions being taken to prepare for the structural changes arising from the Department for Work and Pensions' announcement which introduced a cap on pension charges. These changes to corporate pensions will ensure that future new business is less capital intensive.

General Insurance underlying profit has fallen by £35 million, due to the continued run off of legacy books and the impact of storms in the first quarter, offset by good prior year experience. During the year, underwriting of the home insurance business was brought in-house, ensuring delivery of a first class service to all customers and continued sustainable growth in the underwritten customer base.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER**

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

**Run-off**

Run-off includes assets classified as outside the Group's risk appetite and the results and gains on sale relating to businesses disposed in 2013 and 2014.

|                        | <b>2015</b>   | 2014   | 2013    |
|------------------------|---------------|--------|---------|
|                        | <b>£m</b>     | £m     | £m      |
| Net interest income    | <b>(88 )</b>  | (116 ) | 138     |
| Other income           | <b>145</b>    | 451    | 1,266   |
| Total income           | <b>57</b>     | 335    | 1,404   |
| Operating expenses     | <b>(164 )</b> | (308 ) | (726 )  |
| Impairment             | <b>(8 )</b>   | (203 ) | (1,389) |
| <b>Underlying loss</b> | <b>(115 )</b> | (176 ) | (711 )  |

**2015 COMPARED WITH 2014**

The underlying loss of £115 million was £61 million lower than the loss of £176 million in 2014 as a result of both lower operating expenses and lower impairment charges as the run-off portfolios were managed down.

The reduction in total income from £335 million in 2014 to £57 million in 2015 was due to the sale of Scottish Widows Investment Partnership during 2014 and the continued reduction in run-off assets.

Operating costs were £164 million, down £144 million as a result of business disposals in 2014.

The reduction in the impairment charge from £203 million in 2014 to £8 million in 2015 reflects the continued progress in managing down the run-off portfolios.

## 2014 COMPARED WITH 2013

Underlying loss of £176 million was £535 million lower than the loss of £711 million in 2013 largely as a result of the reduction in impairment charges as the run-off portfolios were managed down.

Total income was £335 million, down £1,069 million or 76 per cent from £1,404 million in 2013 reflecting the disposal of businesses during 2013 and the reduction in run-off assets. 2013 included £662 million of income relating to St James's Place which was sold in the year.

Operating expenses were £308 million, £418 million or 58 per cent lower than 2013 as a result of business disposals during 2013.

## TSB

TSB is a separately listed multi-channel retail banking business with branches in England, Wales and Scotland. It serves retail and small business customers; providing a full range of retail banking products.

As explained in note 55 to the financial statements, the Group sold its controlling interest in TSB in March 2015 and ceased to consolidate TSB's results at that point.

|                          | <b>2015</b>  | 2014   | 2013   |
|--------------------------|--------------|--------|--------|
|                          | <b>£m</b>    | £m     | £m     |
| Net interest income      | <b>192</b>   | 786    | 615    |
| Other income             | <b>31</b>    | 140    | 163    |
| Total income             | <b>223</b>   | 926    | 778    |
| Operating expenses       | <b>(86 )</b> | (370 ) | (563 ) |
| Impairment               | <b>(19 )</b> | (98 )  | (109 ) |
| <b>Underlying profit</b> | <b>118</b>   | 458    | 106    |

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

#### **2015 COMPARED WITH 2014**

Underlying profit was £340 million, or 74 per cent, lower at £118 million in 2015 compared to £458 million in 2014; this principally reflects the fact that TSB was only consolidated for three months in 2015, compared to a full year in 2014.

Total income was £703 million, or 76 per cent, lower at £223 million in 2015 compared to £926 million in 2014; operating expenses were £284 million, or 77 per cent, lower at £86 million in 2015 compared to £370 million in 2014; and the impairment charge was £79 million, or 81 per cent, lower at £19 million in 2015 compared to £98 million in 2014.

#### **2014 COMPARED WITH 2013**

Underlying profit was £458 million, up £352 million compared to £106 million in 2013 as a result of higher income and reduced costs.

Total income was £926 million, up £148 million or 19 per cent compared to £778 million in 2013 driven by improved net interest income. This was largely due to a reduction in funding costs following the creation of TSB as a separate stand alone bank.

Operating expenses were £370 million, down £193 million or 34 per cent compared to £563 million in 2013. This was largely explained by the change in the basis of cost allocation to TSB following the creation of TSB as a separate stand alone bank.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**OTHER** (continued)**Central items**

Central Items includes income and expenses not recharged to the divisions. These largely comprise residual income from the Group's processes to allocate funding and liquidity costs to the divisions and the charge for payments to the Group's charitable foundations.

|                                 | <b>2015</b> | 2014  | 2013   |
|---------------------------------|-------------|-------|--------|
|                                 | <b>£m</b>   | £m    | £m     |
| Total income                    | <b>176</b>  | 132   | (133 ) |
| Operating expenses              | <b>19</b>   | (22 ) | (49 )  |
| Impairment release (charge)     | <b>2</b>    | (2 )  | (5 )   |
| <b>Underlying profit (loss)</b> | <b>197</b>  | 108   | (187 ) |

**2015 COMPARED WITH 2014**

Underlying profit was £197 million in 2015, £89 million higher than the £108 million profit in 2014.

Total income was £176 million, £44 million higher than 2014 as it included a full year benefit in net interest income from the exchange of the Enhanced Capital Notes in 2014.

Operating costs were a credit of £19 million compared with a charge of £22 million in 2014 and represent the residual amount after allocations to the divisions.

There was a net release of impairment of £2 million compared with a charge of £2 million in 2014.

**2014 COMPARED WITH 2013**

Underlying profit was £108 million in 2014, £295 million higher than the £187 million loss in 2013.

Total income was £265 million higher at £132 million in 2014, compared to negative income of £133 million in 2013 mainly as a result of the favourable impact on net interest income of the exchange of approximately £5 billion of the Group's Enhanced Capital Notes for Additional Tier 1 securities and structural interest rate hedging activities.

Operating expenses were £27 million, or 55 per cent, lower at £22 million in 2014 compared to £49 million in 2013.

The impairment charge was £3 million, or 60 per cent, lower at £2 million in 2014 compared to £5 million in 2013.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## AVERAGE BALANCE SHEET AND NET INTEREST INCOME

|   | 2015   |                                 |                                | 2014   |                                 |                                | 2013   |                                 |                                |
|---|--|---------------------------------|--------------------------------|--|---------------------------------|--------------------------------|--|---------------------------------|--------------------------------|
|   | Average<br>balance<br>£m                       | Interest<br>income<br>£m        | Yield<br>%                     | Average<br>balance<br>£m                       | Interest<br>income<br>£m        | Yield<br>%                     | Average<br>balance<br>£m                       | Interest<br>income<br>£m        | Yield<br>%                     |
| Assets  |  |                                 |                                |  |                                 |                                |  |                                 |                                |
| Loans and receivables:  |  |                                 |                                |  |                                 |                                |  |                                 |                                |
| Loans and advances to banks   | 94,543   | 397                             | 0.42                           | 78,762   | 406                             | 0.52                           | 102,190  | 457                             | 0.45                           |
| Loans and advances to customers   | 464,012  | 16,256                          | 3.50                           | 504,246  | 17,806                          | 3.53                           | 518,734  | 19,928                          | 3.84                           |
| Debt securities   | 2,139  | 40                              | 1.87                           | 1,633  | 42                              | 2.57                           | 2,102  | 32                              | 1.52                           |
| Available-for-sale financial assets   | 40,967   | 725                             | 1.77                           | 50,269   | 957                             | 1.90                           | 38,767   | 746                             | 1.92                           |
| Held-to-maturity investments  | 13,256   | 197                             | 1.49                           | –  | –                               | –                              | –  | –                               | –                              |
| Total interest-earning assets of banking book   | 614,917  | 17,615                          | 2.86                           | 634,910  | 19,211                          | 3.03                           | 661,793  | 21,163                          | 3.20                           |
| Total interest-earning trading securities and other financial assets at fair value through profit or loss | 87,583   | 1,955                           | 2.23                           | 82,018   | 1,993                           | 2.43                           | 68,763   | 2,076                           | 3.02                           |
| <b>Total interest-earning assets</b>  | <b>702,500</b>                                 | <b>19,570</b>                   | <b>2.79</b>                    | <b>716,928</b>                                 | <b>21,204</b>                   | <b>2.96</b>                    | <b>730,556</b>                                 | <b>23,239</b>                   | <b>3.18</b>                    |
| Allowance for impairment losses on loans and receivables  | (4,729 )                                       |                                 |                                | (10,051 )                                      |                                 |                                | (14,381 )                                      |                                 |                                |
| Non-interest earning assets   | 145,224  |                                 |                                | 158,584  |                                 |                                | 175,228  |                                 |                                |
| <b>Total average assets and interest income</b>   | <b>842,995</b>                                 | <b>19,570</b>                   | <b>2.32</b>                    | <b>865,461</b>                                 | <b>21,204</b>                   | <b>2.45</b>                    | <b>891,403</b>                                 | <b>23,239</b>                   | <b>2.61</b>                    |
|   | 2015   |                                 |                                | 2014   |                                 |                                | 2013   |                                 |                                |
|   | Average<br>interest<br>earning<br>assets<br>£m | Net<br>interest<br>income<br>£m | Net<br>interest<br>margin<br>% | Average<br>interest<br>earning<br>assets<br>£m | Net<br>interest<br>income<br>£m | Net<br>interest<br>margin<br>% | Average<br>interest<br>earning<br>assets<br>£m | Net<br>interest<br>income<br>£m | Net<br>interest<br>margin<br>% |
| Average interest-earning assets and net interest income:  |  |                                 |                                |  |                                 |                                |  |                                 |                                |
| Banking business  | 614,917  | 11,318                          | 1.84                           | 634,910  | 10,660                          | 1.68                           | 661,793  | 7,338                           | 1.11                           |
|   | 87,583   | 1,205                           | 1.38                           | 82,018   | 1,464                           | 1.78                           | 68,763   | 1,757                           | 2.56                           |

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

|                |               |             |         |        |      |         |       |      |
|----------------|---------------|-------------|---------|--------|------|---------|-------|------|
| <b>702,500</b> | <b>12,523</b> | <b>1.78</b> | 716,928 | 12,124 | 1.69 | 730,556 | 9,095 | 1.24 |
|----------------|---------------|-------------|---------|--------|------|---------|-------|------|

37

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|   | 2015           |              |             | 2014           |              |             | 2013           |               |             |
|---|----------------|--------------|-------------|----------------|--------------|-------------|----------------|---------------|-------------|
|   | Average        | Interest     | Cost        | Average        | Interest     | Cost        | Average        | Interest      | Cost        |
|   | balance        | expense      | %           | balance        | expense      | %           | balance        | expense       | %           |
|   | £m             | £m           |             | £m             | £m           |             | £m             | £m            |             |
| <b>Liabilities and shareholders' funds</b>                                    |                |              |             |                |              |             |                |               |             |
| Deposits by banks   | 10,442         | 43           | 0.41        | 11,604         | 86           | 0.74        | 19,845         | 129           | 0.65        |
| Customer deposits   | 380,137        | 3,299        | 0.87        | 416,651        | 4,781        | 1.15        | 397,881        | 6,119         | 1.54        |
| Liabilities to banks and customers under sale and repurchase agreements       | 5,960          | 34           | 0.57        | 2,104          | 55           | 2.61        | 6,515          | 79            | 1.21        |
| Debt securities in issue  | 85,462         | 586          | 0.69        | 88,289         | 552          | 0.63        | 111,264        | 1,451         | 1.30        |
| Amounts payable to unitholders in consolidated open-ended investment vehicles | 21,059         | 244          | 1.16        | 18,620         | 602          | 3.23        | 25,585         | 3,091         | 12.08       |
| Subordinated liabilities  | 24,975         | 2,091        | 8.37        | 29,332         | 2,475        | 8.44        | 34,486         | 2,956         | 8.57        |
| Total interest-bearing liabilities of banking book                            | 528,035        | 6,297        | 1.19        | 566,600        | 8,551        | 1.51        | 595,576        | 13,825        | 2.32        |
| Total interest-bearing liabilities of trading book                            | 61,560         | 750          | 1.22        | 54,980         | 529          | 0.96        | 37,760         | 319           | 0.84        |
| <b>Total interest-bearing liabilities</b>                                     | <b>589,595</b> | <b>7,047</b> | <b>1.20</b> | <b>621,580</b> | <b>9,080</b> | <b>1.46</b> | <b>633,336</b> | <b>14,144</b> | <b>2.23</b> |
| <b>Interest-free liabilities</b>  |                |              |             |                |              |             |                |               |             |
| Non-interest bearing customer accounts  | 45,294         |              |             | 42,049         |              |             | 35,994         |               |             |
| Other interest-free liabilities   | 158,852        |              |             | 157,824        |              |             | 178,836        |               |             |
| Non-controlling interests and shareholders' funds                             | 49,254         |              |             | 44,008         |              |             | 43,237         |               |             |
| <b>Total average liabilities and interest expense</b>                         | <b>842,995</b> | <b>7,047</b> | <b>0.84</b> | <b>865,461</b> | <b>9,080</b> | <b>1.05</b> | <b>891,403</b> | <b>14,144</b> | <b>1.59</b> |

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## CHANGES IN NET INTEREST INCOME – VOLUME AND RATE ANALYSIS

The following table allocates changes in net interest income between volume and rate for 2015 compared with 2014 and for 2014 compared with 2013. Where variances have arisen from both changes in volume and rate these are allocated to volume.

|  | 2015 compared with 2014<br>Increase/(decrease) |                 |                  | 2014 compared with 2013<br>Increase/(decrease) |               |                  |
|--|--|-----------------|------------------|--|---------------|------------------|
|  | Total<br>change<br>£m                          | Volume<br>£m    | Rate<br>£m       | Total<br>change<br>£m                          | Volume<br>£m  | Rate<br>£m       |
| Interest receivable and similar income   |  |                 |                  |  |               |                  |
| Loans and receivables:   |  |                 |                  |  |               |                  |
| Loans and advances to banks  | (9   | ) 66            | (75              | ) (51  | ) (122        | ) 71             |
| Loans and advances to customers  | (1,550   | ) (1,408        | ) (142           | ) (2,122                                       | ) (511        | ) (1,611)        |
| Debt securities  | (2   | ) 9             | (11              | ) 10   | (12           | ) 22             |
| Available-for-sale financial assets  | (232   | ) (165          | ) (67            | ) 211  | 219           | (8               |
| Held-to-maturity investments   | 197  | –               | 197              | –  | –             | –                |
| Total banking book interest receivable and similar income  | (1,596   | ) (1,498        | ) (98            | ) (1,952                                       | ) (426        | ) (1,526)        |
| Total interest receivable and similar income on trading securities and other financial assets at fair value through profit or loss | (38  | ) 124           | (162             | ) (83  | ) 322         | (405             |
| <b>Total interest receivable and similar income</b>  | <b>(1,634</b>                                  | <b>) (1,374</b> | <b>) (260</b>    | <b>) (2,035</b>                                | <b>) (104</b> | <b>) (1,931)</b> |
| <b>Interest payable</b>  |  |                 |                  |  |               |                  |
| Deposits by banks  | (43  | ) (5            | ) (38            | ) (43  | ) (61         | ) 18             |
| Customer deposits  | (1,481   | ) (318          | ) (1,163         | ) (1,338                                       | ) 216         | (1,554)          |
| Liabilities to banks and customers under sale and repurchase agreements  | (21  | ) 22            | (43              | ) (24  | ) (115        | ) 91             |
| Debt securities in issue   | 34   | (20             | ) 54             | (899   | ) (145        | ) (754           |
| Amounts payable to unitholders in consolidated open-ended investment vehicles  | (358   | ) 28            | (386             | ) (2,489                                       | ) (225        | ) (2,264)        |
| Subordinated liabilities   | (384   | ) (365          | ) (19            | ) (481   | ) (435        | ) (46            |
| Total banking book interest payable  | (2,253   | ) (653          | ) (1,600         | ) (5,274                                       | ) (753        | ) (4,521)        |
| Total interest payable on trading and other liabilities at fair value through profit or loss                                       | 221  | 80              | 141              | 210  | 165           | 45               |
| <b>Total interest payable</b>  | <b>(2,032</b>                                  | <b>) (573</b>   | <b>) (1,459)</b> | <b>(5,064</b>                                  | <b>) (588</b> | <b>) (4,476)</b> |

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RISK OVERVIEW**

**EFFECTIVE RISK MANAGEMENT, GOVERNANCE AND CONTROL**

How we manage risk is a fundamental part of our strategy. We operate as a simple, low risk, UK focused, retail and commercial bank with a culture founded on a prudent through the cycle appetite for risk.

Our approach to risk is founded on an effective control framework and a strong risk management culture which guides how our employees 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, works in tandem with our strategy and is approved by the Board. Our risk appetite is then embedded within policies, authorities and limits across the Group.

**RISK AS A STRATEGIC DIFFERENTIATOR**

Group strategy and risk appetite are developed together to ensure one informs the other and creates a strategy that delivers on becoming the best bank for our customers whilst helping Britain prosper and creating sustainable growth over time.

Risks are identified, managed and mitigated using our Risk Management Framework (see page 41). The principal risks we face, which could significantly impact the delivery of our strategy, are discussed on pages 42 to 45.

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

**Sustainable growth**

Embedding a risk culture that ensures proactive support and constructive challenge takes place across the business in order to deliver sustainable growth.

### **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 Risk Management Framework (RMF) acts as the foundation for the delivery of effective risk control and ensures that the Group risk appetite is adhered to.

### **Effective risk analysis, management and reporting**

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

### **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 are accountable for risk but with oversight from a strong and importantly, independent, Second Line Risk Division.

## **ACHIEVEMENTS IN 2015**

We have continued our strategic journey and created a foundation to deliver our objectives, through reacting to changing customer behaviour, maintaining our strong capital position and increasing dividend payments, whilst continuing to adapt to the ever changing regulatory environment. Close and collaborative working across the Group within risk culture and appetite has supported key risk-related deliverables in the year. These included:

### **Conduct**

Deploying a consistent and relentless approach under the Group conduct strategy to ensure we deliver customer needs with an open and transparent culture.

### **Credit rating**

In recognition of the delivery of the Group's strategy, the three main credit rating agencies have either reaffirmed or upgraded our credit rating in the year.

### **State aid commitments**

We have 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. Our strong risk management has assisted in the government's continued sell-down of shares to a holding which is approximately 9 per cent.

### **Capital strength**

We have maintained our strong capital position through a combination of increased underlying profit and lower risk-weighted assets, partially offset by PPI and other conduct charges, which enabled the Group to pay both an interim dividend at half year and to recommend the payment of both a full year ordinary dividend and a special dividend whilst maintaining strong capital ratios. In 2015 the Group participated in the UK-wide concurrent stress testing run by the Bank of England, comfortably exceeding both the capital and leverage minimum thresholds set.

### **Impairments**

Through effective risk management our impairment charge has fallen to £568 million, while the impairment ratio fell to 0.14 per cent. Reduction in run-off assets and the sustained improvement in asset quality across the Group reflects our robust risk management framework which is ingrained across the entire business, as detailed on page 41.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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 periodically reviewed, updated and approved by the Board 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.

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 will support the effective implementation of the requirements of the SM&CR which comes into force in 2016.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**THE MOST SIGNIFICANT RISKS WE FACE WHICH COULD IMPACT THE DELIVERY OF OUR STRATEGY, TOGETHER WITH KEY MITIGATING ACTIONS, ARE OUTLINED BELOW.**

This year we have added two new principal risks:

Insurance risk, reflecting that we are increasing our exposure to longevity risk, following our entry into the bulk annuity market in 2015; and

Governance risk, given increasing societal and regulatory focus on governance arrangements.

All risks have the potential to impact our strategic priorities and the summary below illustrates the most predominant strategic priority impacted by the principal risks and uncertainties detailed.

**PRINCIPAL RISKS**

**Credit risk**

The risk that customers to whom we have lent money 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.

**KEY MITIGATING ACTIONS**

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

– Robust risk assessment and credit sanctioning, with clearly defined levels of authority 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.

## 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.

## Operational risk

We face significant operational risks which may result in financial loss, disruption or 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 Legal, Regulatory and Mandatory Change Committee ensures we develop plans for delivery of all legal and regulatory changes and tracks their progress. Groupwide 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 relevant industry bodies on forthcoming regulatory changes, market reviews and Competition and Markets Authority investigations.

- Customer focused conduct strategy implemented to ensure customers are at the heart of everything we do.

- Product approval, review processes and outcome testing supported by conduct management information.

- Clear customer accountabilities for colleagues, with rewards driven by customer-centric metrics.

- Learning from past mistakes through root cause analysis of crystallised issues.

- Continual review of our IT environment to ensure that systems and processes can effectively support the delivery of services to customers.

- Addressing the observations and associated resilience risks raised in the Independent IT Resilience Review (2013), with independent verification of progress on an annual basis.

– The dynamic threat posed by cyber risk and the potential for external attacks on the integrity of electronic data or the availability of systems.

– Investing in enhanced cyber controls to protect against external threats to the confidentiality or integrity of electronic data, or the availability of systems. Responding to findings from third party industry testing.

– Focused action on strategy to attract, retain and develop high calibre people.

### **People risk**

Key people risks include the risk that we fail to lead responsibly in an increasing competitive marketplace, particularly with the introduction of the SM&CR in 2016. This may dissuade capable individuals from taking up senior positions within the industry.

– Maintain compliance with legal and regulatory requirements relating to the SM&CR, embedding compliant and appropriate colleague behaviours.

### **Example:**

– Lack of colleague capacity and capability could impact the achievement of business objectives. Additional colleague stretch (including increased dependency on key staff) could result in a loss of expertise.

– Continued focus on our culture, delivering initiatives which reinforce behaviours to generate the best long-term outcomes for customers and colleagues.

– Maintain organisational people capability and capacity levels in response to increasing volumes of organisational and external market changes.



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**KEY RISK INDICATORS**

**ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS**

|   |  |
|---|--|
| Impairment charge   | <p><b>Delivering sustainable growth</b><br/>                 We have a UK customer focused, low risk, conservative and well balanced credit portfolio, managed through the economic cycle and supported by strong credit portfolio management.</p> <p>Credit risk decisions are consistent, fair and responsible, taking account of customers’ circumstances.</p> <p>We support sustainable growth and meet our targets in the Helping Britain Prosper Plan while staying within prudent risk appetite.</p>                          |
| Impaired assets   | <p>Impairments remain below long term levels and are expected to normalise over time. Emerging credit risks that have the potential to increase impairment include the global and UK economic environment as it can impact customer and counterparties’ affordability.</p>   |
| Legal, regulatory and mandatory investment spend                      | <p><b>Delivering sustainable growth</b><br/>                 We are committed to operating sustainably and responsibly, and commit significant resource and expense to ensure we meet our legal and regulatory obligations.</p> <p>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, with numerous developments in each of these areas.</p> |
| FCA reportable complaints per 1,000 accounts (excl. PPI) <sup>1</sup> | <p><b>Creating the best customer experience</b><br/>                 As we transform and simplify our business, minimising conduct risk is critical to achieving our strategic goals and meeting market and regulatory standards. Our customer focused conduct strategy forms the foundation of our vision to be the best bank for customers, allowing us to create the best customer experience through learning from past mistakes.</p>  |
| Availability of core systems  | <p><b>Creating the best customer experience</b><br/>                 We recognise the role that resilient technology plays in enabling us to create the best customer experience, and in maintaining banking services and trust across the wider industry. As such, the availability, resilience and security of our IT systems remains a key focus.</p>   |

<sup>1</sup> This key risk indicator is also a key performance indicator (KPI).

Our Cyber Programme continues to focus on improving the Groupwide cyber security controls and we regularly assess our cyber control environment, through both internal and third party testing.

**Creating the best customer experience**

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.

Best bank for customers  
index

The current regulatory regime presents some far reaching people implications in terms of personal accountability and remuneration arrangements. This coincides with the ongoing challenge of maintaining colleague capacity and capability to deliver our change agenda.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**PRINCIPAL RISKS**

**Insurance risk**

Key insurance risks within the Insurance business are longevity, persistency and property insurance. Longevity risk is expected to increase with the 2015 entry into the bulk annuity market. 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.

**Capital risk**

The risk that we have a sub-optimal amount 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.

**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.

**KEY MITIGATING ACTIONS**

– Insurance processes on underwriting, claims management, pricing and product design seek to control exposure to these risks. A team of longevity and bulk pricing experts has been built to support the new 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 exposure to accumulations of risk and possible catastrophes is mitigated by a broad reinsurance programme.

– A comprehensive capital management framework that sets and monitors capital risk appetite using a number of key metrics.

– Close monitoring of capital and leverage ratios to ensure we meet current and future regulatory requirements.

– Comprehensive stress testing analysis to evidence sufficient levels of capital adequacy under various adverse scenarios.

– Accumulation of retained profits and managing dividend policy appropriately.

– Holding a large portfolio of unencumbered LCR eligible liquid assets to meet cash and collateral outflows and regulatory requirements and maintaining a further large pool of secondary assets that can be used to access central bank liquidity facilities.

**Example:**

- Our funding and liquidity position is supported by a significant and stable customer deposit base. 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.
- Undertaking daily monitoring against a number of market and Group-specific early warning indicators and regular stress tests.

**Governance risk**

Against a background of increased regulatory focus on governance and risk management, the most significant challenges arise from the SM&CR in force from March 2016 and the requirement to improve the resolvability of the Group and to ring-fence core UK financial services and activities from January 2019.

**Example:**

- Non-compliance with or breaches of ring-fencing, resolution and SM&CR requirements will result in legal and regulatory consequences.
- Maintaining a contingency funding plan detailing management actions and strategies available in stressed conditions.
- Our response to the SM&CR is managed through a programme with work streams addressing each of the major components.
- A programme is in place to address the requirements of ring-fencing and resolution and we are in close and regular contact with regulators to develop plans for our anticipated operating and legal structures.

**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 and equity and credit spreads in the Insurance business and 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.
- Our aim is to ensure that evolving risk and governance arrangements continue to be appropriate across the range of business in the Group in order to comply with regulatory objectives.
- Structural hedge programmes have been implemented to manage liability margins and margin compression, and the Group's exposure to Bank Base Rate.
- Equity and credit spread risks are inherent within Insurance products and are closely monitored to ensure they remain within risk appetite. Where appropriate, asset liability matching is undertaken to mitigate risk.
- The Insurance business is exposed indirectly to equity and credit markets 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
- The allocation to credit assets has been increased and equity holdings reduced within the Group's Defined Benefit Pension Schemes. A hedging programme is also in place to minimise exposure to nominal rates/inflation.

annuities. Credit spreads affect the value of the Group's Defined Benefit Pension Schemes' liabilities.

- Stress and scenario testing of Group risk exposures.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**KEY RISK INDICATORS**

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

**Insurance (General Insurance)  
gross written premiums**

**Common equity tier 1 ratio<sup>1</sup>**

**Leverage ratio**

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

2 Ratios are post interim and recommended full year dividends and adjusted, reflecting dividend paid by Insurance in February 2016 in respect of 2015 earnings.

**Regulatory liquidity**

**ALIGNMENT TO STRATEGIC PRIORITIES AND FUTURE FOCUS**

**Creating the best customer experience**

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**

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, the Basel Committee is continuing to review aspects of the regulatory capital framework, and the Bank of England has consulted on its approach for setting minimum requirements for own funds and eligible liabilities. There is a risk that these could lead to higher capital requirements than we have anticipated in our strategic plans.

**Delivering sustainable growth**

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 the target range.

Loan to deposit ratio

Liquid assets are broadly equivalent to our total wholesale funding and thus provide a substantial buffer in the event of continued market dislocation.

There is a risk that our options to fund our balance sheet are reduced in future, or that the cost of funding may increase which could impact our performance versus our strategic plans.

3 Individual liquidity adequacy standards eligible primary liquid assets.

**Becoming simpler and more efficient**

Ring-fencing requirements ensure we become simpler and continue to create the best customer experience, through providing further protection to core Retail and SME deposits, provide transparency on our operations and facilitate the options available in resolution.

N/A

Resolution requirements are aimed at reducing the probability of failure and its impact on customers should we fail through continuity of critical banking services, helping rebuild trust in the financial services sector.

We already have a strong culture of ownership and accountability, and compliance with the SM&CR will enable us to further strengthen our ability to clearly demonstrate the responsibilities of Senior Managers and how these are discharged.

**Delivering sustainable growth**

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.

**Pension surplus**

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

By reducing the volatility in the Group's Defined Benefit Pension Schemes through hedging in 2014, we have taken a conservative approach to risk in line with our strategy.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### **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 40 to 45) provides a summary of risk management within the Group. It highlights the important role of risk as a strategic differentiator, risk achievements in 2015 and priorities for 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 46 to 54) and a full analysis of the primary risk drivers (pages 55 to 120) – the framework by which risks are identified, managed, mitigated and monitored.

Each risk driver is described and managed using the following standard headings: definition, appetite, 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 emerging risks to support sustainable business growth within 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 refreshed its Codes of Business and Personal Responsibility in 2015 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**

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

- The Group's strategy operates in tandem with its high level risk appetite which is supported by more detailed metrics and limits. An updated Risk Appetite Statement was approved by the Board in 2015. This incorporated challenge and recommendations from the Board Risk Committee and is fully aligned with Group strategy.

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.

Performance is optimised by allowing business units to operate within approved risk appetite and limits.

## **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 Groupwide 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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.

| Division                    | Lloyds Banking Group |                |                |         |                           |                               | Total<br>£bn |
|-----------------------------|----------------------|----------------|----------------|---------|---------------------------|-------------------------------|--------------|
|                             | Commercial           |                | Consumer       | Run-off | Central                   |                               |              |
|                             | Retail<br>£bn        | Banking<br>£bn | Finance<br>£bn |         | Items <sup>1</sup><br>£bn | Insurance <sup>2</sup><br>£bn |              |
| Risk-weighted assets (RWAs) |                      |                |                |         |                           |                               |              |
| – Credit risk               | 48.8                 | 83.4           | 17.6           | 10.0    | 12.7                      | –                             | 172.5        |
| – Counterparty credit risk  | –                    | 9.1            | –              | –       | 0.6                       | –                             | 9.7          |
| – Operational risk          | 17.1                 | 6.3            | 2.5            | 0.2     | –                         | –                             | 26.1         |
| – Market risk               | –                    | 3.7            | –              | –       | 0.1                       | –                             | 3.8          |
| Total (excluding threshold) | 65.9                 | 102.5          | 20.1           | 10.2    | 13.4                      | –                             | 212.1        |
| – Threshold <sup>4</sup>    | –                    | –              | –              | –       | 10.6                      | –                             | 10.6         |
| Total                       | 65.9                 | 102.5          | 20.1           | 10.2    | 24.0                      | –                             | 222.7        |

<sup>1</sup> 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.

As a separate regulated business, Insurance maintains its own regulatory solvency requirements, including appropriate management buffers, and reports directly to 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 the CRD IV rules, while the remainder is taken as a capital deduction.

<sup>3</sup> Exposures relating to the default fund of a central counterparty and credit valuation adjustments are included in Credit Risk and Counterparty Credit Risk respectively for the purposes of this table.

<sup>4</sup> 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 40 to 45). The Group's emerging risks are shown overleaf. Full analysis of the Group's risk drivers is on pages 55 to 120.



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**EMERGING RISKS**

The Group considers the following to be risks that have the potential to increase in significance and affect the performance of the Group.

These risks are considered alongside the Group's operating plan.

**Risk**

**Key mitigating actions**

**Regulatory and legal change:** The pace and volume of regulatory and legal change and developments including: competition; pensions; capital requirements; payments; accounting standards changes; Senior Managers and Certification Regime (SM&CR); and consumer protection laws, all have the potential to impact the delivery of our strategic objectives.

Continue to implement our conduct strategy ensuring 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 landscape.

Programmes in place to deliver SM&CR by March 2016 implementation and ring-fencing and resolution by January 2019.

**Low interest rate environment:** Continuation of the present low interest rate environment has the potential to negatively impact the delivery of the Group's strategic and operational objectives. As a result there may be a requirement to review our cost and investment priorities.

Regular reviews and updates to strategic milestones provide opportunity to reposition and reprioritise to minimise and negate potential impacts.

**Response to market changes (agility):** The dynamic nature of external influences has the potential to impact the delivery of the strategy and risk profile of the Group. As technology advances, the typical banking model is evolving, and as such, operational complexity has the potential to restrict the Group's speed of response.

Organisational and behavioural effectiveness is reviewed through regular Group Strategic Reviews, ensuring the continued drive for simplicity and efficiency, and the building of new capabilities to support sustainable growth.

Sustained and continuing investment in digital capability and customer channels with our plans progressively updated to reflect market trends and customer behaviour.

Rigorous implementation of our conduct strategy with customer needs at the centre rather than a product driven model.

**Conduct risk:** In a low growth environment we cannot compromise on our Conduct Strategy for revenue growth. Further provisions for legacy issues may be required if issues emerge which require remediation.

Programmes in place to deliver redress to customers with Groupwide rectification governance in place to enhance effectiveness.

**Data integrity, IT and cyber:** Cyber remains an evolving threat to the Group and its strategic objectives. Increased digital interconnectivity across the Group, its customers and suppliers has the potential to heighten our vulnerability to cyber-attacks, which could disrupt service for customers, and cause financial loss and reputational damage.

Delivery of the Group cyber control framework, aligned to industry-recognised cyber security framework, and continued investment in the Group's Cyber Programme to ensure integrity of key systems and processes remains a priority.

**Market liquidity:** Financial markets continue to exhibit signs of a lack of liquidity and potential impacts include the speed at which structural hedging can be undertaken and relevant asset portfolio liquidated.

–Resilience programmes in place to protect the integrity and availability of the Group's systems and mitigate the impacts of cyber-attacks.

Market liquidity is reviewed on a regular basis through specific committees which approve funding plans, based on detailed analysis to ensure regulatory compliance and future liquidity requirements are satisfied.

Engagement with relevant governmental and regulatory bodies and other agencies to deliver compliance by January 2019.

**Ring-fencing and resolution:** UK ring-fencing legislation, regulation and rules impact the Group's business and operating model and could impact the ability to, and cost of, serving customers effectively to a greater extent than current assumptions, with potential changes in the competitive landscape and changes to customer and market behaviour.

Business model design will optimise delivery of the full range of services to ring-fenced Bank customers through the provision of certain propositions from Group entities outside the ring-fence.

Assessment of the possible impacts of legislation is ongoing and the Group expects to deliver enhanced systems to fulfil related regulatory requirements.

**Leveraging data:** Increasing regulatory scrutiny under EU Data Protection Regulation may limit the extent to which customer data can be used to support the Group in achieving its strategic objectives.

Chief Data Officer reviewing Groupwide operating model and aligning the Group's appetite appropriately.

**UK political uncertainty:** An EU in-out referendum has been called for the 23 June 2016. In the event that the referendum outcome determines an exit from the EU, there may be an impact on UK trade, the domestic economy and inward investment and, in the short term, the potential for market volatility.

The Group will monitor and assess the potential impacts on an on-going basis, manage exposures according to its current risk appetite and continue to review our existing contingency plans for market volatility before and after the referendum. Current risk appetite criteria limits single counterparty bank and non-bank exposures complemented by a UK-focused strategy.

**Geopolitical shocks:** Current uncertainties could further impede the global economic recovery and adjustment from a period of ultra-accommodative monetary policy. Events in China, Russia and the Middle-East, as well as terrorist activity, have the potential to trigger changes in market risk pricing which could lead to rising funding costs.

The Group's Financial Stability Forum is in place to develop and maintain the Group's Stability Response Plan, whilst also acting as a Rapid Reaction Group, meeting when external crises occur.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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. Stress testing is fully embedded in the planning process of the Group as a key activity in medium term planning. Senior management is actively involved in stress testing activities via a strict governance process.

The Group uses scenario stress testing to:

–Assess its strategic plans to adverse economic conditions and understand key vulnerabilities of the Group.

Assess results against Board risk appetite to ensure the Group is managed within its risk parameters, allowing senior management and the Board to adjust strategies if the plan does not meet risk appetite in a stressed scenario. At the same time, the results of the stress tests will also inform the setting of risk appetite by assessing the underlying risks under stress conditions.

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.

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 buffer (see Capital Risk on pages 111 to 116).

–Meet the required standards and the information needs of internal and external stakeholders, including regulators.

#### REGULATORY STRESS TESTS

During 2015, the Group was subject to the UK-wide concurrent stress test run by the Bank of England. As announced in December, the Group comfortably exceeded the capital thresholds set by the regulator 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 a detailed macroeconomic stress test of the operating plan, which is supplemented with higher-level refreshes if necessary. The exercise aims to highlight the key vulnerabilities of the Group to adverse changes in the economic environment, and to ensure that there are adequate financial resources in the event of a downturn. The internal stress test includes different economic scenarios, both in terms of severity and focus (for example exploring the impacts of both low and high interest rate environments).

## **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 operational risk scenarios, liquidity scenarios, market risk sensitivities and business specific scenarios (see the principal risks on pages 55 to 120 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 and executive review and challenge process, supported by analysis and insight into impacts on customers and business drivers.

The Chief Economist's Office develops the internal macroeconomic scenarios used by the Group, based on key uncertainties for the Group's economic outlook. A wide set of economic parameter assumptions is constructed, with over 150 metrics provided such as Gross Domestic Product, Base Rate, unemployment, property indices, insolvencies and corporate failures to facilitate modelling of scenarios across the Group. Where an external scenario is provided, as was the case with the UK-wide concurrent Bank of England stress exercise, the Chief Economist's Office broadens the externally supplied parameters to the level of detail required by the Group.



The engagement of all required Risk and control 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.

Below is an overview of the principal output responsibilities by team:

Finance teams in the business prepare and review finance related stress testing results including, but not limited to, income, margins, costs, lending and deposit volumes.

Credit risk and market risk teams prepare and review risk-related stress outputs, including, but not limited to, impairment charges, risk-weighted assets, expected loss and trading losses.

The Group Corporate Treasury team reviews the stress outputs and evaluates the impact upon the Group's Capital and Funding Plan.

The Central Finance and Tax teams consolidate the Group position and assess the tax and regulatory capital impacts.

The Group Financial Risk team provides oversight of the Finance and Risk stress submissions as well as the consolidated Group position and capital ratios, and produces analysis packs for the Group's senior committees.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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 Procedures, which are reviewed at least annually.

The Group Financial Risk Committee (GFRC), chaired by the Chief Risk Officer and attended by the Chief Finance 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 are finalised by the divisional Finance Director's, appropriate Risk Director's and Managing Director's sign-off. The outputs are then presented to GFRC, 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 41) 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 Groupwide 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'.

Risk appetite is documented in a Board Risk Appetite Statement reviewed by the Board Risk Committee and approved annually by the Board. The Board Risk Appetite is aligned to the Risk Appetite Framework, and in turn the RMF and Group Risk Principles. An updated Board Risk Appetite Statement was approved by the Board in 2015.

The Board metrics are supported by more detailed sub-Board appetite functional risk metrics and sub-Board appetite divisional risk metrics.

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.

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 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.

Accountabilities under the Risk Appetite Framework are apportioned as follows:

### *Board:*

Approves the type and level of risk the Group is prepared to accept and the boundaries within which management must operate when setting strategy and executing the business plan.

Holds the Group Chief Executive and other Senior Executives accountable for the integrity of the Board Risk Appetite Statement.

Reviews and approves reporting against the Board Risk Appetite Statement.

Ensure executive remuneration is aligned with risk appetite adherence.

### *Group Chief Executive and Group Executive Committee members (GEC):*

Ensure that the Board Risk Appetite Statement is developed in collaboration with the Chief Risk Officer and is fully embedded in the business.

Ensure resources and processes are in place to support the Board Risk Appetite framework.

Are accountable for the integrity of the Board Risk Appetite Statement, including the timely identification and escalation of breaches and for developing mitigating actions.

–Ensure risk appetite is fully embedded across strategy, planning, decision-making processes and remuneration.

–Monitor compliance with Board Risk Appetite.

*Group Chief Risk Officer:*

Develops the Board Risk Appetite Statement in collaboration with the Group Chief Executive and other GEC members.

–Obtains the Board’s support and approval of the Board Risk Appetite Statement.

–Oversees that the metrics are fully embedded by the business and reported on a monthly basis.

–Ensures breaches are identified, escalated and appropriate mitigating action is taken by the business.

50

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Risk appetite is embedded across the Group in the following ways:

**Communication** – Board Risk Appetite metrics developed and agreed with business and operational teams. In addition Board Risk Appetite cascaded down into more detailed metrics and limits within Functional and Divisional sub-Board Risk Appetite Statements along with additional supporting metrics which should be used to drive local decision making and behaviours.

**Policies** – Group policies are aligned with Risk Appetite Statement.

**Reporting** – Performance against Board Risk Appetite metrics reported to Divisional, Functional, and Group Risk Committees and the BRC and Board.

**Performance Management** – Group and Divisional Scorecards include adherence to risk appetite as a general measure and include more detailed risk appetite measures which are pertinent for that area of the Group.

**Key Decision Making** – Strategy operates in tandem with risk appetite and the Group’s annual Operating Plan is developed within the boundaries set by risk appetite.

**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, objective assurance and consulting activity 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 Risk Division and the business, 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 six 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, key risks both current and emerging, 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.

51

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 annually, reviewing the effectiveness of their internal controls and putting in place a programme of enhancements where appropriate. Executives from each business area and each GEC member challenge and certify the accuracy of their assessment. This key process is overseen and independently challenged by Policy Owners, Risk Division and Group Audit, and reported to the Board.

**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.

**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 Conduct Strategy, Customer Treatment Policy/Standards and Financial Conduct Authority requirements.

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



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RISK GOVERNANCE**

The risk governance structure below is integral to effective risk management across the Group. Risk Division is appropriately represented on key committees to ensure that risk management is discussed in these meetings. This structure outlines the flow and escalation of risk information and reporting from business areas and Risk Division to 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**

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**BOARD, EXECUTIVE AND RISK COMMITTEES**

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

Assisted by the Board Risk and Audit Committees, the Board approves the Group’s overall governance, risk and control frameworks and risk appetite. Refer to the Corporate Governance section on pages 156 to 182, 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:**

| <b>Committees</b>                           | <b>Risk focus</b>  |
|---|--|
| Group Executive Committee (GEC)             | Supports the Group Chief Executive in exercising his authority in relation to material matters having strategic, cross-business area or Groupwide 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 Groupwide 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 Product  
Governance Committee

Provides strategic and senior oversight over design, launch and management of products including new product approval, periodic product reviews and management of risk in the back book.

Executive

Compensation  
Committee

Provides governance and oversight for Groupwide remuneration matters and policies.

Pensions Committee

Supports the Chief Financial Officer in relation to Group pension arrangements.

**The Group Risk Committee is supplemented by the following committees to 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  
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 Financial Risk  
Committee

Responsible for reviewing, challenging and recommending to GEC/GRC, the Group Individual Liquidity Adequacy Assessment and Internal Capital Adequacy Assessment Process 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 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.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**FULL ANALYSIS OF RISK DRIVERS**

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

**PRIMARY RISK DRIVERS**

| <b>Credit risk<sup>1</sup></b> | <b>Conduct risk<sup>1</sup></b> | <b>Market risk<sup>1</sup></b> | <b>Operational risk<sup>1</sup></b> | <b>Funding and liquidity risk<sup>1</sup></b> | <b>Capital risk<sup>1</sup></b> | <b>Regulatory and legal risk<sup>1</sup></b> | <b>Insurance risk<sup>1</sup></b> | <b>People risk<sup>1</sup></b> | <b>Financial reporting risk</b> | <b>Governance risk<sup>1</sup></b> |
|--------------------------------|---------------------------------|--------------------------------|-------------------------------------|---|---------------------------------|--|-----------------------------------|--------------------------------|---------------------------------|------------------------------------|
| Page 56                        | Page 93                         | Page 94                        | Page 101                            | Page 103                                      | Page 111                        | Page 117                                     | Page 117                          | Page 118                       | Page 119                        | Page 120                           |

<sup>1</sup>The Group considers these to be principal risks. See risk overview pages 42 to 45 for further details.

**SECONDARY RISK DRIVERS**

|                              |                                   |                       |                                     |                |                     |                  |  |  |  |
|------------------------------|-----------------------------------|-----------------------|-------------------------------------|----------------|---------------------|------------------|--|--|--|
| Portfolio concentration risk | Customer risk                     | Interest rate risk    | Regulatory and legal process        | Funding risk   | Capital sufficiency | Compliance risk  | Longevity risk                                       | Resourcing and Performance               | Financial and prudential regulatory reporting and compliance |
| Counterparty credit risk     | Product distribution/ advice risk | Equity risk           | Client money/ fiduciary obligations | Liquidity risk | Capital efficiency  | Competition risk | Mortality risk                                       | Culture and engagement                   | Tax reporting and compliance                                 |
| Country risk                 |                                   | Foreign exchange risk | Conduct process                     |                |                     | Legal risk       | Morbidity risk                                       | Culture and engagement                   | Tax reporting and compliance                                 |
| Collateral management risk   |                                   | Credit spread risk    | Financial crime                     |                |                     |                  | Customer behaviour risk (including persistency risk) | Talent and succession Learning Wellbeing | Pillar 3 disclosure Financial delegated                      |

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|                |                                |           |            |             |
|----------------|--------------------------------|-----------|------------|-------------|
| Alternative    | Fraud                          | Property  | regulatory | authorities |
| assets risk    | People                         | insurance | (people)   |             |
| Basis risk     | process                        | risk      |            |             |
| Commodity risk | Sourcing                       | Expenses  |            |             |
|                | Service provision              | risk      |            |             |
|                | Physical                       |           |            |             |
|                | security and health and safety |           |            |             |
|                | Information and                |           |            |             |
|                | cyber security                 |           |            |             |
|                | 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.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### CREDIT RISK

#### DEFINITION

The risk that customers to whom we have lent money or other counterparties with whom we have contracted, fail to meet their financial obligations (both on and off balance sheet), resulting in loss to the Group.

#### RISK APPETITE

Credit risk appetite is described and reported on a monthly basis through a suite of Board metrics derived from credit portfolio performance measures. The Board metrics are supported by more detailed sub-Board appetite metrics at Divisional and Business level and by a comprehensive suite of credit risk appetite statements, credit policies, sector caps, and product and country limits to manage concentration risk and exposures within the Group's approved risk appetite. The metrics cover but are not limited to geographic concentration, single name customer concentration, product exposure, Loan to Value ratios (LTVs), higher risk sector concentration, limit utilisation, leveraged exposure, equity exposure, affordability and the obligor quality of new to bank lending.

Credit risk appetite statements and credit policies are regularly reviewed to ensure that the metrics continue to reflect the Group's risk appetite appropriately. For further information on risk appetite, refer to page 46.

#### 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 53 on page F-91. 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 corporates, banks, financial institutions, sovereigns and larger SMEs) 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 as required within documentation. With respect to commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most retail commitments to extend credit can be cancelled without notice 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 2015 is shown on page 65. 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 53 on page F-90.

Credit risk exposures in the Insurance business 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 31 on page F-46 provides further information on the defined benefit 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 would be impaired and/or 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 an expected loss. If not appropriate, regulatory prescribed exposure at default and loss given default values are used in order to derive Risk-Weighted Assets (RWAs) and regulatory Expected Loss (EL). In contrast, impairment allowances are recognised for financial reporting purposes only for loss events that have occurred at the balance sheet date, based on objective evidence of impairment. Due to the different methodologies applied, the amount of incurred credit losses provided for in the financial statements differs from the amount determined from the regulatory expected loss models. Note 2(H) on page F-15 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 commercial portfolios the PD models segment counterparties into a number of rating grades, with each grade representing a defined range of default probabilities, and there are a number of different model rating scales. Counterparties/exposures migrate between rating grades if the assessment of the PD changes. The modelled PDs 'map' through local scales to a single Corporate (non-retail) Master Scale comprising of 19 non-default ratings. Together with four default ratings the Corporate Master Scale forms the basis on which internal reporting is completed.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In the principal retail portfolios, exposure at default and loss given default models are also in use. For regulatory reporting purposes, counterparties are also segmented into a number of rating grades, each representing a defined range of default probabilities and exposures migrate between rating grades if the assessment of the counterparty probability of default changes. The Retail Master scale comprises 13 non-default ratings and 1 default rating.

### 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 Group Audit and Credit Risk Assurance.

**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 systems 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 restricts exposure to higher risk countries and more vulnerable sectors and segments. Note 18 on page F-38 provides an analysis of loans and advances to customers by industry (for commercial customers) and product (for retail customers). Exposures are monitored to prevent 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 certain 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 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 49.

**Frequent and robust credit risk oversight and assurance:** Undertaken by independent Credit Risk Assurance functions operating within Retail and Consumer Credit Risk and Commercial Banking which are part of the Group's second line of defence. Its 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, credit risk classification and 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 bespoke assignments 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 of the borrower under a stressed interest rate scenario. In addition, the Group has in place quantitative limits such as product maximum limits, the level of borrowing to income and the ratio of borrowing to collateral. Some of these limits relate to internal approval levels and others are hard limits above which the Group will reject the application. The Group also has certain criteria that are applicable to specific products such as for applications for a mortgage on a property that is to be let by the applicant, Retail and Consumer Finance affordability assessments are compliant with relevant

regulatory conduct guidelines.

For UK mortgages, the Group's policy is to reject all standard applications with a Loan to Value (LTV) greater than 90 per cent. Applications with a LTV up to 95 per cent are permitted for certain schemes, for example the UK government's Help to Buy scheme. For mainstream mortgages the Group has maximum per cent LTV limits which depend upon the loan size. These limits are currently:

Table 1.4: UK mainstream loan to value analysis

| <b>Loan size</b> | <b>From To</b> | <b>Maximum LTV</b> |
|------------------|----------------|--------------------|
| £1               | £570,000       | 95%                |
| £570,001         | £750,000       | 90%                |
| £750,001         | £1,000,000     | 85%                |
| £1,000,001       | £2,000,000     | 80%                |
| £2,000,001       | £5,000,000     | 70%                |

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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The Group's approach to underwriting applications for unsecured products ensures that lending is affordable and sustainable. The Group takes reasonable steps to validate information used in the assessment of a customer's income and expenditure. The Group rejects any application for an unsecured lending product where a customer is registered as bankrupt or insolvent, or has a County Court Judgment in excess of £1,000 registered at a CRA used by the Group. In addition, the Group rejects any applicant with total unsecured debt greater than £50,000 registered at the CRA; policy rules are also in place to provide additional scrutiny to applications where an applicant's total unsecured debt-to-income ratio greater than 100 per cent.

Where credit acceptance scorecards are used, Risk Division reviews model effectiveness, while new models and model changes are referred by them to the appropriate Model Governance Committees for approval. All changes are 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 are 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 the transaction amount, the customer's aggregate facilities, credit risk ratings and the nature and term of the risk. The Group's credit risk appetite criteria for counterparty and customer underwriting is generally the same as that for assets intended to be held to maturity. All underwriting must be sanctioned via credit limits.

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 counterparty to cover the aggregate of all settlement risk arising from the Group's market transactions on any single day.

## Collateral

The principal collateral types for loans and advances, 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.

It is policy that 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 types of collateral taken and the requirement for which collateral is required at origination is dependent upon 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 mortgage debenture over the company's undertaking and one or more of its assets, and key man insurance. The Group maintains policies setting out acceptable collateral, maximum LTV ratios and other criteria to be considered when reviewing an application. The decision as to whether or not collateral is required will be based upon the nature of the transaction and the credit worthiness of the

customer/counterparty. Other than for project finance, object finance and income producing real estate where charges over the subject assets are a basic requirement, 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 rigorously assessed at the time of loan origination. It is the Group's policy that collateral should always be realistically valued by an appropriately qualified source, independent of both the credit decision process and the customer, at the time of borrowing. Collateral values are reviewed on a regular basis and will vary according to the type of lending and collateral involved. For residential mortgages, the Group adjusts open market property values to take account of the costs of realisation and any discount associated with the realisation of the collateral when estimating credit losses. In order to minimise the credit loss, the Group may seek additional collateral from the counterparty as soon as early warning signs are identified for the relevant individual loans and advances.

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

Credit policies are in place to avoid correlation or wrong way risk. Under the repo policies, the issuer of the collateral and the repo counterparty should be neither the same nor connected. The same rule applies for derivatives under collateral policies. The Risk Division has the necessary discretion to

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 53 for further information on collateral.

### **Master netting agreements**

Where it is appropriate and likely to be effective, the Group seeks to enter into master netting agreements. Although master netting agreements do not generally result in an offset of balance sheet assets and liabilities for accounting purposes, as transactions are usually settled on a gross basis, they do reduce the credit risk to the extent that, if an event of default occurs, all amounts with the counterparty are terminated and settled on a net basis. The Group's overall exposure to credit risk on derivative instruments subject to master netting agreements can change substantially within a short period, since 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 treatments to assist borrowers who are experiencing financial stress. The material elements of these treatments 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 retail customers in financial distress is to benefit both the customer and the Group by discharging the Group's regulatory and social responsibilities to support its customers and act in their best long-term interests and 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 retail customers who are encountering financial difficulties. Cases are managed on an individual basis, with the circumstances of each customer considered separately and the action taken judged as being affordable and sustainable for the customer. Operationally, the provision and review of such assistance is controlled through the application of an appropriate policy framework, controls around the execution of policy, regular review of the different treatments to confirm that they remain appropriate, monitoring of customers' performance and the level of payments received, and management visibility of the nature and extent of assistance provided and the associated risk.

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

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.

#### *CUSTOMERS RECEIVING SUPPORT FROM UK GOVERNMENT SPONSORED PROGRAMMES*

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

Income Support for Mortgage Interest – This is a government medium term initiative that provides certain defined categories of customers, principally those who are unemployed, access to a benefit scheme, paid for by the government, which covers all or part of the interest on the mortgage. Qualifying customers are able to claim for mortgage interest on up to £200,000 of the mortgage. All decisions regarding an individual's eligibility and any amounts payable under the scheme rest solely with the government. Payments are made directly to the Group by the Department of Work and Pensions.

Mortgage Rescue Schemes – This is a government initiative for borrowers in difficulty and facing repossession, who would have priority for re-housing by a local authority (e.g. the elderly, disabled, single parents). Eligible customers can have their property bought in full or part by the social rented sector and then remain in their home as a tenant or shared equity partner. If the property is sold outright the mortgage is redeemed in full. Government sponsored Mortgage Rescue Scheme (MRS) options are currently available in Wales and Scotland (in Scotland the MRS option is called

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

the Home Owner's Support Fund). No MRS options are available in Northern Ireland although one may be launched by the government in the future. In England, the government ceased funding and closed its MRS option in the second quarter of 2015.

The Group assesses whether a loan benefiting from a UK government sponsored programme is impaired using the same accounting policies and practices as it does for loans not benefiting from such a programme. There is no direct impact on the impairment status of a loan benefiting from the Mortgage Rescue schemes, as these schemes involve the purchase, and eventual sale, of the property. The loans included within the Income Support for Mortgage Interest scheme may be impaired, in accordance with the normal definition of impairment.

The Income Support for Mortgage Interest scheme remains the most successful of the government backed schemes. It is the longest-running, is the most widely known and provides both the customer and the Group with an assurance as to the maintenance of at least two years' worth of interest payments. The Group estimates that customers representing approximately £2.2 billion of its mortgage exposures are receiving this benefit. This includes those who are also receiving other treatments for financial difficulty.

### *FORBEARANCE IDENTIFICATION, CLASSIFICATION AND MEASUREMENT*

The Group classifies a retail account 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. Details of the exit criteria are shown in the analysis on page 61. 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.

### *CUSTOMERS IN FINANCIAL DIFFICULTY RECEIVING SUPPORT UNDER OTHER SCHEMES*

The Group measures the success of a forbearance scheme 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, 79 per cent of customers accepting reduced payment arrangements are performing. For permanent treatments, 82 per cent of customers who have accepted capitalisations of arrears and 84 per cent of customers who have accepted term extensions are performing.

### **Commercial customers**

Early identification, control and monitoring are key in order to support the customer and protect 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 by the independent Risk Division (and more frequently where required). As part of the Group's established Credit Risk Classification system, every exposure in the good book is categorised as either 'good' or 'watchlist'. 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 the possibility to become higher risk in the future.

Those customers deemed higher risk where there is cause for concern over future repayment capability or where there is a risk of impairment will lead to the customer being transferred to the Business Support Unit (BSU) at an early stage. The over-arching aim of the BSU is to provide support and work consensually with each customer to try and resolve the issues, to 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.

BSU case officers manage non-retail distressed assets in Commercial Banking and Run-off divisions, 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.

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, cashflow (and therefore debt serviceability) and will 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 customer's ability to successfully manage the business effectively in a distressed situation where turnaround is required;

analysis of market sector factors, i.e. products, customers, suppliers, pricing and margin issues;

performance review of operational areas that should be considered in terms of current effectiveness and efficiency and scope for improvements;

-financial analysis to model plans and factor in potential sensitivities, vulnerabilities and upsides; and

-determining the most appropriate corporate and capital structure suitable for the work-out strategy concerned.

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

The level of Commercial Banking division BSU gross lending to customers reduced from £5.0 billion to £4.2 billion between 31 December 2014 and 31 December 2015. 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 accounting policy for loan renegotiations is set out in note 2(H) on page F-16. Income statement information set out in the credit risk tables is on an underlying basis (see page 26).

#### *FORBEARANCE*

A key factor in determining whether the Group treats a commercial customer as forborne is the granting of a concession to a borrower who experiences, or is believed to be about to experience, financial difficulty and which is outside the Group's current risk appetite. 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

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 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.

### *TYPES OF FORBEARANCE*

The Group's strategy and offer of forbearance is largely dependent on the individual situation and 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 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 the forbearance concession.

#### *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.

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.



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**THE GROUP CREDIT RISK PORTFOLIO IN 2015**

*Significant reduction in impairments and impaired assets*

Excluding TSB, the impairment charge decreased by 48 per cent to £568 million in 2015 compared to £1,102 million in 2014. The impairment charge is lower across all divisions and benefited from provision releases, but at lower levels than seen during 2014.

The reduction reflects lower levels of new impairment as a result of effective risk management, a favourable credit environment, improving UK economic conditions and continued low interest rates.

The asset quality ratio (impairment charge as a percentage of average loans and advances to customers) improved to 0.14 per cent compared to 0.23 per cent during 2014.

At the Group Strategic Update in October 2014, we outlined that although it would be lower between 2015 to 2017, we expect the Group asset quality ratio to be c.40 basis points through the economic cycle.

In 2016, the Group expects to benefit from its continued disciplined approach to the management of credit and the resilient UK economy. Write-backs and provision releases, however, are expected to be at a lower level and as a result, the Group expects the asset quality ratio for the 2016 full year to be around 20 basis points.

Impaired loans as a percentage of closing loans and advances reduced to 2.1 per cent at 31 December 2015, from 2.9 per cent at 31 December 2014 driven by reductions within the continuing and run-off portfolios, including the sale of Irish commercial loans during the third quarter. Provisions as a percentage of impaired loans reduced from 56.4 per cent to 46.1 per cent reflecting the disposal of highly covered assets during the year.

Retail division impairment provisions as a percentage of impaired loans have increased to 40.4 per cent from 38.8 per cent at 31 December 2014, with Secured increasing by 0.5 percentage points to 37.5 per cent. Consumer Finance division impairment provisions as a percentage of impaired loans have increased to 72.8 per cent from 70.5 per cent at 31 December 2014, with Credit Cards increasing by 5.3 percentage points to 81.8 per cent and Asset Finance UK decreasing by 2.8 percentage points to 67.2 per cent.

*Low risk culture and prudent risk appetite*

The Group is delivering sustainable lending growth by maintaining its lower risk origination discipline and underwriting standards, despite terms and conditions in some of the Group's markets being impacted by increased competition. The overall quality of the portfolio has improved over the last 12 months.

Credit performance of the UK Retail secured portfolio has been good, with improvements in LTVs, arrears, impaired loans and impairment charge on both Mainstream and Buy-to-let portfolios. Loans and advances to mainstream customers were broadly flat during the year at £227.3 billion with the Buy-to-let portfolio growing by 4 per cent to £55.6 billion. The closed specialist portfolio has continued to run-off, reducing by 10 per cent to £19.5 billion.

The Group's UK Direct Real Estate gross lending (defined internally as exposure which is directly supported by cash flows from property activities) at 31 December 2015 in Commercial Banking, Wealth (within Retail division) and Run-off divisions was £19.5 billion (31 December 2014: gross £21.6 billion). The portfolio continues to reduce significantly, and the higher risk Run-off element of the book has reduced from gross £3.3 billion to gross £1.1 billion during 2015. The remaining gross lending of £18.4 billion (31 December 2014: £18.3 billion) is the lower risk element in Commercial Banking and Wealth, where the Group continues to write new business within conservative risk appetite parameters.

Our Commercial Banking portfolios continue to benefit from our robust focus on credit at origination and our through the cycle risk appetite.

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

The Group's extensive and thorough credit processes and controls ensure effective risk management, including early identification and management of potential concern customers and counterparties.

***Re-shaping of the group is substantially complete***

The run-off portfolio has materially reduced through de-risking and the strategic desire to exit the residual portfolio still remains. There was a 38 per cent reduction in gross loans and advances in 2015 to £11,422 million (31 December 2014: £18,316 million).

Run-off net external assets have reduced from £16,857 million to £12,154 million during 2015. The portfolio now represents only 2.3 per cent of the overall Group's loans and advances (31 December 2014: 3.0 per cent).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.5: Group impairment charge  
2015

|   | Loans and advances to customers<br>£m | Debt securities classified as loans and receivables<br>£m | Available-for-sale financial assets<br>£m | Other credit risk provisions<br>£m | Total<br>£m  | 2014<br>£m   | Change<br>%   |
|---|---------------------------------------|---|---|------------------------------------|--------------|--------------|---------------|
| Retail  | 432                                   | –   | –   | –                                  | 432          | 599          | 28            |
| Commercial Banking  | 9                                     | –   | –   | (31)                               | (22)         | 83           |               |
| Consumer Finance  | 152                                   | –   | –   | –                                  | 152          | 215          | 29            |
| Run-off   | 28                                    | (2)   | 4   | (22)                               | 8            | 203          | 96            |
| Central items   | –                                     | –   | –   | (2)                                | (2)          | 2            |               |
| Total impairment charge excluding TSB                     | 621                                   | (2)   | 4   | (55)                               | 568          | 1,102        | 48            |
| TSB   |                                       |   |   |                                    | –            | 98           |               |
| <b>Total impairment charge</b>                            |                                       |   |   |                                    | <b>568</b>   | <b>1,200</b> | <b>53</b>     |
| Impairment charge as a % of average advances <sup>1</sup> |                                       |   |   |                                    | <b>0.14%</b> | <b>0.23%</b> | <b>(9)bps</b> |

1 Excludes TSB.

Table 1.6: Movement in gross impaired loans  
2015

|  | Retail<br>£m | Commercial Banking<br>£m | Consumer Finance<br>£m | Run-off<br>£m | TSB<br>£m | Total<br>£m  | 2014<br>Total<br>£m |
|--|--------------|--------------------------|------------------------|---------------|-----------|--------------|---------------------|
| At 1 January                                   | 4,927        | 3,241                    | 720                    | 5,215         | 205       | 14,308       | 32,259              |
| Classified as impaired during the year         | 2,008        | 631                      | 179                    | 583           | –         | 3,401        | 4,825               |
| Transferred to not impaired during the year    | (1,080)      | (146)                    | (72)                   | (60)          | –         | (1,358)      | (4,526)             |
| Repayments                                     | (831)        | (693)                    | (68)                   | (137)         | –         | (1,729)      | (3,075)             |
| Amounts written off                            | (523)        | (225)                    | (107)                  | (648)         | –         | (1,503)      | (7,004)             |
| Impact of disposal of business and asset sales | (3)          | (48)                     | (55)                   | (3,092)       | (205)     | (3,403)      | (7,288)             |
| Exchange and other movements                   | (4)          | (232)                    | (54)                   | 164           | –         | (126)        | (883)               |
| <b>At 31 December</b>                          | <b>4,494</b> | <b>2,528</b>             | <b>543</b>             | <b>2,025</b>  | <b>–</b>  | <b>9,590</b> | <b>14,308</b>       |

63

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.7: Group impaired loans and provisions

|  | Loans and advances to customers<br>£m | Impaired loans<br>£m | Impaired loans as % of closing advances<br>% | Impairment provisions <sup>1</sup><br>£m | Impairment provision as % of impaired loans <sup>2</sup><br>% |
|--|---------------------------------------|----------------------|--|--|---|
| <b>At 31 December 2015</b>                 |                                       |                      |  |  |   |
| Retail                                     | 316,036                               | 4,494                | 1.4  | 1,670                                    | 40.4  |
| Commercial Banking                         | 102,435                               | 2,528                | 2.5  | 1,087                                    | 43.0  |
| Consumer Finance                           | 23,938                                | 543                  | 2.3  | 265                                      | 72.8  |
| Run-off                                    | 11,422                                | 2,025                | 17.7   | 1,150                                    | 56.8  |
| TSB  |                                       |                      |  |  |   |
| Reverse repos and other items <sup>3</sup> | 5,798                                 | –                    |  | –  |   |
| <b>Total gross lending</b>                 | <b>459,629</b>                        | <b>9,590</b>         | <b>2.1</b>                                   | <b>4,172</b>                             | <b>46.1</b>   |
| Impairment provisions                      | (4,172)                               | )                    |  |  |   |
| Fair value adjustments <sup>4</sup>        | (282)                                 | )                    |  |  |   |
| <b>Total Group</b>                         | <b>455,175</b>                        |                      |  |  |   |
| <b>At 31 December 2014</b>                 |                                       |                      |  |  |   |
| Retail                                     | 317,347                               | 4,927                | 1.6  | 1,734                                    | 38.8  |
| Commercial Banking                         | 102,459                               | 3,241                | 3.2  | 1,594                                    | 49.2  |
| Consumer Finance                           | 21,273                                | 720                  | 3.4  | 309                                      | 70.5  |
| Run-off                                    | 18,316                                | 5,215                | 28.5   | 3,927                                    | 75.3  |
| TSB  | 21,729                                | 205                  | 0.9  | 88                                       | 42.9  |
| Reverse repos and other items <sup>3</sup> | 9,635                                 |                      |  |  |   |
| <b>Total gross lending</b>                 | <b>490,759</b>                        | <b>14,308</b>        | <b>2.9</b>                                   | <b>7,652</b>                             | <b>56.4</b>   |
| Impairment provisions                      | (7,652)                               | )                    |  |  |   |
| Fair value adjustments <sup>4</sup>        | (403)                                 | )                    |  |  |   |
| <b>Total Group</b>                         | <b>482,704</b>                        |                      |  |  |   |

1 Impairment provisions include collective unidentified impairment provisions.

Impairment provisions as a percentage of impaired loans are calculated excluding Retail and Consumer Finance loans in recoveries (31 December 2015: £335 million in Retail Loans and Overdrafts, £28 million in Retail other and £179 million in Consumer Finance credit cards; 31 December 2014: £437 million in Retail loans and overdrafts, £26 million in Retail other and £282 million in Consumer Finance Credit Cards).

<sup>3</sup> Includes £5.7 billion (31 December 2014: £4.4 billion) of lower risk loans sold by Commercial Banking and Retail to Insurance to back annuitant liabilities.

<sup>4</sup> The fair value adjustments relating to loans and advances were made on the acquisition of HBOS to reflect the fair value of the acquired assets and took into account both the expected losses and market liquidity at the date of acquisition. The unwind relating to future impairment losses requires management judgement to assess whether the losses incurred in the current period were expected at the date of the acquisition and assessing whether the remaining losses expected at the date of the acquisition will still be incurred. The element relating to market liquidity unwinds to the income statement over the estimated expected lives of the related assets (until 2014 for commercial loans and 2018 for retail loans) although if an asset is written-off or suffers previously unexpected impairment then this

element of the fair value will no longer be considered a timing difference (liquidity) but permanent (impairment). The fair value unwind in respect of impairment losses incurred was £97 million for the period ended 31 December 2015 (31 December 2014: £251 million). The fair value unwind in respect of loans and advances is expected to continue to decrease in future years as fixed-rate periods on mortgages expire, loans are repaid or written-off, and will reduce to zero over time.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.8: Derivative credit risk exposures

|                      | Traded on<br>recognised<br>exchanges<br>£m | 2015  |   |                         | Total<br>£m | Traded on<br>recognised<br>exchanges<br>£m | 2014  |  |
|----------------------|--|---|---|-------------------------|-------------|--|---|--|
|                      |  | Traded over the counter                       |   | Traded over the counter |             |  |   |  |
|                      |  | Settled<br>by central<br>counterparties<br>£m | Not settled<br>by central<br>counterparties<br>£m |                         |             | Settled by central<br>counterparties<br>£m | Not settled<br>by central<br>counterparties<br>£m |  |
| Notional<br>balances |  |   |   |                         |             |  |   |  |
| Foreign<br>exchange  | 6,568                                      | –   | 383,722   | 390,290                 | –           | –  | 456,215   |  |
| Interest<br>rate     | 31,128                                     | 3,598,307                                     | 791,351   | 4,420,786               | 82,201      | 5,768,373                                  | 972,531   |  |
| Equity<br>and other  | 4,837                                      | –   | 9,337   | 14,174                  | 4,808       | –  | 10,034  |  |
| Credit               | –  | –   | 4,566   | 4,566                   | –           | –  | 18,063  |  |
| Total                | 42,533                                     | 3,598,307                                     | 1,188,976   | 4,829,816               | 87,009      | 5,768,373                                  | 1,456,843   |  |
| Fair<br>values       |  |   |   |                         |             |  |   |  |
| Assets               |  | 103   | 28,811  |                         |             | 127  | 35,322  |  |
| Liabilities          |  | (131  | ) (26,149   | )                       |             | (117                                       | ) (32,988   |  |
| Net asset            |  | (28   | ) 2,662   |                         |             | 10   | 2,334   |  |

The total notional principle amount of interest rate, exchange rate, credit derivative and equity and other contracts outstanding at 31 December 2015 and 31 December 2014 is shown in the table above. The notional principle 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 53 on page F-90.

*RETAIL*

The impairment charge was £432 million in 2015, a decrease of 28 per cent against 2014. The decrease reflects continued low risk underwriting discipline, strong portfolio management and a favourable credit environment with low unemployment, increasing house prices and continued low interest rates.

The impairment charge, as a percentage of average loans and advances to customers, improved to 14 basis points in 2015 from 19 basis points in 2014.

Impaired loans decreased by £433 million to £4,494 million, which represented 1.4 per cent of closing loans and advances to customers at 31 December 2015 (31 December 2014: 1.6 per cent).

Retail Division Impairment coverage has increased to 40.4 per cent from 38.8 per cent at the end of 2014, with Secured coverage increasing 0.5 per cent to 37.5 per cent.

Table 1.9: **Retail impairment charge**

|  | 2015  | 2014  | Change |
|--|-------|-------|--------|
|  | £m    | £m    | %      |
| Secured                                      | 98    | 281   | 65     |
| Loans and overdrafts                         | 311   | 279   | (11 )  |
| Wealth                                       | 2     | 8     | 75     |
| Retail Business Banking                      | 21    | 31    | 32     |
| Total impairment charge                      | 432   | 599   | 28     |
| Impairment charge as a % of average advances | 0.14% | 0.19% | (5)bps |

65

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.10: Retail impaired loans and provisions

|                          | Loans and advances to customers<br>£m | Impaired loans<br>£m | Impaired loans as a % of closing advances<br>% | Impairment provisions <sup>1</sup><br>£m | Impairment provisions as a % of impaired loans <sup>2</sup><br>% |
|--------------------------|---------------------------------------|----------------------|--|--|--|
| At 31 December 2015      |                                       |                      |  |  |  |
| Secured                  | 302,413                               | 3,818                | 1.3  | 1,431                                    | 37.5   |
| Loans and overdrafts:    |                                       |                      |  |  |  |
| Collections              |                                       | 243                  |  | 197                                      | 81.8   |
| Recoveries <sup>3</sup>  |                                       | 335                  |  | –  | –  |
|                          | 9,917                                 | 578                  | 5.8  | 197                                      | 81.1   |
| Wealth                   | 2,811                                 | 55                   | 2.0  | 23                                       | 41.8   |
| Retail Business Banking: |                                       |                      |  |  |  |
| Collections              |                                       | 15                   |  | 19                                       |  |
| Recoveries <sup>3</sup>  |                                       | 28                   |  | –  |  |
|                          | 895                                   | 43                   | 4.8  | 19                                       | 126.7  |
| Total gross lending      | 316,036                               | 4,494                | 1.4  | 1,670                                    | 40.4   |
| Impairment provisions    | (1,670 )                              |                      |  |  |  |
| Fair value adjustments   | (273 )                                |                      |  |  |  |
| Total                    | 314,093                               |                      |  |  |  |
| At 31 December 2014      |                                       |                      |  |  |  |
| Secured                  | 303,121                               | 3,911                | 1.3  | 1,446                                    | 37.0   |
| Loans and overdrafts:    |                                       |                      |  |  |  |
| Collections              |                                       | 258                  |  | 220                                      | 85.3   |
| Recoveries <sup>3</sup>  |                                       | 437                  |  | –  | –  |
|                          | 10,395                                | 695                  | 6.7  | 220                                      | 85.3   |
| Wealth                   | 2,962                                 | 270                  | 9.1  | 40                                       | 14.8   |
| Retail Business Banking: |                                       |                      |  |  |  |
| Collections              |                                       | 25                   |  | 28                                       |  |
| Recoveries <sup>3</sup>  |                                       | 26                   |  | –  |  |
|                          | 869                                   | 51                   | 5.9  | 28                                       | 112.0  |
| Total gross lending      | 317,347                               | 4,927                | 1.6  | 1,734                                    | 38.8   |
| Impairment provisions    | (1,734 )                              |                      |  |  |  |
| Fair value adjustments   | (392 )                                |                      |  |  |  |
| Total                    | 315,221                               |                      |  |  |  |

1 Impairment provisions include collective unidentified impairment provisions.

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

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

*SECURED*



The impairment charge was £98 million, a decrease of 65 per cent against 2014. The impairment charge as a percentage of average loans and advances to customers, improved to 3 basis points from 9 basis points in 2014.

Loans and advances to Mainstream customers were broadly flat during the year at £227.3 billion with the Buy-to-let portfolio growing by 4 per cent to £55.6 billion. The closed Specialist portfolio has continued to run-off, reducing by 10 per cent to £19.5 billion.

Impaired loans reduced by £93 million in 2015 to £3,818 million at 31 December 2015 with reductions in both the Mainstream and Buy-to-let portfolios. Impairment provisions as a percentage of impaired loans increased to 37.5 per cent from 37.0 per cent at 31 December 2014.

The value of mortgages greater than three months in arrears (excluding repossessions) decreased by £439 million to £5,905 million at 31 December 2015 (31 December 2014: £6,344 million), with reductions in both the Mainstream and Buy-to-let portfolios.

The average indexed loan to value (LTV) of the residential mortgage portfolio at 31 December 2015 decreased to 46.1 per cent compared with 49.2 per cent at 31 December 2014. The percentage of closing loans and advances with an indexed LTV in excess of 100 per cent decreased to 1.1 per cent at 31 December 2015, compared with 2.2 per cent at 31 December 2014.

The average LTV for new residential mortgages written in 2015 was 64.7 per cent compared with 64.8 per cent for 2014.

#### *LOANS AND OVERDRAFTS*

The impairment charge was £311 million, an increase of 11 per cent against 2014.

The impairment charge as a percentage of average loans and advances to customers, increased to 3.0 per cent in 2015 from 2.6 per cent in 2014.

Impaired loans reduced by £117 million in 2015 to £578 million representing 5.8 per cent of closing loans and advances to customers, compared with 6.7 per cent at 31 December 2014.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.11: Retail secured and unsecured loans and advances to customers

|                         | At<br>31 Dec 2015<br>£m | At<br>31 Dec 2014<br>£m |
|-------------------------|-------------------------|-------------------------|
| Secured:                |                         |                         |
| Mainstream              | 227,267                 | 228,176                 |
| Buy-to-let              | 55,598                  | 53,322                  |
| Specialist <sup>1</sup> | 19,548                  | 21,623                  |
|                         | 302,413                 | 303,121                 |
| Loans and overdrafts:   |                         |                         |
| Loans                   | 7,889                   | 8,204                   |
| Overdrafts              | 2,028                   | 2,191                   |
|                         | 9,917                   | 10,395                  |
| Wealth                  | 2,811                   | 2,962                   |
| Retail Business Banking | 895                     | 869                     |
| Total gross lending     | 316,036                 | 317,347                 |

<sup>1</sup> Specialist lending has been closed to new business since 2009.

Table 1.12: Mortgages greater than three months in arrears (excluding repossessions)

|            | Number of cases |            | Total mortgage accounts % |        | Value of loans <sup>1</sup> |         | Total mortgage balances % |        |
|------------|-----------------|------------|---------------------------|--------|-----------------------------|---------|---------------------------|--------|
|            | 2015 cases      | 2014 cases | 2015 %                    | 2014 % | 2015 £m                     | 2014 £m | 2015 %                    | 2014 % |
| Mainstream | 34,850          | 37,849     | 1.6                       | 1.7    | 3,803                       | 4,102   | 1.7                       | 1.8    |
| Buy-to-let | 5,021           | 5,077      | 1.0                       | 1.1    | 626                         | 658     | 1.1                       | 1.2    |
| Specialist | 8,777           | 9,429      | 6.4                       | 6.3    | 1,476                       | 1,584   | 7.6                       | 7.3    |
| Total      | 48,648          | 52,355     | 1.7                       | 1.8    | 5,905                       | 6,344   | 2.0                       | 2.1    |

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

The stock of repossessions decreased to 654 cases at 31 December 2015 compared to 1,740 cases at 31 December 2014.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.13: Period end and average LTVs across the Retail mortgage portfolios

|                                     | Mainstream<br>% | Buy-to-let<br>% | Specialist<br>% | Total<br>% | Unimpaired<br>% | Impaired<br>% |
|-------------------------------------|-----------------|-----------------|-----------------|------------|-----------------|---------------|
| 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: <sup>1</sup> |                 |                 |                 |            |                 |               |
| 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       |                 |               |
| At 31 December 2014                 |                 |                 |                 |            |                 |               |
| Less than 60%                       | 44.6            | 32.4            | 31.4            | 41.5       | 41.7            | 22.5          |
| 60% to 70%                          | 19.9            | 27.3            | 19.5            | 21.2       | 21.3            | 15.3          |
| 70% to 80%                          | 18.5            | 21.8            | 19.8            | 19.2       | 19.2            | 17.8          |
| 80% to 90%                          | 10.6            | 9.4             | 14.9            | 10.7       | 10.6            | 16.7          |
| 90% to 100%                         | 4.5             | 6.8             | 8.7             | 5.2        | 5.2             | 11.9          |
| Greater than 100%                   | 1.9             | 2.3             | 5.7             | 2.2        | 2.0             | 15.8          |
| Total                               | 100.0           | 100.0           | 100.0           | 100.0      | 100.0           | 100.0         |
| Outstanding loan value (£m)         | 228,176         | 53,322          | 21,623          | 303,121    | 299,210         | 3,911         |
| Average Loan to value: <sup>1</sup> |                 |                 |                 |            |                 |               |
| Stock of residential mortgages      | 46.3            | 61.3            | 59.2            | 49.2       |                 |               |
| New residential lending             | 65.3            | 62.7            | n/a             | 64.8       |                 |               |
| Impaired mortgages                  | 60.1            | 81.0            | 72.6            | 64.9       |                 |               |

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

*INTEREST-ONLY MORTGAGES*

The Group provides interest-only mortgages to customers, whereby payments of interest only are made for the term of the mortgage, with the customer responsible for repaying the principal outstanding at the end of the loan term.

Retail has reduced its exposure to owner occupier interest-only mortgages throughout 2015. New owner occupier interest only mortgages are limited to a maximum loan to value of 75 per cent, with a verifiable repayment vehicle sufficient to repay the loan. Interest-only mortgages represented 0.1 per cent of new residential mortgages in 2015 (0.1 per cent in 2014).

Table 1.14: Analysis of owner occupier interest-only mortgages

|  | 2015   | 2014   |
|--|--------|--------|
| Interest-only balances (£m) <sup>1</sup>                 | 81,558 | 90,649 |
| Impaired Loans (£m)                                      | 2,071  | 2,012  |
| Interest-only balances as a % of owner occupier balances | 33.9   | 37.2   |
| Average loan to value (%)                                | 46.6   | 51.0   |

<sup>1</sup> In addition the Group has Buy-to-let interest only balances of £49,751 million (2014: £47,761 million) and certain other interest only balances of £3,705 million (2014: £4,153 million).

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. The weighted-average term to maturity of the interest-only balances included in the table above is 11 years; the profile of owner occupier interest-only maturities is shown below.

Table 1.15: Analysis of owner occupier interest-only mortgages maturities

|  | 1<br>Year<br>£bn | 2-5<br>Years<br>£bn | 6-10<br>Years<br>£bn | > 11<br>Years<br>£bn |
|--|------------------|---------------------|----------------------|----------------------|
| <b>Value of loans as at 31 December 2015<sup>1</sup></b> | 2.0              | 9.1                 | 14.5                 | 45.2                 |
| Value of loans as at 31 December 2014 <sup>1</sup>       | 1.8              | 9.2                 | 14.6                 | 52.7                 |

<sup>1</sup> Excludes mortgage accounts which consist of partial interest only and partial capital repayment.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Treatment strategies exist to help customers who may not be able to fully repay the principal balance at maturity. Of the owner occupier interest only mortgages that have missed the payment of principal at the end of term, balances of £1,313 million remain at 31 December 2015 (£1,117 million at 31 December 2014). The average indexed loan to value of these accounts is 28.0 per cent at 31 December 2015 (28.7 per cent at 31 December 2014). Of these accounts, 9.1 per cent are impaired (8.4 per cent at 31 December 2014).

*FORBORNE LOANS*

At 31 December 2015, UK secured loans and advances currently or recently subject to forbearance were 1.0 per cent (31 December 2014: 1.4 per cent) of total UK secured loans and advances. The reduction in forbearance is due to the overall improvement of credit quality of the portfolio. Loans and overdrafts currently or recently subject to forbearance were 1.5 per cent (31 December 2014: 1.6 per cent) of total loans and overdrafts.

Further analysis of the forborne loan balances is set out below:

Table 1.16: UK retail forborne loans and advances (audited)

|  | Total loans and advances which are forborne <sup>1</sup> |            | Total forborne loans and advances which are impaired <sup>1</sup> |            | Impairment provisions as % of loans and advances which are forborne <sup>1</sup> |           |
|--|--|------------|---|------------|--|-----------|
|  | 2015<br>£m   | 2014<br>£m | 2015<br>£m  | 2014<br>£m | 2015<br>%  | 2014<br>% |
| UK secured lending:                              |  |            |   |            |  |           |
| Temporary forbearance arrangements               |  |            |   |            |  |           |
| Reduced contractual monthly payment <sup>2</sup> | –  | 146        | –   | 29         | –  | 6.0       |
| Reduced payment arrangements <sup>3</sup>        | 414  | 552        | 41  | 69         | 4.2  | 3.4       |
|  | 414  | 698        | 41  | 98         | 4.2  | 4.0       |
| Permanent treatments                             |  |            |   |            |  |           |
| Repair and term extensions <sup>4</sup>          | 2,688  | 3,696      | 132   | 168        | 4.2  | 3.5       |
| Total  | 3,102  | 4,394      | 173   | 266        | 4.2  | 3.5       |
| <b>Loans and overdrafts<sup>5</sup>:</b>         | 147  | 162        | 119   | 139        | 40.0   | 39.4      |

<sup>1</sup> Includes accounts where the customer is currently benefiting from a forbearance treatment or the treatment has recently ended.

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2 Includes temporary interest-only arrangements and short-term payment holidays granted in collections where the customer is currently benefiting from the treatment and where the concession has ended within the previous six months (temporary interest-only) and previous 12 months (short-term payment holidays).

3 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.

4 Includes capitalisation of arrears and term extensions which commenced during the previous 24 months and where the borrowers remain as customers at 31 December.

5 Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the previous six months. Permanent changes which commenced during the last 24 months for existing customers as at 31 December are also included.

UK secured forbore loans and advances have reduced by £1,292 million in 2015 to £3,102 million, driven primarily by an improvement in the underlying quality of the portfolio, with a greater value exiting forbearance than entering. Loans and Overdrafts forbore loans and advances have reduced by £15 million in 2015.

Further analysis of the movements in UK retail lending forbore loans and advances during the year is as follows:

Table 1.17: **Movement in UK retail forbore loans and advances (audited)**

|                                       | 2015                     |  | 2014                     |  |
|---------------------------------------|--------------------------|--|--------------------------|--|
|                                       | Secured<br>lending<br>£m | Loans and<br>Overdrafts<br>lending<br>£m | Secured<br>lending<br>£m | Loans and<br>Overdrafts<br>lending<br>£m |
| At 1 January                          | 4,394                    | 162                                      | 6,153                    | 191                                      |
| Classified as forbore during the year | 1,290                    | 69                                       | 1,805                    | 123                                      |
| Written-off/sold                      | (25 )                    | (55 )                                    | (93 )                    | (77 )                                    |
| Good exit from forbearance            | (2,252)                  | (25 )                                    | (2,957)                  | (35 )                                    |
| Redeemed or repaid                    | (263 )                   | (6 )                                     | (462 )                   | (10 )                                    |
| Exchange and other movements          | (42 )                    | 2  | (52 )                    | (30 )                                    |
| At 31 December                        | 3,102                    | 147                                      | 4,394                    | 162                                      |

69

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*COMMERCIAL BANKING*

There was a net impairment release of £22 million in 2015, compared to a charge of £83 million in 2014. This has been driven by lower levels of new impairment as a result of effective risk management, improving UK economic conditions and the continued low interest rate environment; as well as write backs and provision releases, but at lower levels than seen during 2014.

The credit quality of the portfolio and new business remains good. Surplus market liquidity continues to lead to some relaxation of credit conditions in the marketplace, although the Group remains disciplined within its low risk appetite approach.

Impaired loans reduced by 22 per cent to £2,528 million at 31 December 2015 compared with 31 December 2014 (£3,241 million) and as a percentage of closing loans and advances reduced to 2.5 per cent from 3.2 per cent at 31 December 2014.

Impairment provisions reduced to £1,087 million at 31 December 2015 (December 2014: £1,594 million) and includes collective unidentified impairment provisions of £229 million (31 December 2014: £338 million). Provisions as a percentage of impaired loans reduced from 49.2 per cent to 43.0 per cent, predominantly due to the change in the mix of impaired assets during 2015, with newly impaired connections having lower coverage levels compared to the portfolio average. The decrease is also partly due to the reduction in the collective unidentified impairment provisions fund during the year as a result of improved conditions.

The Group expects to benefit from its continued disciplined approach to the management of credit, and sustained UK economic growth. Nevertheless, market volatility and the uncertain global economic outlook such as the continued slowdown in Chinese economic growth and the fall in commodity prices may impact the Commercial portfolios.

The Group manages and limits exposure to certain sectors and asset classes, and closely monitors credit quality, sector and single name concentrations. This together with our conservative through the cycle risk appetite approach, means our portfolios are well positioned.

**Table 1.18: Commercial Banking impairment charge**

|   | 2015  | 2014  | Change |
|---|-------|-------|--------|
|   | £m    | £m    | %      |
| SME   | (22 ) | 15    |        |
| Other   | –     | 68    |        |
| Total impairment (release)/charge                         | (22 ) | 83    |        |
| Impairment charge as a % of average advances <sup>1</sup> | 0.01% | 0.08% | (7)bps |

<sup>1</sup> In respect of loans and advances to customers.

**Table 1.19: Commercial Banking impaired loans and provisions**

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|                       | Loans and<br>advances<br>to<br>customers<br>£m | Impaired<br>loans<br>£m | Impaired<br>loans<br>as a % of<br>closing<br>advances<br>% | <b>Impairment<br/>provisions<sup>1</sup><br/>£m</b> | Impairment<br>provisions<br>as a % of<br>impaired<br>loans<br>% |
|-----------------------|--|-------------------------|--|---|---|
| At 31 December 2015   |  |                         |  |   |   |
| SME                   | 29,393   | 1,149                   | 3.9  | 213   | 18.5  |
| Other                 | 73,042   | 1,379                   | 1.9  | 874   | 63.4  |
| Total gross lending   | 102,435  | 2,528                   | 2.5  | 1,087   | 43.0  |
| Reverse repos         | –  |                         |  |   |   |
| Impairment provisions | (1,087 )                                       |                         |  |   |   |
| Total                 | 101,348  |                         |  |   |   |
| At 31 December 2014   |  |                         |  |   |   |
| SME                   | 28,256   | 1,546                   | 5.5  | 398   | 25.7  |
| Other                 | 74,203   | 1,695                   | 2.3  | 1,196   | 70.6  |
| Total gross lending   | 102,459  | 3,241                   | 3.2  | 1,594   | 49.2  |
| Reverse repos         | 5,145  |                         |  |   |   |
| Impairment provisions | (1,594 )                                       |                         |  |   |   |
| Total                 | 106,010  |                         |  |   |   |

<sup>1</sup> Impairment provisions include collective unidentified impairment provisions.



OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*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.

There was a net impairment release of £22 million compared to a net charge of £15 million in 2014 with lower new impairment offset by writebacks and releases.

*OTHER COMMERCIAL BANKING*

Other Commercial Banking comprises £73,042 million of gross loans and advances to customers in Mid Markets, Global Corporates and Financial Institutions.

In the Mid Markets portfolio, credit quality has remained stable. The portfolio is focused on UK businesses and dependent on the performance of the domestic economy and to some extent, the global economy. The oil and gas services element of the portfolio has been reviewed given ongoing low oil prices and this review has not revealed any material concerns with portfolio quality at this time.

The Global Corporate business continues to have a predominance of investment grade clients, primarily UK based. As a result of this profile, allied to our conservative risk appetite, our portfolio remains of good quality despite the current global economic headwinds particularly relating to the energy and mining sectors. We continue to monitor the portfolio closely to ensure there is no material deterioration.

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 market for UK real estate has been buoyant and credit quality remains good with minimal impairments/stressed loans. All asset classes are attracting investment but, recognising this is a cyclical sector, appropriate caps are in place to control exposure and business propositions continue to be written in line with prudent risk appetite with conservative LTV, 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.

Trading exposures continue to be predominantly short-term and/or collateralised with inter-bank activity mainly undertaken with acceptable investment grade counterparties.

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).

The Group manages its exposures to Direct Real Estate across a number of different coverage segments.

Approximately 70 per cent of loans and advances to UK Direct Real Estate relate to commercial real estate with the remainder residential real estate.

The Group makes use of a variety of methodologies to assess the value of property collateral, where external valuations are not available. These include use of market indices, models and subject matter expert judgement.

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

Table 1.20: LTV – UK Direct Real Estate

|                          | At 31 December 2015 <sup>1</sup> |                |             |       | At 31 December 2014 <sup>1</sup> |                |             |       |
|--------------------------|----------------------------------|----------------|-------------|-------|----------------------------------|----------------|-------------|-------|
|                          | Unimpaired<br>£m                 | Impaired<br>£m | Total<br>£m | %     | Unimpaired<br>£m                 | Impaired<br>£m | Total<br>£m | %     |
| UK exposures >£5 million |                                  |                |             |       |                                  |                |             |       |
| Less than 60%            | 4,989                            | 72             | 5,061       | 63.7  | 3,985                            | 52             | 4,037       | 47.8  |
| 60% to 70%               | 1,547                            | 6              | 1,553       | 19.5  | 1,644                            | 62             | 1,706       | 20.2  |
| 70% to 80%               | 610                              | 13             | 623         | 7.9   | 964                              | 17             | 981         | 11.6  |
| 80% to 100%              | 75                               | 36             | 111         | 1.4   | 66                               | 211            | 277         | 3.3   |
| 100% to 120%             | –                                | 8              | 8           | 0.1   | –                                | –              | –           | –     |
| 120% to 140%             | –                                | –              | –           | –     | 130                              | 6              | 136         | 1.6   |
| Greater than 140%        | 5                                | 100            | 105         | 1.3   | –                                | 95             | 95          | 1.1   |
| Unsecured                | 487                              | –              | 487         | 6.1   | 1,222                            | –              | 1,222       | 14.4  |
|                          | 7,713                            | 235            | 7,948       | 100.0 | 8,011                            | 443            | 8,454       | 100.0 |
| UK exposures <£5 million | 9,656                            | 508            | 10,164      |       | 8,833                            | 644            | 9,477       |       |
| Total                    | 17,369                           | 743            | 18,112      |       | 16,844                           | 1,087          | 17,931      |       |

Exposures exclude £0.3 billion (31 December 2014: £0.4 billion) of gross UK Direct Real Estate lending in Wealth 1 (within Retail division) and £1.1 billion (31 December 2014: £3.3 billion) of UK Direct Real Estate lending in Run-off. Also excludes Social Housing and Housebuilder lending.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*FORBORNE LOANS**Commercial Banking forbearance*

At 31 December 2015, £3,514 million (31 December 2014: £5,137 million) of total loans and advances were forborne of which £2,528 million (31 December 2014: £3,241 million) were impaired. Impairment provisions as a percentage of forborne loans and advances decreased marginally from 31.0 per cent at 31 December 2014 to 30.9 per cent at 31 December 2015.

Table 1.21: **Commercial Banking forborne loans and advances (audited)**

|            | Total loans and advances which are forborne |            | Impairment provisions as % of loans and advances which are forborne |           |
|------------|---|------------|---|-----------|
|            | 2015<br>£m                                  | 2014<br>£m | 2015<br>%   | 2014<br>% |
| Impaired   | 2,528                                       | 3,241      | 43.0  | 49.2      |
| Unimpaired | 986   | 1,896      | –   | –         |
| Total      | 3,514                                       | 5,137      | 30.9  | 31.0      |

All impaired assets are considered forborne.

*Impaired loans and advances*

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

Table 1.22: **Movement in Commercial Banking impaired forborne loans and advances (audited)**

| 2015<br>£m | 2014<br>£m |
|------------|------------|
|------------|------------|

|   |        |        |
|---|--------|--------|
| At 1 January                                  | 3,241  | 5,047  |
| Classified as impaired during the year:       |        |        |
| Exposures >£5m                                | 505    | 775    |
| Exposures <£5m                                | 126    | 188    |
|   | 631    | 963    |
| Transferred to unimpaired:                    |        |        |
| Exposures >£5m but still reported as forborne | (15 )  | (268 ) |
| Exposures >£5m no longer reported as forborne | (20 )  | –      |
| Exposures <£5m                                | (111 ) | (477 ) |
|   | (146 ) | (745 ) |
| Written-off                                   | (225 ) | (719 ) |
| Asset disposal/sales of impaired assets       | (48 )  | (357 ) |
| Drawdowns/repayments                          | (693 ) | (732 ) |
| Exchange and other movements                  | (232 ) | (216 ) |
| At 31 December                                | 2,528  | 3,241  |

### *Unimpaired loans and advances*

Unimpaired forborne loans and advances were £986 million at 31 December 2015 (31 December 2014: £1,896 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 2015 by type of forbearance:

**Table 1.23: Commercial Banking unimpaired forborne loans and advances (audited)**

|                        | 31<br>December<br>2015<br>£m | 31<br>December<br>2014<br>£m |
|------------------------|------------------------------|------------------------------|
| Exposures >£5 million: |                              |                              |
| Covenants              | 310                          | 1,018                        |
| Extensions/alterations | 350                          | 426                          |
| Multiple               | 9                            | 6                            |
|                        | 669                          | 1,450                        |
| Exposures < £5 million | 317                          | 446                          |
| Total                  | 986                          | 1,896                        |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.24: Movement in Commercial Banking unimpaired forborne loans and advances >£5m<sup>1</sup> (audited)

|   | 31<br>December<br>2015<br>£m |   | 31<br>December<br>2014<br>£m |
|---|------------------------------|---|------------------------------|
| At 1 January  | 1,450                        |   | 1,654                        |
| Classified as impaired during the year                                | (141)                        | ) | (147)                        |
| Cured no longer forborne  | (655)                        | ) | (1,004)                      |
| Classified as forborne during the year                                | 156                          |   | 709                          |
| Transferred from impaired but still reported as forborne <sup>2</sup> | 15                           |   | 743                          |
| Asset disposal/sales  | –                            |   | (451)                        |
| Net drawdowns/repayments  | (153)                        | ) | (6)                          |
| Exchange and other movements  | (3)                          | ) | (48)                         |
| At 31 December  | 669                          |   | 1,450                        |

<sup>1</sup> Balances exclude intra-year movements.

<sup>2</sup> 2014 included £475 million in respect of two loans transferred from Run-off.

*CONSUMER FINANCE*

– The impairment charge reduced by 29 per cent to £152 million from £215 million in 2014. The reduction was driven by a continued underlying improvement of portfolio quality supported by an increased level of write-backs from the sale of recoveries assets in the Credit Cards portfolio.

– Impairment provisions as a percentage of impaired loans have increased to 72.8 per cent from 70.5 per cent at 31 December 2014, with Credit Cards increasing by 5.3 percentage points to 81.8 per cent and Asset Finance UK decreasing by 2.8 percentage points to 67.2 per cent.

– Loans and advances increased by £2,665 million to £23,938 million during 2015. The growth was achieved in both Asset Finance UK and Credit Cards portfolio with no relaxation in risk appetite and underwriting standards. Impaired loans decreased by £177 million in 2015 to £543 million which represented 2.3 per cent of closing loans and advances to customers (31 December 2014: 3.4 per cent).

Table 1.25: Consumer Finance impairment charge

|  | 2015<br>£m | 2014<br>£m | Change<br>% |
|--|------------|------------|-------------|
| Credit Cards                                 | 129        | 186        | 31          |
| Asset Finance UK                             | 22         | 30         | 27          |
| Asset Finance Europe                         | 1          | (1)        | )           |
| <b>Total impairment charge</b>               | 152        | 215        | 29          |
| Impairment charge as a % of average advances | 0.68%      | 1.05%      | (37) bps    |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.26: Consumer Finance impaired loans and provisions

|                         | Loans and advances to customers<br>£m | Impaired loans<br>£m | Impaired loans as a % of closing advances<br>% | Impairment provisions <sup>1</sup><br>£m | Impairment provisions as a % of impaired loans <sup>2</sup><br>% |
|-------------------------|---------------------------------------|----------------------|--|--|--|
| At 31 December 2015     |                                       |                      |  |  |  |
| Credit Cards:           |                                       |                      |  |  |  |
| Collections             |                                       | 187                  |  | 153                                      | 81.8   |
| Recoveries <sup>3</sup> |                                       | 179                  |  | –  |  |
|                         | 9,425                                 | 366                  | 3.9  | 153                                      | 81.8   |
| Asset Finance UK        | 9,582                                 | 134                  | 1.4  | 90                                       | 67.2   |
| Asset Finance Europe    | 4,931                                 | 43                   | 0.9  | 22                                       | 51.2   |
|                         | 14,513                                | 177                  | 1.2  | 112                                      | 63.3   |
|                         | 23,938                                | 543                  | 2.3  | 265                                      | 72.8   |
| Impairment provisions   | (265 )                                |                      |  |  |  |
| Fair value adjustments  | (9 )                                  |                      |  |  |  |
| Total                   | 23,664                                |                      |  |  |  |
| At 31 December 2014     |                                       |                      |  |  |  |
| Credit Cards:           |                                       |                      |  |  |  |
| Collections             |                                       | 217                  |  | 166                                      | 76.5   |
| Recoveries <sup>3</sup> |                                       | 282                  |  | –  |  |
|                         | 9,119                                 | 499                  | 5.5  | 166                                      | 76.5   |
| Asset Finance UK        | 7,204                                 | 160                  | 2.2  | 112                                      | 70.0   |
| Asset Finance Europe    | 4,950                                 | 61                   | 1.2  | 31                                       | 50.8   |
|                         | 12,154                                | 221                  | 1.8  | 143                                      | 64.7   |
|                         | 21,273                                | 720                  | 3.4  | 309                                      | 70.5   |
| Impairment provisions   | (309 )                                |                      |  |  |  |
| Fair value adjustments  | (30 )                                 |                      |  |  |  |
| Total                   | 20,934                                |                      |  |  |  |

1 Impairment provisions include collective unidentified impairment provisions.

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

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

**FORBORNE LOANS**

At 31 December 2015, Consumer Credit Card loans and advances currently or recently subject to forbearance were 2.4 per cent (31 December 2014: 2.6 per cent) of total Consumer Credit Card loans and advances. At 31 December 2015, Asset Finance UK Retail loans and advances on open portfolios currently or recently subject to forbearance were 1.4 per cent (31 December 2014: 2.1 per cent) of total Asset Finance UK Retail loans and advances. Further analysis of the forborne loans and advances is set out below:

Table 1.27: Consumer Finance forbore loans and advances (audited)

|                                      | Total loans and advances which are forbore <sup>1</sup> |            | Total forbore loans and advances which are impaired <sup>1</sup> |            | Impairment provisions as % of loans and advances which are forbore <sup>1</sup> |           |
|--------------------------------------|---|------------|--|------------|---|-----------|
|                                      | 2015<br>£m  | 2014<br>£m | 2015<br>£m   | 2014<br>£m | 2015<br>%   | 2014<br>% |
| Consumer Credit Cards <sup>2</sup>   | 225   | 234        | 120  | 140        | 26.8  | 29.1      |
| Asset Finance UK Retail <sup>2</sup> | 100   | 109        | 51   | 53         | 25.5  | 20.5      |

<sup>1</sup> Includes accounts where the customer is currently benefiting from a forbearance treatment or the treatment recently ended.

<sup>2</sup> Includes temporary treatments where the customer is currently benefiting from the change or the treatment has ended within the last six months. Permanent changes which commenced during the last 24 months for existing customers as at 31 December are also included.

74

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Consumer Credit Cards and Asset Finance UK Retail forbore loans have reduced in 2015 by £9 million and £9 million respectively, driven primarily by improvements in the underlying quality of the portfolios. The movements in forbore loans and advances during the year were as follows:

Table 1.28: Movement in Consumer Finance forbore loans and advances (audited)

|                                       | 2015                  |               | 2014                  |               |    |
|---------------------------------------|-----------------------|---------------|-----------------------|---------------|----|
|                                       | Consumer credit cards | Asset Finance | Consumer credit cards | Asset Finance | £m |
|                                       | £m                    | £m            | £m                    | £m            |    |
| At 1 January                          | 234                   | 109           | 326                   | 149           |    |
| Classified as forbore during the year | 108                   | 61            | 128                   | 56            |    |
| Written off/sold                      | (48 )                 | (14 )         | (93 )                 | (25 )         |    |
| Good exit from forbearance            | (36 )                 | (17 )         | (92 )                 | (19 )         |    |
| Redeemed or repaid                    | (9 )                  | (19 )         | (14 )                 | (26 )         |    |
| Exchange and other movements          | (24 )                 | (20 )         | (21 )                 | (26 )         |    |
| At 31 December                        | 225                   | 100           | 234                   | 109           |    |

*RUN-OFF*

With the exception of a small residual book (£37 million of which £5 million is impaired), the Irish Wholesale book (which contained the Commercial Real Estate portfolio), is now effectively exited following completion of the divestment announced on 30 July 2015. The Ireland Retail portfolio has reduced from £4,464 million at 31 December 2014 to £4,040 million at 31 December 2015.

The Corporate real estate and other corporate portfolio has continued to reduce significantly ahead of expectations. Net loans and advances reduced by £1,908 million, from £3,036 million to £1,128 million for 2015.

Net loans and advances for the specialist finance asset based run-off portfolio stood at £4,001 million at 31 December 2015 (gross £4,190 million), and include Ship Finance, Aircraft Finance and Infrastructure, with around half of the remaining lending in the lower risk leasing sector. Including the reducing Treasury Asset Legacy investment portfolio, and operating losses, total net external assets reduced to £5,552 million at 31 December 2015 (gross £5,742 million).

Ireland retail loans and advances with an indexed LTV in excess of 100 per cent decreased to £1,269 million (31.4 per cent) at 31 December 2015, compared with £1,737 million (38.9 per cent) at 31 December 2014. Of this amount £71 million were impaired (31 December 2014: £78 million).

Table 1.29: Run-off impairment charge



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|   | 2015  | 2014  | Change  |
|---|-------|-------|---------|
|   | £m    | £m    | %       |
| Ireland retail  | (5 )  | (6 )  | (17 )   |
| Ireland commercial real estate                            | 11    | 67    | 84      |
| Ireland corporate   | 61    | 247   | 75      |
| Corporate real estate and other corporate                 | 21    | (28 ) |         |
| Specialist finance  | (45 ) | 22    |         |
| Other   | (35 ) | (99 ) | (65 )   |
| Total   | 8     | 203   | 96      |
| Impairment charge as a % of average advances <sup>1</sup> | 0.20% | 0.64% | (44)bps |

<sup>1</sup> In respect of loans and advances to customers.

75

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.30: Run-off impaired loans and provisions

|   | Advances<br>to<br>customers<br>£m | Impaired<br>loans<br>£m | Impaired<br>loans as a<br>%<br>of closing<br>advances<br>% | Impairment<br>provisions<br>£m | Impairment<br>provisions<br>as a % of<br>impaired<br>loans<br>% |
|---|-----------------------------------|-------------------------|--|--------------------------------|---|
| <b>At 31 December 2015</b>                |                                   |                         |  |                                |   |
| Ireland retail                            | 4,040                             | 132                     | 3.3  | 120                            | 90.9  |
| Ireland commercial real estate            | 8                                 | 5                       | 62.5   | –                              |   |
| Ireland corporate                         | 29                                | –                       |  | –                              |   |
| 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  |
|   | 11,422                            | 2,025                   | 17.7   | 1,150                          | 56.8  |
| Impairment provisions                     | (1,150                            | )                       |  |                                |   |
| Fair value adjustments                    | –                                 |                         |  |                                |   |
| <b>Total</b>                              | <b>10,272</b>                     |                         |  |                                |   |
| <b>At 31 December 2014</b>                |                                   |                         |  |                                |   |
| Ireland retail                            | 4,464                             | 120                     | 2.7  | 141                            | 117.5   |
| Ireland commercial real estate            | 1,797                             | 1,659                   | 92.3   | 1,385                          | 83.5  |
| Ireland corporate                         | 1,639                             | 1,393                   | 85.0   | 1,095                          | 78.6  |
| Corporate real estate and other corporate | 3,947                             | 1,548                   | 39.2   | 911                            | 58.9  |
| Specialist finance                        | 4,835                             | 364                     | 7.5  | 254                            | 69.8  |
| Other                                     | 1,634                             | 131                     | 8.0  | 141                            | 107.6   |
|   | 18,316                            | 5,215                   | 28.5   | 3,927                          | 75.3  |
| Impairment provisions                     | (3,927                            | )                       |  |                                |   |
| Fair value adjustments                    | 19                                |                         |  |                                |   |
| <b>Total</b>                              | <b>14,408</b>                     |                         |  |                                |   |

*FORBORNE LOANS**RUN-OFF IRELAND RETAIL LENDING*

At 31 December 2015, £169 million or 4.2 per cent (31 December 2014: £280 million or 6.3 per cent) of Irish retail secured loans and advances were subject to current or recent forbearance. Of this amount £26 million (31 December 2014: £41 million) were impaired.

*RUN-OFF CORPORATE REAL ESTATE, OTHER CORPORATE AND SPECIALIST FINANCE*

At 31 December 2015 £1,780 million (31 December 2014: £1,998 million) of total loans and advances were forborne of which £1,771 million (31 December 2014: £1,912 million) were impaired. Impairment provisions as a percentage of forborne loans and advances decreased from 58.3 per cent at 31 December 2014 to 52.5 per cent at 31 December 2015.

Unimpaired forborne loans and advances were £9 million at 31 December 2015 (31 December 2014: £86 million).

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*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 1.31: Movement in Run-off corporate real estate, other corporate and Specialist Finance impaired forborne loans and advances (audited)**

|   | <b>2015</b>   | <b>2014</b> |
|---|---------------|-------------|
|   | <b>£m</b>     | <b>£m</b>   |
| At 1 January  | <b>1,912</b>  | 9,499       |
| Classified as impaired during the year:                                   |               |             |
| Exposures >£5m  | <b>414</b>    | 557         |
| Exposures <£5m  | <b>11</b>     | 46          |
|   | <b>425</b>    | 603         |
| Transferred to unimpaired but still reported as forborne during the year: |               |             |
| Exposures >£5m <sup>1</sup>   | <b>(13 )</b>  | (961 )      |
| Exposures <£5m  | <b>(11 )</b>  | (12 )       |
|   | <b>(24 )</b>  | (973 )      |
| Write offs  | <b>(238 )</b> | (2,565)     |
| Asset disposal/sales of impaired assets                                   | <b>(763 )</b> | (4,363)     |
| Drawdowns/repayments  | <b>(19 )</b>  | (248 )      |
| Exchange and other movements  | <b>478</b>    | (41 )       |
| <b>At 31 December</b>   | <b>1,771</b>  | 1,912       |

<sup>1</sup> 2014 included £475 million in respect of two loans classified as impaired during the year and subsequently transferred to Commercial Banking.

*Run-off Ireland commercial real estate and corporate*

All loans and advances (whether impaired or unimpaired) are treated as forborne. At 31 December 2015, £37 million (31 December 2014: £3,436 million) of total loans and advances were forborne of which £5 million (31 December 2014: £3,052 million) were impaired. Impairment provisions as a percentage of forborne loans and advances decreased from 72.2 per cent at 31 December 2014 to nil at 31 December 2015.

The movements in forborne loans and advances were:

Table 1.32: **Movement in Run-off: Ireland commercial real estate and corporate forbore loans and advances (audited)**

|                              | <b>2015</b>    | <b>2014</b> |
|------------------------------|----------------|-------------|
|                              | <b>£m</b>      | <b>£m</b>   |
| At 1 January                 | <b>3,436</b>   | 9,430       |
| Write-offs                   | <b>(419 )</b>  | (2,589)     |
| Asset disposal/sales         | <b>(2,563)</b> | (1,444)     |
| Drawdowns/repayments         | <b>(99 )</b>   | (1,413)     |
| Exchange and other movements | <b>(318 )</b>  | (548 )      |
| <b>At 31 December</b>        | <b>37</b>      | 3,436       |

### **Eurozone exposures**

The following section summarises the Group's direct exposure to Eurozone countries at 31 December 2015. The exposures comprise on-balance sheet exposures based on their balance sheet carrying values and off-balance sheet exposures, and are based on the country of domicile of the counterparty unless otherwise indicated.

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

Identified indirect exposure information, 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 GFSF has carried out a number of scenario analyses and rehearsals to test the Group's resilience in the event of further instability in certain Eurozone countries. The Group has developed and refined pre-determined action plans that would be executed in such scenarios. The plans set out governance requirements and responsibilities for the key actions which would be carried out and cover risk areas such as payments, liquidity and capital, communications,

suppliers and systems, legal, credit, delivery channels and products, employees and the impact on customers.

Exposures to Eurozone countries are detailed in the following tables and are based on balance sheet exposures, net of provisions. Derivative balances are included within exposures to financial institutions or corporates, as appropriate, at fair value adjusted for master netting agreements at obligor level

77

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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. Reverse repurchase exposures to Institutional funds secured by UK Gilts are excluded from all Eurozone exposures as detailed in the footnotes. 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 two funds domiciled in Ireland (Global Liquidity Fund and the Investment Cash Fund) 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 risk of the obligors of the underlying assets rather than treating the insurance holding in the funds as exposure to Ireland.

*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 1.33: Selected Eurozone exposures

|                            | Sovereign debt  |                       | Financial institutions |                    | Asset backed securities | Corporate | Personal | Insurance assets | Total |
|----------------------------|-----------------|-----------------------|------------------------|--------------------|-------------------------|-----------|----------|------------------|-------|
|                            | Direct exposure | Cash at central banks | Banks                  | Other <sup>1</sup> |                         |           |          |                  |       |
|                            | £m              | £m                    | £m                     | £m                 | £m                      | £m        | £m       | £m               | £m    |
| <b>At 31 December 2015</b> |                 |                       |                        |                    |                         |           |          |                  |       |
| 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   |

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|                            |   |   |            |            |            |              |              |           |              |
|----------------------------|---|---|------------|------------|------------|--------------|--------------|-----------|--------------|
| Greece                     | - | - | -          | -          | -          | <b>1</b>     | -            | -         | <b>1</b>     |
|                            | - | - | <b>864</b> | <b>547</b> | <b>87</b>  | <b>1,739</b> | <b>3,966</b> | <b>82</b> | <b>7,285</b> |
| <b>At 31 December 2014</b> |   |   |            |            |            |              |              |           |              |
| Ireland                    | - | - | 359        | -          | 115        | 1,672        | 4,325        | -         | 6,471        |
| Spain                      | - | - | 57         | 116        | -          | 1,160        | 49           | 13        | 1,395        |
| Portugal                   | - | - | 9          | 5          | -          | 133          | 6            | -         | 153          |
| Italy                      | - | - | 354        | 5          | -          | 93           | -            | 34        | 486          |
| Greece                     | - | - | -          | -          | -          | 3            | -            | -         | 3            |
|                            | - | - | <b>779</b> | <b>126</b> | <b>115</b> | <b>3,061</b> | <b>4,380</b> | <b>47</b> | <b>8,508</b> |

<sup>1</sup> Excludes reverse repurchase exposure to Institutional funds domiciled in Ireland secured by UK gilts of £11,267 million (2014: £10,456 million) on a gross basis.

In addition to the exposures detailed in table 1.33, the Group has the following exposures to sovereigns, financial institutions, asset backed securities, corporates and personal customers in the following Eurozone countries:



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.34: Other Eurozone exposures

|                              | Sovereign debt             |                       | Financial institutions |                    | Asset             |              |              | Insurance assets | Total         |
|------------------------------|----------------------------|-----------------------|------------------------|--------------------|-------------------|--------------|--------------|------------------|---------------|
|                              | Direct sovereign exposures | Cash at central banks | Banks                  | Other <sup>1</sup> | backed securities | Corporate    | Personal     |                  |               |
|                              | £m                         | £m                    | £m                     | £m                 | £m                | £m           | £m           | £m               | £m            |
| <b>At 31 December 2015</b>   |                            |                       |                        |                    |                   |              |              |                  |               |
| 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         |
| Austria                      | –                          | –                     | 3                      | –                  | –                 | 280          | –            | –                | 283           |
| All other Eurozone countries | 15                         | –                     | 400                    | –                  | –                 | 62           | –            | 80               | 557           |
|                              | <b>640</b>                 | <b>11,612</b>         | <b>4,332</b>           | <b>1,580</b>       | <b>819</b>        | <b>7,406</b> | <b>5,104</b> | <b>2,121</b>     | <b>33,614</b> |
| <b>At 31 December 2014</b>   |                            |                       |                        |                    |                   |              |              |                  |               |
| Netherlands                  | 320                        | 5,611                 | 597                    | 129                | 307               | 1,682        | 4,888        | 432              | 13,966        |
| France                       | 245                        | –                     | 3,198                  | 1,435              | 134               | 2,453        | 73           | 1,069            | 8,607         |
| Germany                      | 181                        | 133                   | 806                    | 1,180              | 339               | 1,729        | 32           | 877              | 5,277         |
| Luxembourg                   | –                          | –                     | 8                      | 799                | 74                | 2,241        | –            | 11               | 3,133         |
| Belgium                      | 75                         | –                     | 906                    | 2                  | –                 | 404          | –            | 27               | 1,414         |
| Austria                      | 311                        | –                     | 913                    | –                  | –                 | 163          | –            | –                | 1,387         |
| All other Eurozone countries | 116                        | –                     | 449                    | –                  | –                 | 64           | –            | 94               | 723           |
|                              | 1,248                      | 5,744                 | 6,877                  | 3,545              | 854               | 8,736        | 4,993        | 2,510            | 34,507        |

<sup>1</sup> Excludes reverse repurchase exposure to Institutional funds secured by UK gilts of £1,955 million (2014: £1,455 million) on a gross basis.

*ENVIRONMENTAL RISK MANAGEMENT*

The Group ensures appropriate management of the environmental impact of its lending activities. The Groupwide 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. Further information is contained within the Group's Responsible Business Review (<http://www.lloydsbankinggroup.com/our-group/responsible-business/our-approach/managing-risk/>).

**Table 1.35: Environmental risk management approach**

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## LOAN PORTFOLIO

In the following tables, where lending and the related impairment allowances are analysed between domestic and international, the classification as domestic or international is based on the location of the office recording the transaction, except for certain lending of the international business booked in London including the Group's lending in Ireland which, following the merger of Bank of Scotland (Ireland) Limited into Bank of Scotland plc, is held on the balance sheet of Bank of Scotland plc in the UK but is reported as international.

## ANALYSIS OF LOANS AND ADVANCES TO BANKS AND CUSTOMERS

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

|  | 2015           | 2014           | 2013           | 2012           | 2011           |
|--|----------------|----------------|----------------|----------------|----------------|
|  | £m             | £m             | £m             | £m             | £m             |
| Loans and advances to banks  | 25,117         | 26,155         | 25,365         | 32,760         | 32,620         |
| Loans and advances to customers:                                       |                |                |                |                |                |
| Mortgages  | 312,877        | 333,318        | 335,611        | 337,879        | 348,210        |
| Other personal lending   | 20,579         | 23,123         | 23,230         | 28,334         | 30,014         |
| Agriculture, forestry and fishing                                      | 6,924          | 6,586          | 6,051          | 5,531          | 5,198          |
| Energy and water supply  | 3,247          | 3,853          | 4,414          | 3,321          | 4,013          |
| Manufacturing  | 5,953          | 6,000          | 7,650          | 8,530          | 10,061         |
| Construction   | 4,952          | 6,425          | 7,024          | 7,526          | 9,722          |
| Transport, distribution and hotels                                     | 13,526         | 15,112         | 22,294         | 26,568         | 32,882         |
| Postal and telecommunications  | 2,563          | 2,624          | 2,364          | 1,397          | 1,896          |
| Financial, business and other services                                 | 43,072         | 44,979         | 42,478         | 48,729         | 64,046         |
| Property companies   | 32,228         | 36,682         | 44,277         | 52,388         | 64,752         |
| Lease financing  | 2,751          | 3,013          | 4,435          | 6,477          | 7,800          |
| Hire purchase  | 9,536          | 7,403          | 5,090          | 5,334          | 5,776          |
| <b>Total loans</b>   | <b>483,325</b> | <b>515,273</b> | <b>530,283</b> | <b>564,774</b> | <b>616,990</b> |
| Allowance for impairment losses  | (3,033 )       | (6,414 )       | (11,966 )      | (15,253 )      | (18,746 )      |
| <b>Total loans and advances net of allowance for impairment losses</b> | <b>480,292</b> | <b>508,859</b> | <b>518,317</b> | <b>549,521</b> | <b>598,244</b> |

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of loans and advances at 31 December 2012 and 2011 between domestic and international offices is as follows:

|  | <b>2012</b>    | <b>2011</b>    |
|--|----------------|----------------|
|  | <b>£m</b>      | <b>£m</b>      |
| <b>Domestic</b>  |                |                |
| Loans and advances to banks  | 32,073         | 31,852         |
| Loans and advances to customers:                                       |                |                |
| Mortgages  | 322,687        | 331,715        |
| Other personal lending   | 26,119         | 28,244         |
| Agriculture, forestry and fishing                                      | 5,482          | 5,010          |
| Energy and water supply  | 1,773          | 1,689          |
| Manufacturing  | 7,246          | 8,055          |
| Construction   | 6,481          | 7,885          |
| Transport, distribution and hotels                                     | 22,205         | 27,232         |
| Postal and telecommunications  | 1,239          | 1,491          |
| Financial, business and other services                                 | 44,155         | 56,721         |
| Property companies   | 43,683         | 49,561         |
| Lease financing  | 5,306          | 6,792          |
| Hire purchase  | 4,970          | 5,237          |
| <b>Total loans</b>   | <b>523,419</b> | <b>561,484</b> |
| Allowance for impairment losses  | (7,076 )       | (8,025 )       |
| <b>Total loans and advances net of allowance for impairment losses</b> | <b>516,343</b> | <b>553,459</b> |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|  | <b>2012</b> | <b>2011</b> |
|--|-------------|-------------|
|  | <b>£m</b>   | <b>£m</b>   |
| <b>Foreign</b>   |             |             |
| Loans and advances to banks  | 687         | 768         |
| Loans and advances to customers:                                       |             |             |
| Mortgages  | 15,192      | 16,495      |
| Other personal lending   | 2,215       | 1,770       |
| Agriculture, forestry and fishing                                      | 49          | 188         |
| Energy and water supply  | 1,548       | 2,324       |
| Manufacturing  | 1,284       | 2,006       |
| Construction   | 1,045       | 1,837       |
| Transport, distribution and hotels                                     | 4,363       | 5,650       |
| Postal and telecommunications  | 158         | 405         |
| Financial, business and other services                                 | 4,574       | 7,325       |
| Property companies   | 8,705       | 15,191      |
| Lease financing  | 1,171       | 1,008       |
| Hire purchase  | 364         | 539         |
| <b>Total loans</b>   | 41,355      | 55,506      |
| Allowance for impairment losses  | (8,177 )    | (10,721 )   |
| <b>Total loans and advances net of allowance for impairment losses</b> | 33,178      | 44,785      |
|  |             |             |
|  | <b>2012</b> | <b>2011</b> |
|  | <b>£m</b>   | <b>£m</b>   |
| <b>Total</b>   |             |             |
| Loans and advances to banks  | 32,760      | 32,620      |
| Loans and advances to customers:                                       |             |             |
| Mortgages  | 337,879     | 348,210     |
| Other personal lending   | 28,334      | 30,014      |
| Agriculture, forestry and fishing                                      | 5,531       | 5,198       |
| Energy and water supply  | 3,321       | 4,013       |
| Manufacturing  | 8,530       | 10,061      |
| Construction   | 7,526       | 9,722       |
| Transport, distribution and hotels                                     | 26,568      | 32,882      |
| Postal and telecommunications  | 1,397       | 1,896       |
| Financial, business and other services                                 | 48,729      | 64,046      |
| Property companies   | 52,388      | 64,752      |
| Lease financing  | 6,477       | 7,800       |
| Hire purchase  | 5,334       | 5,776       |
| <b>Total loans</b>   | 564,774     | 616,990     |
| Allowance for impairment losses  | (15,253 )   | (18,746 )   |
| <b>Total loans and advances net of allowance for impairment losses</b> | 549,521     | 598,244     |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## SUMMARY OF LOAN LOSS EXPERIENCE

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

|   | 2015           | 2014     | 2013     | 2012     | 2011     |
|---|----------------|----------|----------|----------|----------|
|   | £m             | £m       | £m       | £m       | £m       |
| <b>Balance at beginning of year</b>             | <b>6,414</b>   | 11,966   | 15,253   | 18,746   | 18,393   |
| <b>Exchange and other adjustments</b>           | <b>(246 )</b>  | (410 )   | 291      | (380 )   | (369 )   |
| <b>Disposal of businesses</b>                   | <b>(82 )</b>   | –        | (176 )   | –        | –        |
| <b>Advances written off:</b>                    |                |          |          |          |          |
| Loans and advances to customers:                |                |          |          |          |          |
| Mortgages                                       | (71 )          | (87 )    | (601 )   | (133 )   | (86 )    |
| Other personal lending                          | (853 )         | (1,329 ) | (1,437 ) | (2,267 ) | (2,617 ) |
| Agriculture, forestry and fishing               | (1 )           | (8 )     | (11 )    | (45 )    | (11 )    |
| Energy and water supply                         | (73 )          | –        | (102 )   | (77 )    | (48 )    |
| Manufacturing                                   | (126 )         | (59 )    | (130 )   | (226 )   | (137 )   |
| Construction                                    | (21 )          | (157 )   | (84 )    | (654 )   | (92 )    |
| Transport, distribution and hotels              | (728 )         | (1,119 ) | (798 )   | (458 )   | (329 )   |
| Postal and telecommunications                   | (11 )          | –        | (14 )    | (7 )     | (1 )     |
| Financial, business and other services          | (604 )         | (946 )   | (1,030 ) | (1,071 ) | (1,120 ) |
| Property companies                              | (1,648 )       | (2,669 ) | (1,891 ) | (3,554 ) | (2,630 ) |
| Lease financing                                 | (31 )          | (4 )     | (10 )    | (75 )    | (224 )   |
| Hire purchase                                   | (37 )          | (54 )    | (121 )   | (130 )   | (192 )   |
| Loans and advances to banks                     | –              | –        | (3 )     | (10 )    | (6 )     |
| <b>Total advances written off</b>               | <b>(4,204)</b> | (6,432 ) | (6,232 ) | (8,707 ) | (7,493 ) |
| <b>Recoveries of advances written off:</b>      |                |          |          |          |          |
| Loans and advances to customers:                |                |          |          |          |          |
| Mortgages                                       | 35             | 18       | 28       | 53       | 26       |
| Other personal lending                          | 366            | 600      | 408      | 757      | 326      |
| Energy and water supply                         | 5              | –        | –        | –        | –        |
| Manufacturing                                   | –              | –        | –        | –        | –        |
| Construction                                    | –              | –        | –        | –        | –        |
| Transport, distribution and hotels              | 63             | –        | –        | 1        | 1        |
| Financial, business and other services          | 193            | –        | –        | –        | –        |
| Property companies                              | 101            | –        | –        | 4        | –        |
| Lease financing                                 | –              | –        | –        | 2        | –        |
| Hire purchase                                   | 1              | 63       | 20       | 26       | 68       |
| <b>Total recoveries of advances written off</b> | <b>764</b>     | 681      | 456      | 843      | 421      |
| <b>Total net advances written off</b>           | <b>(3,440)</b> | (5,751 ) | (5,776 ) | (7,864 ) | (7,072 ) |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|   | 2015         | 2014          | 2013          | 2012          | 2011          |
|---|--------------|---------------|---------------|---------------|---------------|
|   | £m           | £m            | £m            | £m            | £m            |
| <b>Effect of unwinding of discount recognised through interest income</b>                   | <b>(56 )</b> | <b>(126 )</b> | <b>(351 )</b> | <b>(374 )</b> | <b>(226 )</b> |
| <b>Allowances for impairment losses charged against income for the year:</b>                |              |               |               |               |               |
| Loans and advances to customers:  |              |               |               |               |               |
| Mortgages   | 33           | (138 )        | 224           | 278           | 444           |
| Other personal lending  | 437          | 536           | 920           | 881           | 1,669         |
| Agriculture, forestry and fishing   | 1            | 2             | –             | 54            | 27            |
| Energy and water supply   | 35           | 28            | 95            | 71            | 105           |
| Manufacturing   | 23           | (4 )          | 31            | 236           | 206           |
| Construction  | 13           | (81 )         | 66            | 326           | 350           |
| Transport, distribution and hotels  | (88 )        | 198           | 421           | 649           | 884           |
| Postal and telecommunications   | (2 )         | 6             | (3 )          | 8             | 15            |
| Financial, business and other services  | 77           | 179           | 552           | 824           | 1,464         |
| Property companies  | (140 )       | 40            | 457           | 1,725         | 2,776         |
| Lease financing   | 31           | (1 )          | (26 )         | 26            | 60            |
| Hire purchase   | 23           | (30 )         | (12 )         | 47            | 20            |
| Loans and advances to banks   | –            | –             | –             | –             | –             |
| <b>Total allowances for impairment losses charged against income for the year</b>           | <b>443</b>   | <b>735</b>    | <b>2,725</b>  | <b>5,125</b>  | <b>8,020</b>  |
| <b>Total balance at end of year</b>   | <b>3,033</b> | <b>6,414</b>  | <b>11,966</b> | <b>15,253</b> | <b>18,746</b> |
| <b>Ratio of net write-offs during the year to average loans outstanding during the year</b> | <b>0.8%</b>  | <b>1.1%</b>   | <b>1.1%</b>   | <b>1.4%</b>   | <b>1.2%</b>   |

The Group's impairment allowances in respect of loans and advances to banks and customers decreased by £3,381 million, or 53 per cent, from £6,414 million at 31 December 2014 to £3,033 million at 31 December 2015. This decrease resulted from a charge to the income statement of £443 million being more than offset by net advances written off of £3,440 million (advances written off of £4,204 million less recoveries £764 million). A further decrease of £82 million followed the disposal of the Group's interest in TSB Banking Group plc. The reduction in the charge to the income statement of £292 million, or 40 per cent, from £735 million in 2014 to £443 million in 2015 reflects lower charges in all Divisions, particularly in Retail and in respect of the portfolio of assets which are outside of the Group's risk appetite, reflecting the continuing run-off of such assets, in particular exposures in Ireland. By category of lending, the most significant elements of the charge to the income statement were a charge of £437 million in respect of other personal lending and a charge of £77 million in respect of financial business and other services, together with credits of £88 million in relation to transport, distribution and hotels and £140 million in respect of property companies. Of the net advances written off of £3,440 million, £487 million related to other personal lending, £665 million related to transport, distribution and hotels and £1,547 million to property companies.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of movements in the allowance for impairment losses on loans and advances to banks and customers for the years ended 31 December 2012 and 2011 between domestic and international offices is as follows:

| <b>Domestic</b>                                 | 2012           | 2011           |
|---|----------------|----------------|
|   | £m             | £m             |
| <b>Balance at beginning of year</b>             | 8,025          | 9,786          |
| <b>Exchange and other adjustments</b>           | (24 )          | 68             |
| <b>Advances written off:</b>                    |                |                |
| Loans and advances to customers:                |                |                |
| Mortgages                                       | (96 )          | (56 )          |
| Other personal lending                          | (2,258)        | (2,605)        |
| Agriculture, forestry and fishing               | (11 )          | (8 )           |
| Energy and water supply                         | (68 )          | (48 )          |
| Manufacturing                                   | (75 )          | (105 )         |
| Construction                                    | (477 )         | (38 )          |
| Transport, distribution and hotels              | (140 )         | (247 )         |
| Postal and telecommunications                   | (1 )           | (1 )           |
| Financial, business and other services          | (919 )         | (894 )         |
| Property companies                              | (528 )         | (1,594)        |
| Lease financing                                 | (74 )          | (120 )         |
| Hire purchase                                   | (129 )         | (57 )          |
| Loans and advances to banks                     | (10 )          | (6 )           |
| <b>Total advances written off</b>               | <b>(4,786)</b> | <b>(5,779)</b> |
| <b>Recoveries of advances written off:</b>      |                |                |
| Loans and advances to customers:                |                |                |
| Mortgages                                       | 53             | 26             |
| Other personal lending                          | 751            | 326            |
| Agriculture, forestry and fishing               | –              | –              |
| Energy and water supply                         | –              | –              |
| Manufacturing                                   | –              | –              |
| Construction                                    | –              | –              |
| Transport, distribution and hotels              | 1              | 1              |
| Postal and telecommunications                   | –              | –              |
| Financial, business and other services          | –              | –              |
| Property companies                              | –              | –              |
| Lease financing                                 | 2              | –              |
| Hire purchase                                   | 26             | 68             |
| <b>Total recoveries of advances written off</b> | <b>833</b>     | <b>421</b>     |
| <b>Total net advances written off</b>           | <b>(3,953)</b> | <b>(5,358)</b> |



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|   | 2012     | 2011     |
|---|----------|----------|
|   | £m       | £m       |
| <b>Domestic</b>   |          |          |
| <b>Effect of unwinding of discount recognised through interest income</b>         | (405 )   | (406 )   |
| Allowances for impairment losses charged against income for the year:             |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | 32       | 24       |
| Other personal lending  | 1,121    | 1,670    |
| Agriculture, forestry and fishing   | 15       | 19       |
| Energy and water supply   | 77       | 130      |
| Manufacturing   | 81       | 110      |
| Construction  | 221      | 168      |
| Transport, distribution and hotels  | 289      | 298      |
| Postal and telecommunications   | –        | (8 )     |
| Financial, business and other services  | 734      | 1,188    |
| Property companies  | 776      | 287      |
| Lease financing   | 37       | 48       |
| Hire purchase   | 50       | 1        |
| Loans and advances to banks   | –        | –        |
| <b>Total allowances for impairment losses charged against income for the year</b> | 3,433    | 3,935    |
| <b>Total balance at end of year – Domestic</b>                                    | 7,076    | 8,025    |
|   | 2012     | 2011     |
|   | £m       | £m       |
| <b>Foreign</b>  |          |          |
| <b>Balance at beginning of year</b>   | 10,721   | 8,607    |
| <b>Exchange and other adjustments</b>   | (356 )   | (437 )   |
| <b>Advances written off:</b>  |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | (37 )    | (30 )    |
| Other personal lending  | (9 )     | (12 )    |
| Agriculture, forestry and fishing   | (34 )    | (3 )     |
| Energy and water supply   | (9 )     | –        |
| Manufacturing   | (151 )   | (32 )    |
| Construction  | (177 )   | (54 )    |
| Transport, distribution and hotels  | (318 )   | (82 )    |
| Postal and telecommunications   | (6 )     | –        |
| Financial, business and other services  | (152 )   | (226 )   |
| Property companies  | (3,026 ) | (1,036 ) |
| Lease financing   | (1 )     | (104 )   |
| Hire purchase   | (1 )     | (135 )   |
| Loans and advances to banks   | –        | –        |
| <b>Total advances written off</b>   | (3,921 ) | (1,714 ) |
| <b>Recoveries of advances written off:</b>  |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | –        | –        |
| Other personal lending  | 6        | –        |
| Agriculture, forestry and fishing   | –        | –        |
| Energy and water supply   | –        | –        |

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|   |          |         |
|---|----------|---------|
| Manufacturing                                   | –        | –       |
| Construction                                    | –        | –       |
| Transport, distribution and hotels              | –        | –       |
| Postal and telecommunications                   | –        | –       |
| Financial, business and other services          | –        | –       |
| Property companies                              | 4        | –       |
| Hire purchase                                   | –        | –       |
| <b>Total recoveries of advances written off</b> | 10       | –       |
| <b>Total net advances written off</b>           | (3,911 ) | (1,714) |
| 85  |          |         |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|   | 2012     | 2011     |
|---|----------|----------|
|   | £m       | £m       |
| <b>Foreign</b>  |          |          |
| <b>Effect of unwinding of discount recognised through interest income</b>         | 31       | 180      |
| Allowances for impairment losses charged against income for the year:             |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | 246      | 420      |
| Other personal lending  | (240 )   | (1 )     |
| Agriculture, forestry and fishing   | 39       | 8        |
| Energy and water supply   | (6 )     | (25 )    |
| Manufacturing   | 155      | 96       |
| Construction  | 105      | 182      |
| Transport, distribution and hotels  | 360      | 586      |
| Postal and telecommunications   | 8        | 23       |
| Financial, business and other services  | 90       | 276      |
| Property companies  | 949      | 2,489    |
| Lease financing   | (11 )    | 12       |
| Hire purchase   | (3 )     | 19       |
| Loans and advances to banks   | –        | –        |
| <b>Total allowances for impairment losses charged against income for the year</b> | 1,692    | 4,085    |
| <b>Total balance at end of year – Foreign</b>                                     | 8,177    | 10,721   |
|   |          |          |
| <b>Total</b>  | 2012     | 2011     |
|   | £m       | £m       |
| <b>Balance at beginning of year</b>   | 18,746   | 18,393   |
| <b>Exchange and other adjustments</b>   | (380 )   | (369 )   |
| <b>Advances written off:</b>  |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | (133 )   | (86 )    |
| Other personal lending  | (2,267 ) | (2,617 ) |
| Agriculture, forestry and fishing   | (45 )    | (11 )    |
| Energy and water supply   | (77 )    | (48 )    |
| Manufacturing   | (226 )   | (137 )   |
| Construction  | (654 )   | (92 )    |
| Transport, distribution and hotels  | (458 )   | (329 )   |
| Postal and telecommunications   | (7 )     | (1 )     |
| Financial, business and other services  | (1,071 ) | (1,120 ) |
| Property companies  | (3,554 ) | (2,630 ) |
| Lease financing   | (75 )    | (224 )   |
| Hire purchase   | (130 )   | (192 )   |
| Loans and advances to banks   | (10 )    | (6 )     |
| <b>Total advances written off</b>   | (8,707 ) | (7,493 ) |
| <b>Recoveries of advances written off:</b>  |          |          |
| Loans and advances to customers:  |          |          |
| Mortgages   | 53       | 26       |
| Other personal lending  | 757      | 326      |
| Energy and water supply   | –        | –        |
| Manufacturing   | –        | –        |

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|   |          |          |
|---|----------|----------|
| Construction                                    | –        | –        |
| Transport, distribution and hotels              | 1        | 1        |
| Financial, business and other services          | –        | –        |
| Property companies                              | 4        | –        |
| Lease financing                                 | 2        | –        |
| Hire purchase                                   | 26       | 68       |
| <b>Total recoveries of advances written off</b> | 843      | 421      |
| <b>Total net advances written off</b>           | (7,864 ) | (7,072 ) |
| 86  |          |          |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

|  |            |            |
|--|------------|------------|
| Total  | 2012<br>£m | 2011<br>£m |
| Effect of unwinding of discount recognised through interest income         | (374 )     | (226 )     |
| Allowances for impairment losses charged against income for the year:      |            |            |
| Loans and advances to customers:   |            |            |
| Mortgages  | 278        | 444        |
| Other personal lending   | 881        | 1,669      |
| Agriculture, forestry and fishing  | 54         | 27         |
| Energy and water supply  | 71         | 105        |
| Manufacturing  | 236        | 206        |
| Construction   | 326        | 350        |
| Transport, distribution and hotels   | 649        | 884        |
| Postal and telecommunications  | 8          | 15         |
| Financial, business and other services                                     | 824        | 1,464      |
| Property companies   | 1,725      | 2,776      |
| Lease financing  | 26         | 60         |
| Hire purchase  | 47         | 20         |
| Loans and advances to banks  | –          | –          |
| Total allowances for impairment losses charged against income for the year | 5,125      | 8,020      |
| Total balance at end of year – Total                                       | 15,253     | 18,746     |

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

|                                    | 2015<br>Allowance<br>£m | 2015<br>Percentage<br>of loans<br>in each<br>category to<br>total loans<br>% | 2014<br>Allowance<br>£m | 2014<br>Percentage<br>of<br>loans<br>in each<br>category to<br>total loans<br>% | 2013<br>Allowance<br>£m | 2013<br>Percentage<br>of<br>loans<br>in each<br>category to<br>total loans<br>% | 2012<br>Allowance<br>£m | 2012<br>Percentage<br>of<br>loans<br>in each<br>category to<br>total loans<br>% | 2011<br>Allowance<br>£m |
|------------------------------------|-------------------------|--|-------------------------|---|-------------------------|---|-------------------------|---|-------------------------|
| Balance at year end applicable to: |                         |  |                         |   |                         |   |                         |   |                         |
| Loans and advances to banks        | –                       | 5.2  | –                       | 5.1   | –                       | 4.8   | 3                       | 5.8   | 14                      |
| Loans and advances to customers:   |                         |  |                         |   |                         |   |                         |   |                         |
| Mortgages                          | 479                     | 64.7   | 460                     | 64.7  | 657                     | 63.5  | 1,113                   | 60.0  | 948                     |
| Other personal lending             | 388                     | 4.3  | 607                     | 4.5   | 919                     | 4.4   | 1,147                   | 5.0   | 1,89                    |
| Agriculture, forestry and fishing  | 15                      | 1.4  | 18                      | 1.3   | 38                      | 1.1   | 67                      | 1.0   | 51                      |
| Energy and water supply            | 20                      | 0.7  | 61                      | 0.7   | 149                     | 0.8   | 191                     | 0.6   | 165                     |

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|   |       |       |       |       |        |       |        |       |        |
|---|-------|-------|-------|-------|--------|-------|--------|-------|--------|
| Manufacturing                             | 70    | 1.2   | 179   | 1.2   | 296    | 1.4   | 337    | 1.5   | 475    |
| Construction                              | 165   | 1.0   | 158   | 1.3   | 395    | 1.3   | 504    | 1.3   | 898    |
| Transport,<br>distribution and<br>hotels  | 219   | 2.8   | 1,051 | 2.9   | 1,954  | 4.2   | 2,162  | 4.7   | 2,111  |
| Postal and<br>telecommunications          | 4     | 0.5   | 17    | 0.5   | 11     | 0.4   | 40     | 0.2   | 62     |
| Financial, business<br>and other services | 811   | 8.9   | 1,225 | 8.7   | 2,293  | 8.0   | 2,764  | 8.6   | 3,071  |
| Property companies                        | 790   | 6.7   | 2,553 | 7.1   | 5,145  | 8.3   | 6,664  | 9.3   | 8,711  |
| Lease financing                           | –     | 0.6   | 1     | 0.6   | 6      | 0.8   | 33     | 1.1   | 92     |
| Hire purchase                             | 72    | 2.0   | 84    | 1.4   | 103    | 1.0   | 228    | 0.9   | 244    |
| Total balance at year<br>end              | 3,033 | 100.0 | 6,414 | 100.0 | 11,966 | 100.0 | 15,253 | 100.0 | 18,711 |

87

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided for 2013 or later years. The analysis of the coverage of the allowance for loan losses at 31 December 2012 and 2011 between domestic and international offices is as follows:

|  | Domestic        |                                   | Foreign         |                                   | Total           |                                   |
|--|-----------------|-----------------------------------|-----------------|-----------------------------------|-----------------|-----------------------------------|
|  | Allowance<br>£m | Percentage of<br>total loans<br>% | Allowance<br>£m | Percentage of<br>total loans<br>% | Allowance<br>£m | Percentage of<br>total loans<br>% |
| 2012                                   |                 |                                   |                 |                                   |                 |                                   |
| Balance at year end applicable to:     |                 |                                   |                 |                                   |                 |                                   |
| Loans and advances to banks            | 3               | 6.1                               | –               | 1.7                               | 3               | 5.8                               |
| Loans and advances to customers:       |                 |                                   |                 |                                   |                 |                                   |
| Mortgages                              | 106             | 62.0                              | 1,007           | 36.8                              | 1,113           | 60.0                              |
| Other personal lending                 | 1,064           | 5.0                               | 83              | 5.4                               | 1,147           | 5.0                               |
| Agriculture, forestry and fishing      | 57              | 1.0                               | 10              | 0.1                               | 67              | 1.0                               |
| Energy and water supply                | 177             | 0.3                               | 14              | 3.7                               | 191             | 0.6                               |
| Manufacturing                          | 194             | 1.4                               | 143             | 3.1                               | 337             | 1.5                               |
| Construction                           | 215             | 1.2                               | 289             | 2.5                               | 504             | 1.3                               |
| Transport, distribution and hotels     | 715             | 4.2                               | 1,447           | 10.6                              | 2,162           | 4.7                               |
| Postal and telecommunications          | 10              | 0.2                               | 30              | 0.4                               | 40              | 0.2                               |
| Financial, business and other services | 2,008           | 8.4                               | 756             | 11.1                              | 2,764           | 8.6                               |
| Property companies                     | 2,307           | 8.3                               | 4,357           | 21.0                              | 6,664           | 9.3                               |
| Lease financing                        | 14              | 1.0                               | 19              | 2.8                               | 33              | 1.1                               |
| Hire purchase                          | 206             | 0.9                               | 22              | 0.8                               | 228             | 0.9                               |
| Total                                  | 7,076           | 100.0                             | 8,177           | 100.0                             | 15,253          | 100.0                             |

|                                    | Domestic        |                                   | Foreign         |                                   | Total           |                                   |
|------------------------------------|-----------------|-----------------------------------|-----------------|-----------------------------------|-----------------|-----------------------------------|
|                                    | Allowance<br>£m | Percentage of<br>total loans<br>% | Allowance<br>£m | Percentage of<br>total loans<br>% | Allowance<br>£m | Percentage of<br>total loans<br>% |
| 2011                               |                 |                                   |                 |                                   |                 |                                   |
| Balance at year end applicable to: |                 |                                   |                 |                                   |                 |                                   |
| Loans and advances to banks        | 14              | 5.7                               | –               | 1.4                               | 14              | 5.3                               |
| Loans and advances to customers:   |                 |                                   |                 |                                   |                 |                                   |
| Mortgages                          | 123             | 59.1                              | 825             | 29.7                              | 948             | 56.4                              |
| Other personal lending             | 1,555           | 5.0                               | 340             | 3.2                               | 1,895           | 4.9                               |
| Agriculture, forestry and fishing  | 39              | 0.9                               | 12              | 0.3                               | 51              | 0.8                               |
| Energy and water supply            | 137             | 0.3                               | 28              | 4.2                               | 165             | 0.7                               |
| Manufacturing                      | 318             | 1.4                               | 157             | 3.6                               | 475             | 1.6                               |
| Construction                       | 531             | 1.4                               | 367             | 3.3                               | 898             | 1.6                               |
| Transport, distribution and hotels | 668             | 4.9                               | 1,449           | 10.2                              | 2,117           | 5.3                               |
| Postal and telecommunications      | 35              | 0.3                               | 27              | 0.7                               | 62              | 0.3                               |

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|  |       |       |        |       |        |       |
|--|-------|-------|--------|-------|--------|-------|
| Financial, business and other services | 2,172 | 10.1  | 903    | 13.2  | 3,075  | 10.4  |
| Property companies                     | 2,153 | 8.8   | 6,557  | 27.4  | 8,710  | 10.5  |
| Lease financing                        | 63    | 1.2   | 29     | 1.8   | 92     | 1.3   |
| Hire purchase                          | 217   | 0.9   | 27     | 1.0   | 244    | 0.9   |
| Total                                  | 8,025 | 100.0 | 10,721 | 100.0 | 18,746 | 100.0 |

88



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**RISK ELEMENTS IN THE LOAN PORTFOLIO**

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

**NON-PERFORMING LENDING**

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

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

The Group complies with IFRS 7, which requires more detailed qualitative and quantitative disclosures about its loan portfolios. Accordingly, the table below shows separately those loans that are (i) neither past due nor impaired, (ii) past due but not impaired, (iii) impaired, not requiring a provision and (iv) impaired with a provision.

| (audited)                        | Loans and advances to customers   |                          |                      |                  |             | Loans and advances designated at fair value through profit or loss<br>£m |
|----------------------------------|-----------------------------------|--------------------------|----------------------|------------------|-------------|--|
|                                  | Loans and advances to banks<br>£m | Retail – mortgages<br>£m | Retail – other<br>£m | Commercial<br>£m | Total<br>£m |  |
| <b>31 December 2015</b>          |                                   |                          |                      |                  |             |  |
| Neither past due nor impaired    | 25,006                            | 302,063                  | 38,886               | 100,001          | 440,950     | 33,174   |
| Past due but not impaired        | 111                               | 8,233                    | 393                  | 463              | 9,089       | –  |
| Impaired – no provision required | –                                 | 732                      | 690                  | 1,092            | 2,514       | –  |
| – provision held                 | –                                 | 3,269                    | 911                  | 2,896            | 7,076       | –  |
| Gross                            | 25,117                            | 314,297                  | 40,880               | 104,452          | 459,629     | 33,174   |
| 31 December 2014                 |                                   |                          |                      |                  |             |  |

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|                                  |        |         |        |         |         |        |
|----------------------------------|--------|---------|--------|---------|---------|--------|
| Neither past due nor impaired    | 26,003 | 320,324 | 37,886 | 106,768 | 464,978 | 36,725 |
| Past due but not impaired        | 152    | 10,311  | 674    | 488     | 11,473  | –      |
| Impaired – no provision required | –      | 578     | 938    | 847     | 2,363   | –      |
| – provision held                 | –      | 3,766   | 1,109  | 7,070   | 11,945  | –      |
| Gross                            | 26,155 | 334,979 | 40,607 | 115,173 | 490,759 | 36,725 |
| 31 December 2013                 |        |         |        |         |         |        |
| Neither past due nor impaired    | 25,219 | 318,668 | 36,789 | 107,764 | 463,221 | 29,443 |
| Past due but not impaired        | 146    | 12,329  | 580    | 786     | 13,695  | –      |
| Impaired – no provision required | –      | 637     | 1,284  | 1,824   | 3,745   | –      |
| – provision held                 | –      | 6,229   | 1,456  | 20,829  | 28,514  | –      |
| Gross                            | 25,365 | 337,863 | 40,109 | 131,203 | 509,175 | 29,443 |
| 31 December 2012                 |        |         |        |         |         |        |
| Neither past due nor impaired    | 32,726 | 319,613 | 41,223 | 117,152 | 477,988 | 14,551 |
| Past due but not impaired        | 31     | 12,880  | 922    | 1,527   | 15,329  | –      |
| Impaired – no provision required | –      | 741     | 1,530  | 1,504   | 3,775   | –      |
| – provision held                 | 3      | 7,391   | 2,124  | 33,003  | 42,518  | –      |
| Gross                            | 32,760 | 340,625 | 45,799 | 153,186 | 539,610 | 14,551 |
| 31 December 2011                 |        |         |        |         |         |        |
| Neither past due nor impaired    | 32,494 | 330,727 | 41,448 | 146,655 | 518,830 | 11,121 |
| Past due but not impaired        | 15     | 12,742  | 1,093  | 2,509   | 16,344  | –      |
| Impaired – no provision required | 6      | 1,364   | 1,604  | 3,544   | 6,512   | –      |
| – provision held                 | 105    | 6,701   | 2,940  | 44,116  | 53,757  | –      |
| Gross                            | 32,620 | 351,534 | 47,085 | 196,824 | 595,443 | 11,121 |

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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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

| (audited)               | Loans and advances to customers   |   |                      |                  |             | Loans and advances designated at fair value through profit or loss<br>£m |
|-------------------------|-----------------------------------|---|----------------------|------------------|-------------|--|
|                         | Loans and advances to banks<br>£m | Loans and advances Retail – mortgages<br>£m | Retail – other<br>£m | Commercial<br>£m | Total<br>£m |  |
| <b>31 December 2015</b> |                                   |   |                      |                  |             |  |
| 0-30 days               | 111                               | 4,066                                       | 276                  | 248              | 4,590       | –  |
| 30-60 days              | –                                 | 1,732                                       | 81                   | 100              | 1,913       | –  |
| 60-90 days              | –                                 | 1,065                                       | 9                    | 52               | 1,126       | –  |
| 90-180 days             | –                                 | 1,370                                       | 8                    | 19               | 1,397       | –  |
| Over 180 days           | –                                 | –   | 19                   | 44               | 63          | –  |
| Total                   | 111                               | 8,233                                       | 393                  | 463              | 9,089       | –  |
| <b>31 December 2014</b> |                                   |   |                      |                  |             |  |
| 0-30 days               | 152                               | 4,854                                       | 453                  | 198              | 5,505       | –  |
| 30-60 days              | –                                 | 2,309                                       | 110                  | 51               | 2,470       | –  |
| 60-90 days              | –                                 | 1,427                                       | 90                   | 139              | 1,656       | –  |
| 90-180 days             | –                                 | 1,721                                       | 5                    | 38               | 1,764       | –  |
| Over 180 days           | –                                 | –   | 16                   | 62               | 78          | –  |
| Total                   | 152                               | 10,311                                      | 674                  | 488              | 11,473      | –  |
| <b>31 December 2013</b> |                                   |   |                      |                  |             |  |
| 0-30 days               | 146                               | 5,596                                       | 489                  | 347              | 6,432       | –  |
| 30-60 days              | –                                 | 2,639                                       | 87                   | 102              | 2,828       | –  |
| 60-90 days              | –                                 | 1,734                                       | 4                    | 57               | 1,795       | –  |
| 90-180 days             | –                                 | 2,360                                       | –                    | 41               | 2,401       | –  |
| Over 180 days           | –                                 | –   | –                    | 239              | 239         | –  |
| Total                   | 146                               | 12,329                                      | 580                  | 786              | 13,695      | –  |
| <b>31 December 2012</b> |                                   |   |                      |                  |             |  |
| 0-30 days               | –                                 | 5,996                                       | 744                  | 860              | 7,600       | –  |
| 30-60 days              | 3                                 | 2,667                                       | 138                  | 131              | 2,936       | –  |
| 60-90 days              | 2                                 | 1,750                                       | 29                   | 328              | 2,107       | –  |
| 90-180 days             | 6                                 | 2,467                                       | 5                    | 56               | 2,528       | –  |
| Over 180 days           | 20                                | –   | 6                    | 152              | 158         | –  |
| Total                   | 31                                | 12,880                                      | 922                  | 1,527            | 15,329      | –  |
| <b>31 December 2011</b> |                                   |   |                      |                  |             |  |
| 0-30 days               | 1                                 | 5,989                                       | 868                  | 1,163            | 8,020       | –  |
| 30-60 days              | 9                                 | 2,618                                       | 195                  | 481              | 3,294       | –  |
| 60-90 days              | 4                                 | 1,833                                       | 25                   | 260              | 2,118       | –  |
| 90-180 days             | –                                 | 2,302                                       | 4                    | 159              | 2,465       | –  |
| Over 180 days           | 1                                 | –   | 1                    | 446              | 447         | –  |
| Total                   | 15                                | 12,742                                      | 1,093                | 2,509            | 16,344      | –  |

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

90

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**POTENTIAL PROBLEM LOANS**

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

IFRS 7 requires the disclosure of information about the credit quality of loans and advances that are neither past due nor impaired. The Group's disclosures analyse these loans between those that the Group believes are of good quality, satisfactory quality, and lower quality and those that are below standard but not impaired. The below standard but not impaired balances represent potential problem loans.

| <b>(audited)</b>                 | Loans and advances to customers |   |                                    |                                | <b>Total</b><br><b>£m</b> | Loans and advances designated at fair value through <b>profit or loss</b><br><b>£m</b> |
|----------------------------------|---------------------------------|---|------------------------------------|--------------------------------|---------------------------|--|
|                                  | <b>to banks</b><br><b>£m</b>    | <b>Loans and advances</b><br><b>Retail – mortgages</b><br><b>£m</b> | <b>Retail – other</b><br><b>£m</b> | <b>Commercial</b><br><b>£m</b> |                           |  |
| 31 December 2015                 |                                 |   |                                    |                                |                           |  |
| Good quality                     | <b>24,670</b>                   | <b>301,403</b>  | <b>33,589</b>                      | <b>63,453</b>                  |                           | <b>33,156</b>  |
| Satisfactory quality             | <b>311</b>                      | <b>527</b>  | <b>4,448</b>                       | <b>28,899</b>                  |                           | <b>15</b>  |
| Lower quality                    | <b>4</b>                        | <b>27</b>   | <b>476</b>                         | <b>7,210</b>                   |                           | <b>3</b>   |
| Below standard, but not impaired | <b>21</b>                       | <b>106</b>  | <b>373</b>                         | <b>439</b>                     |                           | <b>–</b>   |
| <b>Total</b>                     | <b>25,006</b>                   | <b>302,063</b>  | <b>38,886</b>                      | <b>100,001</b>                 | <b>440,950</b>            | <b>33,174</b>  |
| 31 December 2014                 |                                 |   |                                    |                                |                           |  |
| Good quality                     | 25,654                          | 318,967   | 30,993                             | 65,106                         |                           | 36,482   |
| Satisfactory quality             | 263                             | 1,159   | 5,675                              | 28,800                         |                           | 238  |
| Lower quality                    | 49                              | 72  | 623                                | 11,204                         |                           | 5  |
| Below standard, but not impaired | 37                              | 126   | 595                                | 1,658                          |                           | –  |
| <b>Total</b>                     | <b>26,003</b>                   | <b>320,324</b>  | <b>37,886</b>                      | <b>106,768</b>                 | <b>464,978</b>            | <b>36,725</b>  |
| 31 December 2013                 |                                 |   |                                    |                                |                           |  |
| Good quality                     | 25,044                          | 314,749   | 29,129                             | 66,345                         |                           | 29,432   |
| Satisfactory quality             | 171                             | 2,948   | 6,414                              | 29,038                         |                           | 7  |
| Lower quality                    | 2                               | 308   | 501                                | 9,991                          |                           | 3  |
| Below standard, but not impaired | 2                               | 663   | 745                                | 2,390                          |                           | 1  |
| <b>Total</b>                     | <b>25,219</b>                   | <b>318,668</b>  | <b>36,789</b>                      | <b>107,764</b>                 | <b>463,221</b>            | <b>29,443</b>  |
| 31 December 2012                 |                                 |   |                                    |                                |                           |  |
| Good quality                     | 32,173                          | 313,372   | 30,924                             | 60,049                         |                           | 14,514   |
| Satisfactory quality             | 174                             | 4,532   | 8,579                              | 33,477                         |                           | 28   |
| Lower quality                    | 10                              | 552   | 862                                | 18,153                         |                           | 6  |
| Below standard, but not impaired | 369                             | 1,157   | 858                                | 5,473                          |                           | 3  |
| <b>Total</b>                     | <b>32,726</b>                   | <b>319,613</b>  | <b>41,223</b>                      | <b>117,152</b>                 | <b>477,988</b>            | <b>14,551</b>  |

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|                                  |        |         |        |         |         |        |
|----------------------------------|--------|---------|--------|---------|---------|--------|
| 31 December 2011                 |        |         |        |         |         |        |
| Good quality                     | 32,141 | 323,060 | 29,123 | 71,907  |         | 11,065 |
| Satisfactory quality             | 171    | 5,432   | 9,747  | 42,311  |         | 45     |
| Lower quality                    | 9      | 970     | 1,127  | 24,676  |         | 11     |
| Below standard, but not impaired | 173    | 1,265   | 1,451  | 7,761   |         | –      |
| Total                            | 32,494 | 330,727 | 41,448 | 146,655 | 518,830 | 11,121 |

For further details see note 53 on page F-90.

**INTEREST FOREGONE ON NON-PERFORMING LENDING**

The table below summarises the interest foregone on impaired lending.

|   |              |
|---|--------------|
|   | <b>2015</b>  |
|   | <b>£m</b>    |
| Interest income that would have been recognised under original contract terms | <b>504</b>   |
| Interest income included in profit  | <b>(248)</b> |
| <b>Interest foregone</b>  | <b>256</b>   |
| 91  |              |

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## TROUBLED DEBT RESTRUCTURINGS

In the US, loans whose terms have been modified due to problems with the borrower are required to be separately disclosed. If the new terms were in line with market conditions at the time of the restructuring and the restructured loan remains current as to repayment of principal and interest then the disclosure is discontinued at the end of the first year. The Company's accounting policy for loans that are renegotiated is set out in note 2(H)(1) to the financial statements. The table below sets out loans that are forborne at 31 December 2015 and 2014, separately identifying those loans that are also impaired:

|   | Total forborne<br>loans and<br>advances<br>which<br>are not<br>impaired<br>£m | Total<br>forborne<br>loans and<br>advances<br>which<br>are impaired<br>£m | Total loans<br>and<br>advances<br>which<br>are forborne<br>£m | Impairment<br>allowance as a<br>% of loans and<br>advances<br>which<br>are forborne<br>% |
|---|---|---|---|--|
| <b>At 31 December 2015</b>  |   |   |   |  |
| UK secured retail   | <b>2,929</b>  | <b>173</b>  | <b>3,102</b>  | <b>4.2</b>   |
| UK unsecured retail   | <b>28</b>   | <b>119</b>  | <b>147</b>  | <b>40.0</b>  |
| Consumer credit cards   | <b>105</b>  | <b>120</b>  | <b>225</b>  | <b>26.8</b>  |
| Asset Finance UK Retail   | <b>49</b>   | <b>51</b>   | <b>100</b>  | <b>25.5</b>  |
| Run off: Ireland secured retail   | <b>143</b>  | <b>26</b>   | <b>169</b>  | <b>13.3</b>  |
| Commercial Banking  | <b>986</b>  | <b>2,528</b>  | <b>3,514</b>  | <b>30.9</b>  |
| Run off: Corporate Real Estate, other Corporate and<br>Specialist Finance | <b>9</b>  | <b>1,771</b>  | <b>1,780</b>  | <b>52.5</b>  |
| Run-off Ireland: Commercial real estate and corporate                     | <b>32</b>   | <b>5</b>  | <b>37</b>   | <b>0.0</b>   |
| <b>At 31 December 2014</b>  |   |   |   |  |
| UK secured retail   | 4,128   | 266   | 4,394   | 3.5  |
| UK unsecured retail   | 23  | 139   | 162   | 39.4   |
| Consumer credit cards   | 94  | 140   | 234   | 29.1   |
| Asset Finance UK Retail   | 56  | 53  | 109   | 20.5   |
| Run off: Ireland secured retail   | 239   | 41  | 280   | 12.7   |
| Commercial Banking  | 1,896   | 3,241   | 5,137   | 31.0   |
| Run off: Corporate Real Estate, other Corporate and<br>Specialist Finance | 86  | 1,912   | 1,998   | 58.3   |
| Run-off Ireland: Commercial real estate and corporate                     | 384   | 3,052   | 3,436   | 72.2   |

The Group assesses whether a loan benefiting from a UK Government-sponsored programme is impaired or a troubled debt restructuring using the same accounting policies and practices as it does for loans not benefiting from such a

programme.

Further information on the schemes operated by the Group to assist borrowers who are experiencing financial stress and on the Group's forbore loans is set out on pages 59 to 61 and pages 69 to 78.

## **ASSETS ACQUIRED IN EXCHANGE FOR ADVANCES**

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

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

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

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



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CROSS BORDER OUTSTANDINGS**

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

|                          |             | Total  | Governments<br>and official<br>institutions | Banks and other<br>financial<br>institutions | Commercial,<br>industrial<br>and other |
|--------------------------|-------------|--------|---|--|--|
|                          | % of assets | £m     | £m  | £m   | £m                                     |
| At 31 December 2015:     |             |        |   |  |  |
| United States of America | 1.5         | 11,748 | 6,349                                       | 952  | 4,447                                  |
| At 31 December 2014:     |             |        |   |  |  |
| United States of America | 1.3         | 11,437 | 7,838                                       | 1,177  | 2,422                                  |
| At 31 December 2013:     |             |        |   |  |  |
| United States of America | 1.3         | 10,679 | 7,156                                       | 1,626  | 1,897                                  |
| Republic of Ireland      | 1.1         | 8,990  | 2   | 119  | 8,869                                  |

At 31 December 2015, United States of America had commitments of £1,096 million.

At 31 December 2015, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2014, no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

At 31 December 2013 no countries had cross-border outstandings of between 0.75 per cent and 1 per cent of assets.

**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.

## **RISK APPETITE**

The Group's conduct risk appetite is designed to safeguard customers from systemic unfair outcomes and is monitored through a number of key metrics with defined limits and triggers which are reviewed and approved by the Board annually. The metrics and their outputs are regularly assessed by Executive and Board Risk committees to ensure that the Group operates within appetite policies, processes and standards. These are in place to provide a framework for businesses and colleagues to operate in accordance with the laws, regulations and voluntary codes, which apply to the Group and its activities.

For further information on risk appetite refer to page 46.

## **EXPOSURES**

Conduct risk affects all aspects of the Group's operations, all types of customers and other stakeholders. The Group faces significant conduct risks, for example, through products or services not meeting the needs of its customers; sales processes resulting in poor advice; failure to deal with a customer's complaint effectively where the Group has not met customer expectations, which may lead to a referral to the Financial Ombudsman Service; or engaging in conduct which disrupts the fair and effective operation of a market in which it is active. Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media, politicians and consumer groups, there is a risk that certain aspects of the Group's current or legacy business may be determined by the Financial Conduct Authority and 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 treatment. The Group may also be liable for damages to third parties harmed by the conduct of its business.

## **MEASUREMENT**

To articulate its conduct risk appetite, the Group has sought more granularity through the use of suitable conduct risk metrics and tolerances that indicate where it may potentially be operating outside its conduct appetite. Conduct Risk Appetite Metrics (CRAMs) have been designed for all product families offered by the Group; a set of common metrics have been agreed for all products to support a consistent approach. These contain a range of product, 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 month by month. At a consolidated level these metrics are part of the Board approved risk appetite. The Group also continues to measure how effectively the overall Conduct Strategy is embedded across all divisions and functions and its impact on customer outcomes through the Group Customer First Committee (GCFC). In relation to market conduct, metrics have also been generated, covering, for example, the way in which confidential information and potential conflicts of interest are managed.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MITIGATION**

The Group takes a range of mitigating actions with respect to this risk; it has implemented a customer-focused, UK-centric strategy, 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) as part of the transition of the Group's Conduct Strategy from a programme to business as usual supported by the GCFC, including:

-Conduct risk appetite established at Group and business area level;

-Customer needs explicitly considered within business and product level planning and strategy;

-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;

-Enhanced product governance framework to ensure products continue to offer customers fair value, and meet the needs of the relevant target market throughout their life cycle;

-Sales processes and governance framework to deliver consistently fair outcomes;

-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, and a focus on how the Group manages colleagues' performance with clearer customer accountabilities; and

-Application of the Conduct Strategy to third parties involved in serving the Group's customers.

The Group has also prioritised activity designed to reinforce good conduct in its engagement with the markets in which it operates, together with the development of preventative and detective controls in order to be able to demonstrate this.

The Group's leadership team is committed to embedding the Conduct Strategy within the business following its approved transition into business as usual to support the development of the right customer centric culture. The Board and Group Risk Committee receive regular reports and metrics to track progress on how the Group is meeting customer needs and minimising conduct risk.

All Group business areas have continued to apply significant resources to the Conduct Strategy to achieve the target of transition to business as usual and to continue delivering improved outcomes for customers.

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 implementation of the Group's conduct strategy meets 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 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. There is also focus on the enhancement of preventative and detective controls to encourage and demonstrate the Group's support for the fair and effective operation of relevant markets.

## **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 bond prices, foreign exchange rates, equity, property and commodity prices and other instruments), lead to reductions in earnings and/or value.

### **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. The Group's Risk Management Framework and Market Risk Principle, reviewed and approved annually by the Board, articulate accountabilities for the management of market risk across the Group, and how this is discharged through a robust governance structure with the objective of seeking an optimal risk profile which supports sustainable business growth and minimises losses. The Group Asset and Liability Committee (GALCO), chaired by the Chief Financial Officer, is responsible for approving and monitoring group market risks, management techniques, market

risk measures, behavioural assumptions, and the market risk policy.

The market risk policy defines the framework and mandatory requirements for market risk management and oversight adopted by the Group. The 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.

For further information on risk appetite refer to page 46.

94

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**BALANCE SHEET LINKAGES**

The information provided in table 1.36 (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. This breakdown of financial instruments included and not included in trading book Value at Risk (VaR) provides a linkage with the trading book market risk measures reported later on in the market risk section. It is important to highlight that this table does not reflect how the Group manages trading book market risk, since it does not discriminate between assets and liabilities in its VaR model.

Table 1.36: Market risk linkage to the balance sheet

| <b>2015</b>  | <b>Total<br/>£m</b> | <b>Banking<br/>Trading<br/>book<br/>only<br/>£m</b> | <b>Non-trading<br/>£m</b> | <b>Insurance<br/>£m</b> | <b>Primary risk factor</b>                     |
|--|---------------------|---|---------------------------|-------------------------|--|
| <b>Assets</b>  |                     |   |                           |                         |  |
| Cash and balances at central banks   | 58,417              | –   | 58,417                    | –                       | Interest rate                                  |
| Items in the course of collection from banks                                 | 697                 | –   | 697                       | –                       | Interest rate                                  |
| Trading and other financial assets at fair value through profit or loss      | 140,536             | 42,661  | 2,181                     | 95,694                  | Interest rate, foreign exchange, credit spread |
| Derivative financial instruments   | 29,467              | 25,305  | 2,570                     | 1,592                   | Interest rate, foreign exchange, credit spread |
| <b>Loans and receivables:</b>  |                     |   |                           |                         |  |
| Loans and advances to banks  | 25,117              | –   | 3,385                     | 21,732                  | Interest rate                                  |
| Loans and advances to customers  | 455,175             | –   | 455,175                   | –                       | Interest rate                                  |
| Debt securities  | 4,191               | –   | 4,191                     | –                       | Interest rate, credit spread                   |
|  | 484,483             | –   | 462,751                   | 21,732                  |  |
| Available-for-sale financial assets  | 33,032              | –   | 33,030                    | 2                       | Interest rate, credit spread, foreign exchange |
| Held-to-maturity investments   | 19,808              | –   | 19,808                    | –                       | Interest rate                                  |
| Value of in-force business   | 4,596               | –   | –                         | 4,596                   | Equity   |
| Other assets   | 35,652              | –   | 16,656                    | 18,996                  | Interest rate                                  |
| <b>Total assets</b>  | <b>806,688</b>      | <b>67,966</b>                                       | <b>596,110</b>            | <b>142,612</b>          |  |
| <b>Liabilities</b>   |                     |   |                           |                         |  |
| Deposits from banks  | 16,925              | –   | 16,925                    | –                       | Interest rate                                  |
| Customer deposits  | 418,326             | –   | 418,326                   | –                       | Interest rate                                  |
| Items in course of transmission to banks                                     | 717                 | –   | 717                       | –                       | Interest rate                                  |
| Trading and other financial liabilities at fair value through profit or loss | 51,863              | 43,984  | 7,879                     | –                       | Interest rate, foreign exchange                |
| Derivative financial instruments   | 26,301              | 22,124  | 2,413                     | 1,764                   |  |

|   |         |        |         |         |  |
|---|---------|--------|---------|---------|--|
| Debt securities in issue                                    | 82,056  | –      | 82,056  | –       | Interest rate, foreign exchange, credit spread |
| Liabilities arising from insurance and investment contracts | 103,071 | –      | –       | 103,071 | Interest rate                                  |
| Subordinated liabilities                                    | 23,312  | –      | 21,638  | 1,674   | Credit spread                                  |
| Other liabilities   | 37,137  | –      | 7,103   | 30,034  | Interest rate, foreign exchange                |
| Total liabilities   | 759,708 | 66,108 | 557,057 | 136,543 | Interest rate                                  |

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.

Derivative assets and liabilities are held 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 25, page F-42).

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 103. Interest rate risk in the asset portfolios is swapped into floating.

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.

Table 1.37 shows the key market risks for the Group's banking, defined benefit pension schemes and trading, banking and Insurance and trading activities.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.37: Key market risks for the Group by individual business activity (profit before tax impact measured against Group single stress scenarios)

|                                | Risk type     |            |    |               |        |           |
|--------------------------------|---------------|------------|----|---------------|--------|-----------|
|                                | Interest rate | Basis risk | FX | Credit spread | Equity | Inflation |
| Banking activities             | l             | l          | o  | l             | l      | o         |
| Defined benefit pension scheme | l             |            | o  | n             | l      | o         |
| Insurance portfolios           | i             |            | i  | l             | l      | i         |
| Trading portfolios             | o             |            | o  | i             |        | o         |
| <b>Key</b>                     |               |            |    |               |        |           |
| Profit before tax:             | Loss          | Gain       |    |               |        |           |
| >£500m                         | l             | n          |    |               |        |           |
| £250m – £500m                  | l             | n          |    |               |        |           |
| <£250m                         | l             | n          |    |               |        |           |
| <£50m                          | i             | o          |    |               |        |           |

**MEASUREMENT**

Group market risk is managed within a Board approved framework and risk appetite. Board risk appetite is calibrated primarily to five economic multi-risk 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 GALCO 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 levels of risk appetite comprise scenarios/stress based measures (single factor stresses), percentile based measures (e.g. VaR and Stressed VaR), and sensitivity based measures (e.g. sensitivity to 1 basis point move in interest rates), as well as stochastic measures within the Insurance business. These measures are reviewed regularly by senior management to inform effective decision making.

**MITIGATION**

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

## 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.

## BANKING ACTIVITIES

### *EXPOSURES*

The Group's banking activities expose it to the risk of adverse movements in interest rates, credit spreads, exchange rates and equity prices, with little or no exposure to commodity risk. The volatility of market values can be affected by both the transparency of prices and the amount of liquidity in the market for the relevant asset 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 of the Group. 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 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 53 on page F-90). 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.

96

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*Equity risk*

Equity risk arises primarily from three different sources; (i) the Group's strategic equity holdings in Banco Sabadell, Aberdeen, 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) liquid asset portfolio held in the management of Group liquidity comprising government, supranational, and other eligible assets; and ii) the Credit Valuation Adjustment (CVA) and Debit Valuation Adjustment (DVA) sensitivity to credit spreads.

*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 notional 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. Interest rate repricing profiles are reported by currency and used to calculate the income and value sensitivities (in GBP equivalent). Repricing assumptions and customer reaction to changes in product pricing is a major determinant of the risk profile. The Group is aware that any assumptions based model is open to challenge. However, a full behavioural review is performed annually by Group ALM functions to ensure the assumptions remain appropriate, and is reviewed by Risk Division.

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 1.38 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 rate.

Table 1.38: **Banking activities: market value sensitivity**

|                      | 2015              |                     |                    |                      | 2014              |                     |                    |                      |
|----------------------|-------------------|---------------------|--------------------|----------------------|-------------------|---------------------|--------------------|----------------------|
|                      | Up<br>25bps<br>£m | Down<br>25bps<br>£m | Up<br>100bps<br>£m | Down<br>100bps<br>£m | Up<br>25bps<br>£m | Down<br>25bps<br>£m | Up<br>100bps<br>£m | Down<br>100bps<br>£m |
| Sterling             | 48.7              | (48.8)              | 194.2              | (115.9)              | (15.7)            | 15.5                | (63.8)             | 3.9                  |
| US dollar            | 1.9               | (1.9)               | 7.5                | (5.9)                | 4.7               | (4.9)               | 17.8               | (15.9)               |
| Euro                 | 1.7               | (2.1)               | 6.9                | (6.8)                | (7.2)             | 4.8                 | (27.3)             | 15.0                 |
| Australian<br>dollar | (0.1)             | 0.1                 | (0.2)              | 0.2                  | (0.4)             | 0.4                 | (1.3)              | 1.8                  |
| Other                | (0.3)             | 0.3                 | (1.4)              | 0.9                  | (0.3)             | 0.3                 | (1.2)              | 0.8                  |
| <b>Total</b>         | <b>51.9</b>       | <b>(52.4)</b>       | <b>207.0</b>       | <b>(127.5)</b>       | <b>(18.9)</b>     | <b>16.1</b>         | <b>(75.8)</b>      | <b>5.6</b>           |

This is a risk based disclosure and the amounts shown would be amortised in the income statement over the duration of the portfolio. The measure, however, is simplified in that it assumes all interest rates, for all currencies and maturities, move at the same time and by the same amount.

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 1.39 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 1.39: **Banking activities: market value sensitivity to a steepening and flattening of the yield curve**

|                   | 2015            |                 | 2014            |                 |
|-------------------|-----------------|-----------------|-----------------|-----------------|
|                   | Steepener<br>£m | Flattener<br>£m | Steepener<br>£m | Flattener<br>£m |
| Sterling          | (105.7 )        | 97.1            | 69.3            | (85.7 )         |
| US dollar         | (3.4 )          | 4.8             | 19.5            | (6.8 )          |
| Euro              | (0.5 )          | 2.0             | (8.6 )          | 3.0             |
| Australian dollar | (0.0 )          | (0.0 )          | 0.5             | 7.5             |
| Other             | 0.2             | (0.2 )          | 0.2             | (0.2 )          |
| <b>Total</b>      | <b>(109.4 )</b> | <b>103.7</b>    | <b>80.9</b>     | <b>(82.2 )</b>  |

97

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 1.40: **Banking activities: net interest income sensitivity (audited)**

|  | 2015              |                     |                    |                      | 2014              |                     |                    |                      |
|--|-------------------|---------------------|--------------------|----------------------|-------------------|---------------------|--------------------|----------------------|
|  | Up<br>25bps<br>£m | Down<br>25bps<br>£m | Up<br>100bps<br>£m | Down<br>100bps<br>£m | Up<br>25bps<br>£m | Down<br>25bps<br>£m | Up<br>100bps<br>£m | Down<br>100bps<br>£m |
| Client facing activity and associated hedges | 152.4             | (140.1)             | 604.7              | (464.2)              | (4.6)             | (46.0)              | 176.3              | (222.3)              |

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 asset class.

**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 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 target 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 Risk Management Framework, Policy and Procedures document articulate the monitoring of Banking book market risk through the committee structure. The Group's Three Lines of Defence ensure risk is identified, and appropriately measured, reported and understood. 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 both their assets and from the present value of their liabilities, primarily real interest rate, credit spread, equity, and alternative asset risks. 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 37 on page F-51.

#### *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. The difference between assets and liabilities determines whether there is a surplus or deficit. Any deficit must be met by the Group with additional funding agreed with the Trustees as part of a triennial valuation process.

#### *MITIGATION*

The Group takes an active involvement in agreeing risk management and mitigation strategies with the Trustees of the schemes through whom any such activity must be conducted. An interest rate and inflation hedging programme is in place to reduce liability risk. The schemes have also reduced equity allocation and are investing 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 regularly monitored. Hedges are in place and asset/liability matching positions are also actively monitored.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 25 on page F-42). 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 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 this exposure 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 is 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 1.41 demonstrates the impact of the Group's Fiscal Solvency 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 1.41: **Insurance business: profit before tax sensitivities**

|  | <b>Increase<br/>(reduction)<br/>in profit<br/>before tax</b> |             |
|--|--|-------------|
|  | <b>2015</b>  | <b>2014</b> |
|  | <b>£m</b>  | <b>£m</b>   |
| Interest rates – increase 100 basis points | <b>(43 )</b>   | (124 )      |
| Inflation – increase 50 basis points       | <b>(23 )</b>   | (143 )      |
| Credit spreads – 100% widening             | <b>(864 )</b>  | (582 )      |
| Equity – 30% fall                          | <b>(616 )</b>  | (745 )      |
| Property – 25% fall                        | <b>(51 )</b>   | (60 )       |

Credit spread exposure increased in 2015 reflecting the Insurance business entry into the bulk annuity market, with a £0.4 billion deal in the fourth quarter, building on the £2.4 billion Scottish Widows with-profits deal earlier in the year.

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 34.

#### *MITIGATION*

Equity and credit spread risks are inherent within Insurance products and are closely monitored to ensure they remain within risk appetite. 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 £1.5 million for year end 2015 compared to £3.0 million for year end 2014. 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 1.42), sensitivity based measures, and stress testing calculations.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*MEASUREMENT*

The Group internally uses VaR as the primary risk measure for all trading book positions.

Table 1.42 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 2015 and year end 2014.

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 1.42: Trading portfolios: VaR (1-day 95 per cent confidence level) (audited)

|                              | At 31 December 2015 |               |               |               | At 31 December 2014 |               |               |               |
|------------------------------|---------------------|---------------|---------------|---------------|---------------------|---------------|---------------|---------------|
|                              | Close<br>£m         | Average<br>£m | Maximum<br>£m | Minimum<br>£m | Close<br>£m         | Average<br>£m | Maximum<br>£m | Minimum<br>£m |
| Interest rate risk           | 0.8                 | 1.4           | 3.5           | 0.8           | 1.7                 | 2.8           | 4.8           | 1.3           |
| Foreign exchange risk        | 0.2                 | 0.3           | 0.8           | 0.1           | 0.2                 | 0.4           | 1.3           | 0.0           |
| Equity risk                  | –                   | –             | –             | –             | –                   | –             | –             | –             |
| Credit spread risk           | 0.2                 | 0.4           | 1.0           | 0.2           | 0.6                 | 0.7           | 1.1           | 0.5           |
| Inflation risk               | 0.1                 | 0.3           | 1.6           | 0.1           | 0.4                 | 0.3           | 0.8           | 0.2           |
| <b>Sub-total</b>             |                     |               |               |               |                     |               |               |               |
| Sum of risk factors          | 1.3                 | 2.3           | 6.2           | 1.3           | 2.8                 | 4.3           | 6.4           | 2.5           |
| Portfolio Diversification    | (0.4 )              | (0.9 )        |               |               | (0.9 )              | (1.3 )        |               |               |
| <b>Total VaR<sup>1</sup></b> | <b>0.9</b>          | <b>1.4</b>    | <b>3.1</b>    | <b>0.8</b>    | <b>1.9</b>          | <b>3.0</b>    | <b>4.6</b>    | <b>1.6</b>    |

<sup>1</sup> VaR over 2015 is based on diversified VaR across risk factors following the PRA granting the Group permission to calculate VaR on a diversified basis. We have applied the same diversification approach for 2014.

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.

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*

Active management of the Group portfolio is necessary such that the level of exposure is strictly controlled and managed within the approved risk limits.

#### *MONITORING*

Trading risk appetite is monitored daily with 1-day 95 per cent VaR and Stress Testing limits. These limits are complemented with position level action triggers and profit and loss referrals. Risk and position limits are set and managed at both desk and overall trading book levels. They are reviewed at least annually and can be changed as required within the overall Group risk appetite framework.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**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 in line with defined appetites, and to protect both customers and the Group whilst delivering sustainable growth. The Group Operational Risk Management Framework is the method by which operational risks are managed in terms of setting risk appetite, evaluating key exposures, measuring risk, mitigating risk, and monitoring risks on an ongoing basis, as set out below.

**RISK APPETITE**

The Group's operational risk appetite is designed to safeguard the interests of customers, internal and external stakeholders, and shareholders. Appetite is expressed through four high level statements summarised below, each of which are defined with limits and triggers approved by the Board, and are regularly monitored by executive and Board Risk Committee (BRC):

–Customer: The Group builds trust and does not expect its customers to be impacted negatively.

Reputation: The Group does not expect to suffer events or behaviours that have a material negative impact on its reputation. The Group minimises the impact from cyber attacks that could result in a significant loss of customer confidence or undermine the stability of the Group.

Financial loss: The Group does not expect to experience cumulative fraud or operational losses above 3 per cent or more of budgeted Group income, or individual losses of more than £100 million.

Management time and resources: The Group does not expect internal events that divert excessive senior management time from running the business or have extensive impact on colleague time and/or morale.

For further information on risk appetite refer to page 46.

## 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;

-External fraud arising from an act of deception or omission;

-Risks arising from inadequate delivery of services to customers; and

-The risk associated with the ongoing provision of services to TSB and other organisations.

The risks below also have potential to negatively impact customers and the Group's future results:

Terrorist acts, other acts of war or hostility, geopolitical, pandemic or other such events and responses to those acts/events may create economic and political uncertainties, which could have a material adverse effect on UK and international macroeconomic conditions generally, and more specifically on the Group's results of operations, financial condition or prospects in ways that cannot necessarily be predicted.

Systems and procedures are implemented and maintained by the Group to comply with increasingly complex and detailed anti-money laundering and anti-terrorism laws and regulations. However, these may not always be fully effective in preventing third parties from using the Group as a conduit for money laundering, terrorist financing and other illegal or prohibited activities. Should the Group be associated with money laundering, terrorist financing or breaches of financial crime regulations and prohibitions, its reputation could suffer and/or it could become subject to fines, sanctions and legal enforcement; any one of which could have a material adverse effect upon operating results, financial condition and prospects.

## MEASUREMENT

Operational risk is managed within a Board approved framework and risk appetite, as set out above. A variety of measures are used such as: scoring of potential risks, using impact and likelihood, with impact thresholds aligned to the risk appetite statements above; assessment of the effectiveness of controls; monitoring of events and losses by size, business unit and internal risk categories.

Based on data captured on the Group's Operational Risk System, in 2015, the highest frequency of events occurred in external fraud (71.96 per cent) and execution, delivery and process management (15.81 per cent). Clients, products



and business practices accounted for 83.43 per cent of losses by value, driven by legacy issues where impacts materialised in 2015 (excluding PPI).

Table 1.43 below shows high level loss and event trends for the Group using Basel II categories.

**Table 1.43: Operational risk events by risk category (losses greater than or equal to £10,000)**

|  | <b>% of total<br/>volume</b> |                   | <b>% of total<br/>losses</b> |                   |
|--|------------------------------|-------------------|------------------------------|-------------------|
|  | <b>2015</b>                  | 2014 <sup>1</sup> | <b>2015</b>                  | 2014 <sup>1</sup> |
| Business disruption and system failures    | <b>0.40</b>                  | 1.20              | <b>0.13</b>                  | 0.39              |
| Clients, products and business practices   | <b>11.46</b>                 | 14.31             | <b>83.43</b>                 | 80.87             |
| Damage to physical assets                  | <b>0.06</b>                  | –                 | <b>0.04</b>                  | –                 |
| Employee practices and workplace safety    | <b>0.03</b>                  | 0.04              | –                            | –                 |
| Execution, delivery and process management | <b>15.81</b>                 | 20.30             | <b>11.08</b>                 | 14.12             |
| External fraud                             | <b>71.96</b>                 | 63.69             | <b>5.27</b>                  | 4.58              |
| Internal fraud                             | <b>0.28</b>                  | 0.46              | <b>0.05</b>                  | 0.04              |
| Total                                      | <b>100.00</b>                | 100.00            | <b>100.00</b>                | 100.00            |

During the year, the Group undertook a review of the internal classification of operational risk events to improve alignment to the Basel categories. As a result of this review, the Group has changed the classification categories for a number of events. 2014 has been revised to reflect the new categorisations.

101

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 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. 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. The IT Resilience Programme is making significant progress in addressing the observations and associated resilience risks raised in the Independent IT Resilience Review performed by PwC (2013). 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 our resilience.

The threat landscape associated with cyber risk has continued to evolve alongside increasing Regulatory attention. The Board has defined a Cyber Risk Appetite and is supporting investment to help mitigate this risk.

In addition to initiatives that protect the Group against a malicious cyber-attack 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 external fraud risks it faces, reflecting the current and emerging external fraud risks within the market. This approach drives an annual programme of enhancements to the Group's technology, process and people related controls, with an emphasis on preventative controls supported by real-time detective controls wherever feasible. Groupwide 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.

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 Simplification.

Following the successful divestment of TSB the Group retains responsibility for the ongoing provision of key services which are managed via robust change management governance and a consolidated strategic change plan. There are separate governance arrangements in place to oversee the impacts of the divestment on the retained business customers, operations and controls.

Operational resilience measures and recovery planning defined in the Group's Business Continuity Management policy ensure an appropriate and consistent approach to the management of continuity risks, including potential interruptions from a range of internal and external incidents or threats including environmental and climatic issues, terrorism, cyber, economic instability, pandemic planning and operational incidents.

The Group 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. 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 the Related Prohibitions Policy sets out a framework of controls for compliance with legal and regulatory sanctions.

## 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 the Group Conduct, Compliance and Operational Risk Committee, 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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.

#### RISK APPETITE

Funding and liquidity risk is managed separately for the Banking and Insurance businesses. Funding and liquidity risk appetite for the Banking business is set with the support of the Group Asset and Liability Committee (GALCO). The liquidity risk appetite for the Insurance business is reviewed and set annually by the Insurance Board.

For the Banking Group, the liquidity risk appetite covers a range of metrics considered key to maintaining a strong liquidity and funding position, including a number of stressed metrics, with regular reporting to GALCO and the Board. Risk appetite is a key element of the annual Group planning process with risk appetite defined over the life of the funding plan. For further information on risk appetite refer to page 46.

#### 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 53 on page F-90 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. The analysis takes into account items such as early repayment, forbearance and impairment for assets; rollover and early withdrawal for liabilities. The assumptions are subject to governance via divisional asset and liability committees. The behavioural reviews form the foundation of the Group's Liquidity Transfer Pricing (LTP) and are applied to the contractual profile of the Group for the liquidity risk stress testing framework.

## MITIGATION

The Group mitigates the risk of a liquidity mismatch in excess of its risk appetite by managing the liquidity profile of the balance sheet through short term liquidity management and over the life of the funding plan, combining business as usual and stressed conditions. The Group manages its risk appetite and liquidity position as a coverage ratio (proportion of stressed outflows covered by eligible liquid assets) corresponding with the PRA and CRD IV liquidity requirements. Longer term funding is used to manage the Group's strategic liquidity profile, determined by the Group's balance sheet structure. Longer term is defined as having an original maturity of more than one year.

The Group's funding and liquidity position is underpinned by its significant customer deposit base, and 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 an 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.

Relevant interest expenses allocated via LTP include term funding spreads incurred over a three month LIBOR benchmark and the cost of funding and holding liquid asset reserves. LTP makes extensive use of behavioural maturity profiles, taking account of expected customer loan prepayments and stability of customer deposits. Such behavioural maturity assumptions are subject to formal governance, reviewed at least annually and founded on analysis and evidence of actual customer behaviour using historical 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. In addition, liquidity risk is controlled via approved funding and liquidity policies.

## **MONITORING**

Liquidity is actively monitored at Group level. Routine reporting is in place to senior management and through the Group's committee structure, in particular GALCO which meets monthly. In a stress situation the level of monitoring and reporting is increased commensurate with the nature of the stress event. Liquidity policies and procedures are subject to independent internal oversight.

Daily monitoring and control processes are in place to address internal and regulatory liquidity requirements. The Group monitors a range of market and internal early warning indicators on a daily basis for early signs of liquidity risk in the market or specific to the Group. These are a mixture of quantitative and qualitative measures, including: daily variation of customer balances, changes in maturity profiles, cash outflows, funding concentration, changes in primary liquidity portfolio, credit default swap (CDS) spreads and changing funding costs.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

In addition, the monitoring framework has two other important components. Firstly, 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 reflecting possible future liquidity risks. 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 2015 liquidity stress testing results refer to page 108. In addition to the liquidity stress testing framework, the Group funding plan is stressed against a range of macroeconomic scenarios, including those prescribed by the PRA. The Group also applies its own macroeconomic stress scenarios, including a one in 20 year recession. Liquidity Risk Appetite and regulatory metrics are calculated and monitored over the life the plan under base and stress conditions.

Secondly, 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 2015

During 2015 the Group has maintained its strong funding and liquidity position, with a loan to deposit ratio of 109 per cent, LCR eligible liquid assets broadly equal to total wholesale funding and over five times money market funding less than one year to maturity at 31 December 2015. The Group has a diverse funding platform which comprises a strong customer deposit base along with wholesale funding comprising of a range of secured and unsecured funding products.

Total funded assets reduced by £22.2 billion to £471.2 billion during 2015. Loans and advances to customers, excluding reverse repos, reduced by £22.4 billion. Mortgage lending increased by 1 per cent, slightly below market growth, reflecting the Group's focus on protecting margin in a low growth environment. UK loan growth in Consumer Finance was strong at 17 per cent and SME lending growth was 5 per cent, both outperforming the market. The growth was offset by the sale of TSB, the further reduction in run-off and other lending portfolios which are closed to new business.

Total customer deposits fell by £28.8 billion to £418.3 billion at 31 December 2015, largely due to the sale of TSB and the planned reduction in tactical deposits.

Wholesale funding has increased by £3.4 billion to £119.9 billion; the amount with a residual maturity less than one year falling to £37.9 billion (£41.1 billion at 31 December 2014). The Group's term funding ratio (wholesale funding with a remaining life of over one year as a percentage of total wholesale funding) increased to 68 per cent (65 per cent at 31 December 2014). In 2015 the Group's term issuance costs were lower than 2014 and significantly lower than previous years.

In 2015 Standard and Poor's (S&P), Moody's and Fitch completed their exceptional reviews of Lloyds Bank's ratings following the UK implementation of the EU Bank Recovery and Resolution Directive. In all cases, Lloyds Bank's ratings were either affirmed or upgraded due to the delivery of our strategy to be a low risk, customer focused UK bank and/or recognition of the protection Lloyds' sizeable subordinated debt buffer provides to senior creditors. In particular, Fitch upgraded Lloyds Bank to 'A+' from 'A' and revised the outlook to 'Stable' from 'Negative'. Moody's affirmed Lloyds' rating at 'A1' with a 'Positive' outlook. S&P affirmed Lloyds' rating at 'A' with a 'Stable' outlook. Following these rating actions, Lloyds Bank's median rating has improved to 'A+' (previously 'A'). The effects of a potential downgrade from all three rating agencies are included in the 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 and has a robust and well governed reporting framework in place for both regulatory reporting and internal management information. The Net Stable Funding Ratio (NSFR) is due to become a minimum standard from January 2018. The Group continues to monitor the requirements and expects to meet the minimum requirements once these are confirmed by the PRA.

The combination of a strong balance sheet and access to a wide range of funding markets, including government and central bank schemes, provides the Group with a broad range of options with respect to funding the balance sheet.

Table 1.44: **Summary funding and liquidity metrics**

|  | <b>At 31 Dec<br/>2015</b> | At 31 Dec<br>2014 | Change<br>% |
|--|---------------------------|-------------------|-------------|
| LCR eligible liquidity buffer (£bn) <sup>1</sup>   | <b>123.4</b>              | 109.3             | 13          |
| Term funding ratio (%)   | <b>68.4</b>               | 64.7              | 6           |
| Loan to deposit ratio (%)  | <b>108.8</b>              | 106.8             | 2           |
| LCR eligible liquid assets/money market funding less than one year maturity <sup>1</sup> | <b>5.7</b>                | 5.8               | (2 )        |

<sup>1</sup> Comparative 2014 data relates to Individual Liquidity Adequacy Standards (ILAS) eligible primary liquid assets.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.45: Group funding position

|  | <b>At 31<br/>Dec<br/>2015<br/>£bn</b> | At<br>31 Dec<br>2014<br>£bn | Change<br>% |
|--|---------------------------------------|-----------------------------|-------------|
| Funding requirement  |                                       |                             |             |
| Loans and advances to customers <sup>1</sup>                   | <b>455.2</b>                          | 477.6                       | (5 )        |
| Loans and advances to banks <sup>2</sup>                       | <b>3.4</b>                            | 3.0                         | 13          |
| Debt securities  | <b>4.2</b>                            | 1.2                         |             |
| Reverse repurchase agreements                                  | <b>1.0</b>                            | –                           |             |
| Available-for-sale financial assets – non LCR eligible         | <b>2.7</b>                            | 8.0                         | (66 )       |
| Cash and balances at central banks – non LCR eligible          | <b>4.7</b>                            | 3.6                         | 31          |
| Funded assets  | <b>471.2</b>                          | 493.4                       | (4 )        |
| Other assets <sup>5</sup>                                      | <b>234.2</b>                          | 265.2                       | (12 )       |
|  | <b>705.4</b>                          | 758.6                       | (7 )        |
| <b>On balance sheet LCR eligible liquid assets<sup>6</sup></b> |                                       |                             |             |
| Reverse repurchase agreements                                  | –                                     | 7.0                         |             |
| Cash and Balances at central banks <sup>4</sup>                | <b>53.7</b>                           | 46.9                        | 14          |
| Available-for-sale financial assets                            | <b>30.3</b>                           | 48.5                        | (38 )       |
| Held to maturity financial assets                              | <b>19.8</b>                           | –                           |             |
| Trading and fair value through profit and loss                 | <b>3.0</b>                            | (6.1 )                      |             |
| Repurchase agreements  | <b>(5.5 )</b>                         | –                           |             |
|  | <b>101.3</b>                          | 96.3                        | 5           |
| Total Group assets   | <b>806.7</b>                          | 854.9                       | (6 )        |
| Less: Other liabilities <sup>5</sup>                           | <b>(221.5)</b>                        | (240.3)                     | (8 )        |
| Funding requirement  | <b>585.2</b>                          | 614.6                       | (5 )        |
| Funded by  |                                       |                             |             |
| Customer deposits  | <b>418.3</b>                          | 447.1                       | (6 )        |
| Wholesale funding <sup>7</sup>                                 | <b>119.9</b>                          | 116.5                       | 3           |
|  | <b>538.2</b>                          | 563.6                       | (5 )        |
| Repurchase agreements  | –                                     | 1.1                         |             |
| Total equity   | <b>47.0</b>                           | 49.9                        | (6 )        |
| Total funding  | <b>585.2</b>                          | 614.6                       | (5 )        |

<sup>1</sup> Excludes £nil (31 December 2014: £5.1 billion) of reverse repurchase agreements.

<sup>2</sup> Excludes £20.8 billion (31 December 2014: £21.3 billion) of loans and advances to banks within the Insurance business and £0.9 billion (31 December 2014: £1.9 billion) of reverse repurchase agreements.

<sup>3</sup> Non LCR eligible liquidity assets comprise a diversified pool of highly rated unencumbered collateral (including retained issuance).

<sup>4</sup> Cash balances and balances at central banks are combined in the Group's balance sheet.

Other assets and other liabilities primarily include balances in the Group's Insurance business and the fair value of derivative assets and liabilities.

62014 comparators are on an ILAS basis.

<sup>7</sup>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.

105

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.46: Reconciliation of Group funding to the balance sheet (audited)

|                                | At 31 December 2015              |   |   |                   | At 31 December 2014              |   |   |                   |
|--------------------------------|----------------------------------|---|---|-------------------|----------------------------------|---|---|-------------------|
|                                | 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            | 8.5                              | 8.4   | –   | 16.9              | 9.8                              | 1.1   | –   | 10.9              |
| Debt securities in issue       | 88.1                             | –   | (6.0  | ) 82.1            | 80.6                             | –   | (4.4  | ) 76.2            |
| Subordinated liabilities       | 23.3                             | –   | –   | 23.3              | 26.1                             | –   | (0.1  | ) 26.0            |
| <b>Total wholesale funding</b> | 119.9                            | 8.4   |   |                   | 116.5                            | 1.1   |   |                   |
| Customer deposits              | 418.3                            | –   | –   | 418.3             | 447.1                            | –   | –   | 447.1             |
| <b>Total</b>                   | 538.2                            | 8.4   |   |                   | 563.6                            | 1.1   |   |                   |

Table 1.47: Analysis of 2015 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 2015 £bn | Total at 31 Dec 2014 £bn |
|---|-------------------------|-------------------------|-------------------------|------------------------|-----------------------------|----------------------|-----------------------|--------------------------|--------------------------|--------------------------|
| Deposit from banks  | 6.7                     | 0.8                     | 0.5                     | 0.1                    | 0.1                         | –                    | –                     | 0.3                      | 8.5                      | 9.8                      |
| Debt securities in issue:   |                         |                         |                         |                        |                             |                      |                       |                          |                          |                          |
| Certificates of deposit   | 1.0                     | 4.3                     | 2.0                     | 2.5                    | 0.8                         | –                    | –                     | –                        | 10.6                     | 6.8                      |
| Commercial paper  | 3.7                     | 2.3                     | 0.3                     | 0.2                    | 0.1                         | –                    | –                     | –                        | 6.6                      | 7.3                      |
| Medium-term notes <sup>1</sup>                                    | 0.9                     | 0.6                     | 2.0                     | 0.9                    | 0.5                         | 5.2                  | 13.6                  | 13.9                     | 37.6                     | 29.2                     |
| Covered bonds   | –                       | –                       | 1.2                     | 1.1                    | 0.5                         | 5.3                  | 7.4                   | 10.3                     | 25.8                     | 25.2                     |
| Securitisation  | 0.4                     | –                       | 0.8                     | 0.2                    | 0.2                         | 3.6                  | 0.9                   | 1.4                      | 7.5                      | 12.1                     |
|   | 6.0                     | 7.2                     | 6.3                     | 4.9                    | 2.1                         | 14.1                 | 21.9                  | 25.6                     | 88.1                     | 80.6                     |
| Subordinated liabilities  | –                       | 0.2                     | 0.2                     | 0.5                    | 2.3                         | 0.9                  | 7.6                   | 11.6                     | 23.3                     | 26.1                     |
| <b>Total wholesale funding<sup>2</sup></b>                        | <b>12.7</b>             | <b>8.2</b>              | <b>7.0</b>              | <b>5.5</b>             | <b>4.5</b>                  | <b>15.0</b>          | <b>29.5</b>           | <b>37.5</b>              | <b>119.9</b>             | <b>116.5</b>             |
| <b>Of which is issued by Lloyds Banking Group plc<sup>3</sup></b> | –                       | –                       | –                       | –                      | 0.3                         | –                    | –                     | 3.1                      | 3.4                      | 2.6                      |

<sup>1</sup> Medium-term notes include funding from the National Loan Guarantee Scheme (31 December 2015: £1.4 billion; 31 December 2014: £1.4 billion).

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.

<sup>3</sup> Comprises £3.4 billion of subordinated liabilities (31 December 2014: £2.0 billion) and £nil of medium term notes (31 December 2014: £0.6 billion) issued by the holding company, Lloyds Banking Group plc.

Table 1.48: **Total wholesale funding by currency (audited)**

|                            | <b>Sterling<br/>£bn</b> | <b>US dollar<br/>£bn</b> | <b>Euro<br/>£bn</b> | <b>Other currencies<br/>£bn</b> | <b>Total<br/>£bn</b> |
|----------------------------|-------------------------|--------------------------|---------------------|---------------------------------|----------------------|
| <b>At 31 December 2015</b> | <b>34.9</b>             | <b>37.6</b>              | <b>41.3</b>         | <b>6.1</b>                      | <b>119.9</b>         |
| At 31 December 2014        | 34.4                    | 35.6                     | 40.1                | 6.4                             | 116.5                |

Table 1.49: **Analysis of 2015 term issuance (audited)**

|   | <b>Sterling<br/>£bn</b> | <b>US dollar<br/>£bn</b> | <b>Euro<br/>£bn</b> | <b>Other<br/>currencies<br/>£bn</b> | <b>Total<br/>£bn</b> |
|---|-------------------------|--------------------------|---------------------|-------------------------------------|----------------------|
| Securitisation  | <b>1.0</b>              | <b>1.2</b>               | <b>0.3</b>          | –                                   | <b>2.5</b>           |
| Medium-term notes   | <b>0.3</b>              | <b>4.8</b>               | <b>3.3</b>          | <b>1.2</b>                          | <b>9.6</b>           |
| Covered bonds   | <b>1.7</b>              | –                        | <b>2.0</b>          | –                                   | <b>3.7</b>           |
| Private placements <sup>1</sup>                                   | <b>1.0</b>              | <b>2.1</b>               | <b>2.3</b>          | –                                   | <b>5.4</b>           |
| Subordinated liabilities  | –                       | <b>0.3</b>               | –                   | –                                   | <b>0.3</b>           |
| <b>Total issuance</b>   | <b>4.0</b>              | <b>8.4</b>               | <b>7.9</b>          | <b>1.2</b>                          | <b>21.5</b>          |
| <b>Of which is issued by Lloyds Banking Group plc<sup>2</sup></b> | –                       | <b>0.3</b>               | –                   | –                                   | <b>0.3</b>           |

<sup>1</sup> Private placements include structured bonds and term repurchase agreements (repos).

Comprises £0.3 billion of subordinated liabilities issued by the holding company, Lloyds Banking Group plc. In addition Lloyds Banking Group plc issued c£1.2 billion of subordinated liabilities as part of an exchange of outstanding operating company securities for new holding company securities.

Term issuance for 2015 totalled £21.5 billion. The Group continued to maintain a diversified approach to markets with trades in public and private format, secured and unsecured products and a wide range of currencies and markets. For 2016, the Group will continue to maintain this diversified approach to funding, including capital and funding from the holding company, Lloyds Banking Group plc, as needed to optimise the capital and funding position to transition towards final UK Minimum Requirements for Own Funds and Eligible Liabilities (MREL) which is still being consulted on in the UK. Continued use of the UK government's Funding for Lending Scheme (FLS) has further underlined the Group's support to the UK economic recovery and the Group remains committed to passing the benefits of this low cost funding on to its customers. In 2015 the Group drew down £12.1 billion under the FLS, bringing total drawings under the FLS to £32.1 billion. The maturities for the FLS are fully factored into the Group's funding plan.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*LIQUIDITY PORTFOLIO*

The UK regulator adopted the EU delegated Act on 1 October 2015. Prior to this, liquidity was managed on an Individual Liquidity Adequacy Standards (ILAS) basis where liquid assets were divided into Primary and Secondary categories. Post 1 October 2015, liquid assets are classed as LCR eligible or non-LCR eligible.

At 31 December 2015, the Banking business had £123.4 billion of highly liquid unencumbered LCR eligible assets, of which £122.9 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 5.7 times the Group's money market funding less than one year maturity (excluding derivative collateral margins and settlement accounts) and is broadly equivalent to total wholesale funding, and thus provides a substantial buffer in the event of continued market dislocation. During 2015 the Group has increased regulatory liquidity to strengthen the overall liquidity position.

Table 1.50: **LCR eligible assets**

|   | <b>At 31<br/>Dec<br/>2015<br/>£bn</b> | Average<br>2015 <sup>1</sup><br>£bn |
|---|---------------------------------------|-------------------------------------|
| <b>Level 1</b>  |                                       |                                     |
| Cash and central bank reserves                        | <b>53.7</b>                           | 57.2                                |
| High quality government/MDB/agency bonds <sup>2</sup> | <b>65.8</b>                           | 63.0                                |
| High quality covered bonds                            | <b>3.4</b>                            | 3.3                                 |
| <b>Total Level 1</b>                                  | <b>122.9</b>                          | 123.5                               |
| <b>Level 2<sup>3</sup></b>                            | <b>0.5</b>                            | 0.7                                 |
| <b>Total LCR eligible assets</b>                      | <b>123.4</b>                          | 124.2                               |

1 Average for fourth quarter 2015 only.

2 Designated multilateral development bank (MDB). Includes eligible government guaranteed bonds.

3 Includes Level 2A and Level 2B.

Table 1.51: **LCR eligible assets by currency**

|         | <b>At 31 December 2015</b> |                  |             |              |
|---------|----------------------------|------------------|-------------|--------------|
|         | <b>Sterling</b>            | <b>US Dollar</b> | <b>Euro</b> | <b>Total</b> |
|         | <b>£bn</b>                 | <b>£bn</b>       | <b>£bn</b>  | <b>£bn</b>   |
| Level 1 | <b>90.9</b>                | <b>15.8</b>      | <b>16.2</b> | <b>122.9</b> |
| Level 2 | <b>0.1</b>                 | –                | <b>0.4</b>  | <b>0.5</b>   |

**Total** **91.0** **15.8** **16.6** **123.4**

Table 1.52: ILAS eligible assets

|   | <b>At 31<br/>Dec<br/>2015<br/>£bn</b> | <b>At 31<br/>Dec<br/>2014<br/>£bn</b> | <b>Average<br/>2015<br/>£bn</b> | <b>Average<br/>2014<br/>£bn</b> |
|---|---------------------------------------|---------------------------------------|---------------------------------|---------------------------------|
| <b>Primary liquidity<sup>1</sup></b>        |                                       |                                       |                                 |                                 |
| Cash and balances at central bank           | <b>52.6</b>                           | 46.9                                  | <b>65.1</b>                     | 62.3                            |
| Government/MDB bonds <sup>2</sup>           | <b>64.4</b>                           | 62.4                                  | <b>51.3</b>                     | 47.9                            |
| <b>Total</b>                                | <b>117.0</b>                          | 109.3                                 | <b>116.4</b>                    | 110.2                           |
| <b>Secondary liquidity<sup>1</sup></b>      |                                       |                                       |                                 |                                 |
| High-quality ABS/covered bonds <sup>3</sup> | <b>3.3</b>                            | 3.9                                   | <b>3.6</b>                      | 3.6                             |
| Credit institution bonds <sup>3</sup>       | <b>0.2</b>                            | 0.9                                   | <b>0.5</b>                      | 1.4                             |
| Corporate bonds <sup>3</sup>                | <b>0.3</b>                            | 0.6                                   | <b>0.4</b>                      | 0.3                             |
| Own securities (retained insurance)         | <b>14.7</b>                           | 20.6                                  | <b>15.9</b>                     | 22.2                            |
| Other securities                            | <b>9.1</b>                            | 5.7                                   | <b>6.5</b>                      | 5.5                             |
| Other <sup>4</sup>                          | <b>76.6</b>                           | 67.5                                  | <b>65.2</b>                     | 74.1                            |
| <b>Total</b>                                | <b>104.2</b>                          | 99.2                                  | <b>92.1</b>                     | 107.1                           |
| <b>Total liquidity</b>                      | <b>221.2</b>                          | 208.5                                 |                                 |                                 |

1 Primary and secondary liquidity as defined under the ILAS regulatory system.

2 Designated multilateral development bank (MDB).

3 Assets rated A- or above.

4 Includes other central banks eligible assets.

107

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.53: ILAS eligible assets by currency

|                                  | At 31 December 2015 |                  |             |              | At 31 December 2014 |                     |             |              |
|----------------------------------|---------------------|------------------|-------------|--------------|---------------------|---------------------|-------------|--------------|
|                                  | Sterling<br>£bn     | US Dollar<br>£bn | Euro<br>£bn | Total<br>£bn | Sterling<br>£bn     | US<br>Dollar<br>£bn | Euro<br>£bn | Total<br>£bn |
| <b>At 31 December 2015</b>       |                     |                  |             |              |                     |                     |             |              |
| Primary liquidity <sup>1</sup>   | <b>88.6</b>         | <b>14.8</b>      | <b>13.6</b> | <b>117.0</b> | 81.1                | 14.5                | 13.7        | 109.3        |
| Secondary liquidity <sup>1</sup> | <b>97.0</b>         | <b>2.2</b>       | <b>5.0</b>  | <b>104.2</b> | 91.3                | 1.2                 | 6.7         | 99.2         |
| <b>Total</b>                     | <b>185.6</b>        | <b>17.0</b>      | <b>18.6</b> | <b>221.2</b> | 172.4               | 15.7                | 20.4        | 208.5        |

<sup>1</sup> Primary and secondary liquidity as defined under the ILAS regulatory system.

The Banking business also had £98.9 billion of secondary, non-LCR eligible liquidity, the vast majority of which, however, 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 primary and secondary 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, and is a key component of the Group's liquidity management process.

### STRESS TESTING RESULTS

Internal stress testing results at 31 December 2015 showed that the Banking business had liquidity resources representing 163 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 (the three month PRA combined scenario).

The liquidity stress testing assumes that further credit rating downgrades may reduce investor appetite for some of the Group's liability classes and therefore funding capacity. 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 an outflow of £1.5 billion of cash over a period of up to one year, £2.1 billion of collateral posting related to customer financial contracts and £5.6 billion of collateral posting associated with secured funding. The Group's internal liquidity risk appetite includes such a stress scenario. The stress scenario modelling demonstrates the Group has available liquidity resources to manage such an event.

## *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.

**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.

**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.

The following sub analyses have been provided for unencumbered assets not pre-positioned at central banks:

**Unencumbered – 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 – 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 – 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.

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.

The Board and GALCO monitor and manage total balance sheet encumbrance via a number of risk appetite metrics. At 31 December 2015, the Group had £77.4 billion (31 December 2014: £105.2 billion) of externally encumbered on balance sheet assets with counterparties other than central banks. The reduction in encumbered assets was driven by



securitisation and covered bond maturities. The Group also had £573.7 billion (31 December 2014: £641.8 billion) of unencumbered on balance sheet assets, and £155.6 billion (31 December 2014: £107.8 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.54: On balance sheet encumbered and unencumbered assets

|   | Encumbered with counterparties other than central banks |                     |             |             | Pre-positioned and encumbered assets held with central banks<br>£m | Unencumbered assets not pre-positioned with central banks |                               |                      |             | Total<br>£m |
|---|---|---------------------|-------------|-------------|--|---|-------------------------------|----------------------|-------------|-------------|
|   | Securitisations<br>£m                                   | Covered bonds<br>£m | Other<br>£m | Total<br>£m |  | Readily realisable<br>£m                                  | Other realisable assets<br>£m | Cannot be used<br>£m | Total<br>£m |             |
| <b>At 31 December 2015</b>  |   |                     |             |             |  |   |                               |                      |             |             |
| 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     | 140,533     |
| 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     | 455,173     |
| 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 <sup>1</sup>  | –   | –                   | –           | –           | –  | 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     | 806,683     |
| <b>At 31 December 2014</b>  |   |                     |             |             |  |   |                               |                      |             |             |
| Cash and balances at central banks                                      | –   | –                   | –           | –           | –  | 48,302  | –                             | 2,190                | 50,492      | 50,492      |
|   | –   | –                   | 13,389      | 13,389      | –  | 5,149   | 2,259                         | 131,134              | 138,542     | 151,933     |

|   |        |        |        |         |         |         |         |         |         |         |  |
|---|--------|--------|--------|---------|---------|---------|---------|---------|---------|---------|--|
| Trading and other financial assets at fair value through profit or loss |        |        |        |         |         |         |         |         |         |         |  |
| Derivative financial instruments  | –      | –      | –      | –       | –       | –       | –       | 36,128  | 36,128  | 36,128  |  |
| Loans and receivables:  |        |        |        |         |         |         |         |         |         |         |  |
| Loans and advances to banks   | –      | –      | 26     | 26      | –       | 424     | 712     | 24,993  | 26,129  | 26,155  |  |
| Loans and advances to customers   | 25,534 | 39,280 | 7,850  | 72,664  | 107,803 | 16,086  | 161,458 | 124,693 | 302,237 | 482,700 |  |
| Debt securities   | –      | –      | 728    | 728     | –       | 281     | 100     | 104     | 485     | 1,213   |  |
|   | 25,534 | 39,280 | 8,604  | 73,418  | 107,803 | 16,791  | 162,270 | 149,790 | 328,851 | 510,073 |  |
| Available-for-sale financial assets                                     | 119    | –      | 18,321 | 18,440  | –       | 37,711  | 30      | 312     | 38,053  | 56,493  |  |
| Held-to-maturity investments  | –      | –      | –      | –       | –       | –       | –       | –       | –       | –       |  |
| Other <sup>1</sup>  | –      | –      | –      | –       | –       | 2,054   | 2,598   | 45,128  | 49,780  | 49,780  |  |
| Total assets  | 25,653 | 39,280 | 40,314 | 105,247 | 107,803 | 110,007 | 167,157 | 364,682 | 641,846 | 854,890 |  |

Other comprises: items in the course of collection from banks, investment properties, goodwill, value of in-force business, other intangible assets, tangible fixed assets, current tax recoverable, deferred tax assets, retirement benefit assets and other assets.

The above table sets out the carrying value of the Group's encumbered and unencumbered assets, separately identifying those that are available to support the Group's funding needs. It should be noted that 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. The Group provides collateralised security financing services to its clients, providing them with cash financing or specific securities. Collateralised security financing is also used to manage the Group's own short-term cash and collateral needs. For securities accepted as collateral mandates are credit rating driven with appropriate notional limits per rating, asset and individual bond concentration. The vast majority of collateral the Group uses in repo/reverse repo and stock lending/stock borrowing transactions is investment grade government issued, primarily UK government debt. The majority of repo/reverse repo and stock lending/stock borrowing transactions are short-term, having a residual maturity of less than three months.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*CONTRACTUAL CASH OBLIGATIONS*

The following table sets out the amounts and maturities of Lloyds Banking Group's contractual cash obligations at 31 December 2015.

|                            | <b>Within<br/>one year<br/>£m</b> | <b>One to three<br/>years<br/>£m</b> | <b>Three to<br/>five years<br/>£m</b> | <b>Over five<br/>years<br/>£m</b> | <b>Total<br/>£m</b> |
|----------------------------|-----------------------------------|--------------------------------------|---------------------------------------|-----------------------------------|---------------------|
| Enhanced capital notes     | –                                 | –                                    | 3,211                                 | 399                               | 3,610               |
| Long-term debt – dated     | 584                               | 580                                  | –                                     | 12,845                            | 14,009              |
| Debt securities in issue   | 25,759                            | 21,258                               | 14,522                                | 28,395                            | 89,934              |
| Finance leases             | 13                                | 16                                   | –                                     | 12                                | 41                  |
| Operating leases           | 267                               | 451                                  | 434                                   | 1,049                             | 2,201               |
| Capital commitments        | 388                               | –                                    | –                                     | –                                 | 388                 |
| Other purchase obligations | 1,308                             | 2,056                                | 1,275                                 | 660                               | 5,299               |
|                            | <b>28,319</b>                     | <b>24,361</b>                        | <b>19,442</b>                         | <b>43,360</b>                     | <b>115,482</b>      |

Other purchase obligations include amounts expected to be payable in respect of material contracts entered into by the Lloyds Banking Group, in the ordinary course of business, for the provision of outsourced and other services. The cost of these services will be charged to the income statement as it is incurred. The Lloyds Banking Group also has a constructive obligation to ensure that its defined post-retirement benefit schemes remain adequately funded. The amount and timing of the Lloyds Banking Group's cash contributions to these schemes is uncertain and will be affected by factors such as future investment returns and demographic changes. Lloyds Banking Group expects to make cash contributions of at least £600 million to these schemes in 2016.

At 31 December 2015, Lloyds Banking Group also had £5,693 million of preference shares, preferred securities and undated subordinated liabilities outstanding.

At 31 December 2015, the principal sources of potential liquidity for Lloyds Banking Group plc were dividends received from its directly owned subsidiary company, Lloyds Bank, and loans from this and other Lloyds Banking Group companies. The ability of Lloyds Bank and HBOS to pay dividends going forward, or for Lloyds Bank or other Lloyds Banking Group companies to make loans to Lloyds Banking Group plc, depends on a number of factors, including their own regulatory capital requirements, distributable reserves and financial performance.

*OFF-BALANCE SHEET ARRANGEMENTS*

A table setting out the amounts and maturities of Lloyds Banking Group's other commercial commitments at 31 December 2015 is included in note 53 to the financial statements. These commitments are not included in Lloyds Banking Group's consolidated balance sheet.

Lending commitments are agreements to lend to customers in accordance with contractual provisions; these are either for a specified period or, as in the case of credit cards and overdrafts, represent a revolving credit facility which can be drawn down at any time, provided that the agreement has not been terminated. The total amounts of unused commitments do not necessarily represent future cash requirements, in that commitments often expire without being drawn upon.

Lloyds Banking Group's financial guarantee contracts are accounted for as financial instruments and measured at fair value on the balance sheet. The contractual nominal amounts of these guarantees totalled £7,165 million at 31 December 2015 (with £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).

Lloyds Banking Group's banking businesses are also exposed to liquidity risk through the provision of securitisation facilities to certain corporate customers. At 31 December 2015, Lloyds Banking Group offered securitisation facilities to its corporate and financial institution client base through its conduit securitisation vehicles, Argento, Cancara and Grampian. These are funded in the global asset-backed commercial paper market. The assets and obligations of these conduits are included in Lloyds Banking Group's consolidated balance sheet. Lloyds Banking Group provides short-term asset-backed commercial paper liquidity support facilities on commercial terms to the issuers of the commercial paper, for use in the event of a market disturbance should they be unable to roll over maturing commercial paper or obtain alternative sources of funding.

Details of securitisations and other special purpose entity arrangements entered into by the Group are provided in notes 19 and 20 to the financial statements. The successful development of Lloyds Banking Group's ability to securitise its own assets has provided a mechanism to tap a well established market, thereby diversifying Lloyds Banking Group's funding base.

As indicated on page F-35, the Group's securitisations include a number of synthetic securitisation arrangements. Synthetic securitisations use credit default swaps to transfer the credit risk of the underlying assets to a third party without transferring the funding requirement. As the prices of the underlying assets fall, this creates a credit risk on the third party which typically is not collateralised. The total notional amount of credit default swaps used for synthetic securitisation transactions at 31 December 2015 was £83 million.

Within Lloyds Banking Group's insurance businesses, the principal sources of liquidity are premiums received from policyholders, charges levied upon policyholders, investment income and the proceeds from the sale and maturity of

investments. The investment policies followed by Lloyds Banking Group's life assurance companies take account of anticipated cash flow requirements including by matching the cash inflows with projected liabilities where appropriate. Cash deposits and highly liquid government securities are available to provide liquidity to cover any higher than expected cash outflows.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**CAPITAL RISK**

**DEFINITION**

Capital risk is defined as the risk that the Group has a sub-optimal amount or quality of capital or that capital is inefficiently deployed across the Group.

**RISK APPETITE**

Capital risk appetite is set by the Group Board, reflecting the Group's strategic plans, regulatory capital constraints and market expectations. It is defined by a number of minimum capital ratios, a minimum leverage ratio and a minimum buffer over regulatory solvency requirements for the Insurance business set by the Insurance Board. The Group monitors its actual and forecast capital positions aiming to remain within its appetite at all times.

For further information on risk appetite refer to page 46.

**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 framework are provided on page 14 of the 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 total 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. During 2015 the PRA increased the Group's ICG such that at 31 December 2015 it represented 4.6 per cent of risk-weighted assets of which 2.6 per cent had to be covered by CET1 capital. The Group believes that the increase reflects the impact of market and economic factors and the reduction in risk-weighted assets rather than any fundamental changes to the nature of the underlying risks. However the Group is not permitted by the PRA to give any further details of the quantum of the individual components.

The Group is also required to maintain a number of regulatory capital buffers which are required to be met with CET1 capital.

Systemic risk buffers are designed to hold systemically important banks to higher capital standards. The Group is not currently categorised as a global systemically important bank (G-SIB) for which the Financial Stability Board (FSB) has set buffer rates. The Financial Policy Committee (FPC) has recently issued a consultation on the UK systemic risk buffer requirements for ring-fenced banks and large building societies proposing a rate of up to 2.5 per cent. The requirements will come into force from 2019 and the Group awaits finalisation of these later in 2016.

The capital conservation buffer is a general 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.

The countercyclical capital buffer 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 credit risk exposures. The current requirement for the Group is negligible.



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 to inform the setting of a minimum level of capital buffer for the Group. Prior to 2016 this was known as the Capital Planning Buffer but has now been replaced by the PRA Buffer which is set taking account of the capital conservation buffer, countercyclical capital buffer 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.

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.

The minimum leverage ratio is 3 per cent, in line with current Basel Committee proposals. In addition the UK framework requires two buffers to be maintained: The Additional Leverage Ratio Buffer (ALRB), which it is proposed should be up to 0.9 per cent, and a time-varying Countercyclical Leverage Buffer (CCLB) of up to 0.9 per cent (currently negligible for the Group). 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 ALRB applies from 1 January 2016 but only for G-SIBs and as the Group is not categorised as a G-SIB it is not currently subject to the ALRB. Final rules are awaited on the wider application of the ALRB to ring-fenced banks and large building societies within the UK from 2019.

The proposed leverage ratio framework does not currently give rise to higher capital requirements for the Group than the risk-based capital framework.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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. 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 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. In particular, the Basel Committee is continuing to review the treatment of the standardised risk-weighted asset frameworks for credit risk and operational

risk and the credit valuation adjustment risk framework. It is also to finalise recommendations for the capital treatment of interest rate risk in the banking book (IRRBB), the calibration of leverage ratio requirements and continues to consider the treatment of sovereign risk and the setting of additional constraints on the use of internally modelled approaches including the design of a new capital floors framework. In addition the Bank of England is consulting on proposals for the application of the European Commission's MREL (minimum requirements for own funds and eligible liabilities).

In December 2015, the FPC published a document alongside its Financial Stability Report in which it expressed its views on the overall calibration of the capital requirements framework for the UK banking system together with a description of how it expected the framework to transition from its current state to its end point in 2019 as well as ongoing work to refine capital requirements during that transitional period.

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.

#### Stress testing

In addition to the internal stress testing activity undertaken in 2015, the Group participated in the UK-wide concurrent stress testing run by the Bank of England, comfortably exceeding both the capital and leverage minimum thresholds.

#### Capital management in 2015

The continued strengthening of the Group's capital position during 2015, through a combination of increased underlying profits, net of PPI and other conduct charges, and a reduction in risk-weighted assets, provided the Group with the ability to pay both an interim dividend at half year and to recommend the payment of both a full year ordinary dividend and a special dividend whilst maintaining strong capital ratios.

The CET1 ratio before dividends in respect of 2015 increased 0.9 percentage points from 12.8 per cent to 13.7 per cent.

The CET1 ratio after dividends in respect of 2015 was unchanged at 12.8 per cent, increasing to 13.0 per cent on an adjusted basis upon recognition of the dividend paid by the Insurance business in February 2016 in relation to its 2015 earnings.

The leverage ratio after dividends in respect of 2015 reduced from 4.9 per cent to 4.8 per cent.

The transitional total capital ratio after dividends in respect of 2015 reduced 0.5 percentage points from 22.0 per cent to 21.5 per cent.

## Dividends

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, 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.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Distributable reserves are determined as required by the Companies Act 2006 by reference to a company's individual financial statements. At 31 December 2015 Lloyds Banking Group plc ('the Company') had accumulated distributable reserves of approximately £7,500 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 2015, had a consolidated CET1 capital ratio of 15.2 per cent (31 December 2014: 15.1 per cent). The Group actively manages the capital of its subsidiaries, which includes monitoring the regulatory capital ratios for its banking and insurance subsidiaries against approved risk appetite limits. It operates a formal capital management policy which requires all subsidiary entities to remit any surplus capital to their parent companies.

During 2014 and 2015 the Group has undertaken significant capital management actions in order 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. These activities relate to a number of subsidiary entities, and include the court approved capital reductions by HBOS plc and Bank of Scotland plc, the part VII transfers within insurance businesses and obtaining PRA approval for our internal model, which will support the Solvency II capital regime for the Insurance subsidiaries with effect from 1 January 2016.

The Group remains strongly capitalised, increasing its CET1 capital ratio from 12.8 per cent at 31 December 2014 to 13.7 per cent (pre 2015 dividends) at 31 December 2015. The interim and recommended final dividends totalling 2.25 pence per ordinary share and the special dividend of 0.5 pence per ordinary share reduce the Group's CET1 ratio to 12.8 per cent. Recognising the 2015 insurance dividend, paid in February 2016 following the implementation of Solvency II, this rises to 13.0 per cent on an adjusted basis.

### **CAPITAL POSITION AT 31 DECEMBER 2015**

The Group's capital position as at 31 December 2015 is presented in the following section applying CRD IV transitional arrangements, as implemented in the UK by the PRA, and also on a fully loaded CRD IV basis. The table below summarises the consolidated capital position of the Group. The Group's Pillar 3 Report provides a comprehensive analysis of the own funds of the Group.

Table 1.55: Capital resources (audited)

|   | Transitional               |   | Fully loaded               |   |
|---|----------------------------|---|----------------------------|---|
|   | At 31<br>Dec<br>2015<br>£m | At 31<br>Dec<br>2014 <sup>2</sup><br>£m | At 31<br>Dec<br>2015<br>£m | At 31<br>Dec<br>2014 <sup>2</sup><br>£m |
| <b>Capital resources</b>                                  |                            |   |                            |   |
| <b>Common equity tier 1</b>                               |                            |   |                            |   |
| Shareholders' equity per balance sheet                    | <b>41,234</b>              | 43,335                                  | <b>41,234</b>              | 43,335                                  |
| Adjustment to retained earnings for foreseeable dividends | <b>(1,427 )</b>            | (535 )                                  | <b>(1,427 )</b>            | (535 )                                  |
| Deconsolidation of insurance entities <sup>1</sup>        | <b>(1,199 )</b>            | (623 )                                  | <b>(1,199 )</b>            | (623 )                                  |
| Adjustment for own credit                                 | <b>67</b>                  | 158                                     | <b>67</b>                  | 158                                     |
| Cash flow hedging reserve                                 | <b>(727 )</b>              | (1,139 )                                | <b>(727 )</b>              | (1,139 )                                |
| Other adjustments   | <b>72</b>                  | 132                                     | <b>72</b>                  | 132                                     |
|   | <b>38,020</b>              | 41,328                                  | <b>38,020</b>              | 41,328                                  |
| <b>Deductions from common equity tier 1</b>               |                            |   |                            |   |
| Goodwill and other intangible assets                      | <b>(1,719 )</b>            | (1,875 )                                | <b>(1,719 )</b>            | (1,875 )                                |
| Significant investments <sup>1</sup>                      | <b>(2,723 )</b>            | (2,546 )                                | <b>(2,752 )</b>            | (2,546 )                                |
| Deferred tax assets                                       | <b>(3,874 )</b>            | (4,533 )                                | <b>(3,884 )</b>            | (4,533 )                                |
| Other deductions  | <b>(1,160 )</b>            | (1,685 )                                | <b>(1,160 )</b>            | (1,685 )                                |
| <b>Common equity tier 1 capital</b>                       | <b>28,544</b>              | 30,689                                  | <b>28,505</b>              | 30,689                                  |
| Additional tier 1 instruments                             | <b>9,177</b>               | 9,728                                   | <b>5,355</b>               | 5,355                                   |
| Deductions from tier 1 <sup>1</sup>                       | <b>(1,177 )</b>            | (859 )                                  | –                          | –                                       |
| <b>Total tier 1 capital</b>                               | <b>36,544</b>              | 39,558                                  | <b>33,860</b>              | 36,044                                  |
| Tier 2 instruments and eligible provisions                | <b>13,208</b>              | 14,530                                  | <b>9,189</b>               | 11,169                                  |
| Deductions from tier 2 <sup>1</sup>                       | <b>(1,756 )</b>            | (1,288 )                                | <b>(2,933 )</b>            | (2,146 )                                |
| <b>Total capital resources</b>                            | <b>47,996</b>              | 52,800                                  | <b>40,116</b>              | 45,067                                  |
| <b>Risk-weighted assets (unaudited)</b>                   | <b>222,845</b>             | 239,734                                 | <b>222,747</b>             | 239,734                                 |
| Common equity tier 1 capital ratio                        | <b>12.8%</b>               | 12.8%                                   | <b>12.8%</b>               | 12.8%                                   |
| Tier 1 capital ratio                                      | <b>16.4%</b>               | 16.5%                                   | <b>15.2%</b>               | 15.0%                                   |
| Total capital ratio                                       | <b>21.5%</b>               | 22.0%                                   | <b>18.0%</b>               | 18.8%                                   |

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 and the remaining amount is risk weighted, forming part of threshold risk-weighted assets.

<sup>2</sup> Other comprehensive income related to the Group's Insurance business defined benefit pension scheme has been reclassified from common equity tier 1 other adjustments to deconsolidation of insurance entities.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The key differences between the transitional capital calculation as at 31 December 2015 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 1.56: **Movements in capital resources**

|   | <b>Common<br/>equity<br/>tier 1<br/>£m</b> | <b>Additional<br/>tier 1<br/>£m</b> | <b>Tier 2<br/>£m</b> | <b>Total<br/>capital<br/>£m</b> |
|---|--|-------------------------------------|----------------------|---------------------------------|
| At 31 December 2014                                       | 30,689                                     | 8,869                               | 13,242               | 52,800                          |
| Profit attributable to ordinary shareholders <sup>1</sup> | <b>434</b>                                 |                                     |                      | <b>434</b>                      |
| Eligible minority interest                                | (470 )                                     |                                     |                      | (470 )                          |
| Movement in foreseeable dividends                         | (892 )                                     |                                     |                      | (892 )                          |
| Dividends paid out on ordinary shares during the year     | (1,070 )                                   |                                     |                      | (1,070 )                        |
| Movement in treasury shares and employee share schemes    | (537 )                                     |                                     |                      | (537 )                          |
| Available-for-sale reserves                               | (371 )                                     |                                     |                      | (371 )                          |
| Deferred tax assets                                       | <b>659</b>                                 |                                     |                      | <b>659</b>                      |
| Movements in subordinated debt                            |  | (551 )                              | (1,210 )             | (1,761 )                        |
| Significant investments                                   | (177 )                                     | (318 )                              | (468 )               | (963 )                          |
| Other movements   | <b>279</b>                                 |                                     | (112 )               | <b>167</b>                      |
| At 31 December 2015                                       | <b>28,544</b>                              | <b>8,000</b>                        | <b>11,452</b>        | <b>47,996</b>                   |

<sup>1</sup> Under the regulatory framework, profits made by Insurance are removed from CET1 capital. However, when dividends are paid to the Group by Insurance these can then be recognised as CET1 capital.

CET1 capital resources have reduced by £2,145 million in the year largely as a result of dividends paid out during the year and the accrual of the full year ordinary dividend and special dividend, representing returns to ordinary shareholders following strong underlying profit generation. Other reductions to CET1 capital primarily reflected the removal of eligible minority interest related to TSB and movements in treasury shares, employee share schemes and the AFS reserve. These reductions in CET 1 capital were partially offset by reductions in both the deferred tax asset deduction and the excess of expected losses over impairment provisions and value adjustments.

AT1 capital resources have reduced by £869 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 £1,790 million in the year largely reflecting calls and redemptions, amortisation of dated instruments, foreign exchange movements and an increase in the significant investments deduction, partly offset by the issuance of new tier 2 instruments.

Table 1.57: **Risk-weighted assets**

|   | <b>At 31 December<br/>2015<br/>£m</b> | At 31<br>December<br>2014<br>£m |
|---|---------------------------------------|---------------------------------|
| IRB Approach  | <b>151,563</b>                        | 160,603                         |
| Standardised Approach                                       | <b>20,443</b>                         | 25,444                          |
| Contributions to the default fund of a central counterparty | <b>488</b>                            | 515                             |
| Credit risk   | <b>172,494</b>                        | 186,562                         |
| Counterparty credit risk                                    | <b>7,981</b>                          | 9,108                           |
| Credit valuation adjustment risk                            | <b>1,684</b>                          | 2,215                           |
| Operational risk  | <b>26,123</b>                         | 26,279                          |
| Market risk   | <b>3,775</b>                          | 4,746                           |
| Underlying risk-weighted assets                             | <b>212,057</b>                        | 228,910                         |
| Threshold risk-weighted assets <sup>1</sup>                 | <b>10,788</b>                         | 10,824                          |
| <b>Total risk-weighted assets</b>                           | <b>222,845</b>                        | 239,734                         |
| Movement to fully loaded risk-weighted assets <sup>2</sup>  | <b>(98</b>                            | ) –                             |
| Fully loaded risk-weighted assets                           | <b>222,747</b>                        | 239,734                         |

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.

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. At 31 December 2014 the fully loaded threshold was not exceeded and therefore no further adjustment was applied to the transitional threshold risk-weighted assets.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.58: Risk-weighted assets movement by key driver

|   | Credit risk <sup>1</sup><br>£m | Counter<br>party<br>credit risk <sup>1</sup><br>£m | Market risk<br>£m | Operational<br>risk<br>£m | Total<br>£m    |
|---|--------------------------------|--|-------------------|---------------------------|----------------|
| Risk-weighted assets at 31 December 2014                      | 186,562                        | 11,323   | 4,746             | 26,279                    | 228,910        |
| Management of the balance sheet                               | <b>1,772</b>                   | <b>(474)</b>                                       | <b>(838)</b>      | –                         | <b>460</b>     |
| Disposals   | <b>(8,582)</b>                 | <b>(115)</b>                                       | –                 | –                         | <b>(8,697)</b> |
| External economic factors                                     | <b>(6,370)</b>                 | <b>(518)</b>                                       | <b>80</b>         | –                         | <b>(6,808)</b> |
| Model and methodology changes                                 | <b>(888)</b>                   | <b>(551)</b>                                       | <b>(213)</b>      | –                         | <b>(1,652)</b> |
| Other   | –                              | –  | –                 | <b>(156)</b>              | <b>(156)</b>   |
| <b>Risk-weighted assets</b>                                   | <b>172,494</b>                 | <b>9,665</b>                                       | <b>3,775</b>      | <b>26,123</b>             | <b>212,057</b> |
| Threshold risk-weighted assets <sup>2</sup>                   |                                |  |                   |                           | <b>10,788</b>  |
| <b>Total risk-weighted assets</b>                             |                                |  |                   |                           | <b>222,845</b> |
| Movement to fully loaded risk-weighted<br>assets <sup>3</sup> |                                |  |                   |                           | <b>(98)</b>    |
| Fully loaded risk-weighted assets                             |                                |  |                   |                           | <b>222,747</b> |

<sup>1</sup> Credit risk includes movements in contributions to the default fund of central counterparties and counterparty credit risk includes the movements in credit valuation adjustment risk.

<sup>2</sup> 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.

<sup>3</sup> 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. At 31 December 2014 the fully loaded threshold was not exceeded and therefore no further adjustment was applied to the transitional threshold risk-weighted assets.

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 £14.1 billion were driven by the following key movements:

Management of the balance sheet includes risk-weighted asset movements arising from new lending and asset run-off. During 2015, credit risk-weighted assets increased by £1.8 billion, primarily as a result of targeted net lending growth in core businesses, as well as an increase in risk-weighted assets for the Group's strategic equity investments.

Disposals include risk-weighted asset reductions arising from the sale of assets, portfolios and businesses. Disposals reduced credit risk-weighted assets by £8.6 billion, primarily driven by the completion of the sale of TSB as well as disposals in the run-off business.

External economic factors capture movements driven by changes in the economic environment. The reduction in credit risk-weighted assets of £6.4 billion is mainly due to improvements in credit quality, which primarily impacted the Retail and Consumer Finance businesses, and favourable movements in HPI that benefited retail mortgage portfolios.

Model and methodology reductions of £0.9 billion include the movement in credit risk-weighted assets arising from model and methodology refinements and changes in credit risk approach applied to certain portfolios.

Counterparty credit risk and CVA risk reductions of £1.7 billion are principally driven by trading activity and compressions, hedging and yield curve movements.

Risk-weighted assets related to market risk reduced by £1.0 billion primarily due to active portfolio management and model and methodology refinements.

#### Leverage ratio

In January 2015 the existing CRD IV rules on the calculation of the leverage ratio were amended to align with the European Commission's interpretation of the revised Basel III leverage ratio framework. The Group's leverage ratio has been calculated in accordance with the amended CRD IV rules on leverage.

The table on the next page summarises the component parts of the Group's leverage ratio. Further analysis is provided in the Group's Pillar 3 Report.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Table 1.59: Leverage ratio

|  | <b>Fully loaded</b>   |                             |
|--|-----------------------|-----------------------------|
|  | <b>At 31 Dec 2015</b> | At 31 Dec 2014 <sup>1</sup> |
|  | <b>£m</b>             | £m                          |
| <b>Total tier 1 capital</b>                        | <b>33,860</b>         | 36,044                      |
| <b>Exposure measure</b>                            |                       |                             |
| Derivative financial instruments                   | <b>29,467</b>         | 36,128                      |
| Securities financing transactions (SFTs)           | <b>34,136</b>         | 43,772                      |
| Loans and advances and other assets                | <b>743,085</b>        | 774,996                     |
| <b>Total statutory balance sheet assets</b>        | <b>806,688</b>        | 854,896                     |
| Deconsolidation and other adjustments <sup>2</sup> | <b>(135,926)</b>      | ) (144,122 )                |
| Derivatives adjustments                            | <b>(9,235)</b>        | ) (12,064 )                 |
| Counterparty credit risk add-on for SFTs           | <b>3,361</b>          | 1,364                       |
| Off-balance sheet items                            | <b>56,424</b>         | 50,980                      |
| Regulatory deductions and other adjustments        | <b>(9,112)</b>        | ) (10,362 )                 |
| <b>Total exposure</b>                              | <b>712,200</b>        | 740,692                     |
| <b>Leverage ratio</b>                              | <b>4.8%</b>           | 4.9%                        |

<sup>1</sup> Restated to align with the amended CRD IV rules on leverage implemented in January 2015.

<sup>2</sup> Deconsolidation adjustments predominantly reflect the deconsolidation of assets related to Group subsidiaries that fall outside the scope of the Group's regulatory consolidation (primarily the Group's insurance entities).

**KEY MOVEMENTS**

The Group's fully loaded leverage ratio reduced by 0.1 per cent to 4.8 per cent reflecting the impact of the reduction in tier 1 capital offset by the £28.5 billion reduction in the exposure measure, the latter largely reflecting the reduction in balance sheet assets arising, in part, from the disposal of TSB.

The derivatives exposure measure, representing derivative financial instruments per the balance sheet net of deconsolidation and derivatives adjustments, reduced by £3.7 billion reflecting a combination of market movements, trading activity and trade compressions and the recognition and subsequent deduction of receivable assets for eligible cash variation margin provided in derivative transactions.

The SFT exposure measure, representing SFTs per the balance sheet inclusive of deconsolidation adjustments and counterparty credit risk add-on, reduced by £9.7 billion primarily reflecting active balance sheet management and reduced trading volumes.

Off-balance sheet items increased by £5.4 billion, primarily reflecting an increase in new corporate lending facilities and corporate customer limits and an increase in new residential mortgage offers placed.

## **G-SIB REQUIREMENTS**

Although the Group is not currently classified as a Global Systemically Important Bank (G-SIB), by virtue of the leverage exposure exceeding €200 billion, the Group is required to report G-SIB metrics to the PRA. The Group's metrics used within the 2015 Basel G-SIBs annual exercise will be disclosed from April 2016, 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.

On 31 December 2015, the long-term insurance business of seven life insurance companies within the Group were transferred to Clerical Medical Investment Group Limited (CMIG) pursuant to an insurance business transfer scheme, under Part VII of the Financial Services and Markets Act 2000. Scottish Widows plc and CMIG hold the only with-profit funds managed by the Group, and the Scottish Widows plc with-profit fund was transferred to a new with-profit fund within CMIG. On 31 December 2015, CMIG changed its name to Scottish Widows Limited (SW Ltd), and Scottish Widows plc changed its name to SW Funding plc.

Each life insurance company within the Group is regulated by the PRA. The PRA specifies the minimum amount of capital that must be held by each life insurance company within the Group. Under the PRA rules, applying during the year, each life insurance company within the Group must hold assets in excess of the higher of:

- (i) the Pillar 1 amount, which is calculated by applying fixed percentages of mathematical reserves and capital at risk; and
- (ii) the Pillar 2 amount, which is derived from an economic capital assessment undertaken by each regulated life insurance company, which is reviewed by the PRA.

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.

During the year Scottish Widows Group Limited (SWG) was also subject to the capital adequacy requirements of the Insurance Group Directive (IGD), which comprises the consolidated surplus of the Group's regulated insurance subsidiaries.

All minimum regulatory requirements of the life insurance companies are expected to be met during the year.

The new Solvency II regime for insurers and insurance groups is in force from 1 January 2016. The insurance businesses are required to calculate capital requirements and available capital on a revised risk-based approach. The insurance business of the Group will calculate regulatory capital from 1 January 2016 on the basis of an internal model, which was approved by the PRA on 5 December 2015. The estimated solvency II capital ratio of SWG at 1 January 2016 was 148 per cent before allowing for dividends.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**REGULATORY AND LEGAL RISK**

**DEFINITION**

Regulatory and legal risk is defined as the risk that the Group is exposed to fines, censure, legal or enforcement action, civil or criminal proceedings in the courts (or equivalent) and risk that the Group is unable to enforce its rights as anticipated.

**RISK APPETITE**

The Group has a zero risk appetite for material regulatory breaches or material legal incidents. This appetite is reviewed and approved annually by the Board. To achieve this, the Group has policies, processes and standards which provide the framework for businesses and colleagues to operate in accordance with applicable laws (including Codes of Practice), regulations, codes of conduct and legal obligations.

For further information on risk appetite refer to page 46.

**EXPOSURES**

The Group periodically experiences material regulatory breaches and material legal incidents outside its risk appetite. Exposure is also driven by significant ongoing and new legislation, regulation and court proceedings within the UK and overseas with which the Group has to comply, which in each case needs to be interpreted, implemented and embedded into day-to-day operational and business practices across the Group. The industry continues to witness increased levels of government and regulatory intervention in the financial sector with increasing regulatory rules and laws from both the UK and overseas affecting the Group's operations.

**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

Mitigation is undertaken across the Group and comprises 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 controls to assure 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 produce regularly 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.

When appropriate Risk Division will conduct thematic reviews of regulatory compliance across businesses and divisions.

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.

## **INSURANCE RISK**

### **DEFINITION**

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

### **RISK APPETITE**

Insurance risk appetite in the Insurance business is set by the Insurance Board and includes capital and earnings limits on insurance risk drivers.

Insurance risk appetite for longevity in the defined benefit pension schemes is set by the Board using two key metrics: a one year increase to life expectancy, and a combined market and longevity stress.

For further information on risk appetite, refer to page 46.

### **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 following the 2015 entry into 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.



## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 floodings, 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 (Group defined benefit pension schemes utilise 1-in-20 year stresses) and other supporting measures where appropriate, including those set out in note 34 to the financial statements.

### MITIGATION

Insurance risk in the Insurance business is mitigated in a number of ways:

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.

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.

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 (one Group executive sub-committee and a supporting management committee). 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.

## **PEOPLE RISK**

### **DEFINITION**

People risk is defined as the risk that the Group fails to lead, manage and enable colleagues to deliver to customers, shareholders and regulators leading to an inability to deliver the Group's strategy.

### **RISK APPETITE**

The Group's people risk appetite and corresponding measures enable the Group to lead responsibly and proficiently, manage people resources effectively, support and develop colleague talent, and meet legal and regulatory obligations related to its people.

The appetite is reviewed and approved annually by the Board. To stay within appetite, the Group has policies, processes and standards which provide the framework for business and colleagues to operate in accordance with the

laws, regulations and voluntary codes which apply to the Group and its activities.

For further information on risk appetite, refer to page 46.

## 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:

The new Senior Managers and Certification Regime (SM&CR), which brings a statutory duty of responsibility and increased accountability may impact the Group's ability to attract and retain talent;

Attracting and retaining talent may be impacted by a more active external market alongside increasing regulatory constraints around remuneration structures;

The increasing digitisation of the business is changing the capability mix required and may impact our ability to attract and retain talent;

Colleague engagement may continue to be challenged by ongoing media attention on banking sector culture, sales practices and ethical conduct; and

Maintaining organisational people capability and capacity levels in response to increasing volumes of organisational and external market change.

118

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### 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:

Working with the regulators to ensure their guidance on increased accountability in the new SM&CR strengthens remuneration governance to balance implementation costs with the benefits gained from enhanced governance;

Continued focus on the Group's culture by developing and delivering initiatives that reinforce the appropriate conduct behaviours which generate the best possible long-term outcomes for customers and colleagues;

Maintain effective remuneration arrangements to ensure they promote an appropriate culture and colleague behaviours that meet customer needs and regulatory expectations;

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

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 HR & 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, is intended to assess 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, Compliance, Conduct 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 financial and regulatory reporting, failure to manage the associated risks of changes in taxation rates, law, ownership or corporate structure and the failure to disclose accurate and timely information.

### **RISK APPETITE**

The risk appetite is set by the Board and reviewed on an annual basis or more frequently. It includes complying with statutory and regulatory reporting requirements and compliance with tax legislation in the jurisdictions in which the Group operates.

For further information on risk appetite refer to page 46.

### **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 market 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

119

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 174 to 177.

## 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.

### RISK APPETITE

Governance risk appetite is defined and embedded through the Group's Governance Principle and Policy Framework which are reviewed and approved by the Board on an annual basis. The Group has governance arrangements that support the effective long-term operation of the business and the vision of being the best bank for customers, maximise shareholder value and meet regulatory and social expectations.

For further information on risk appetite refer to page 46.

## **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.

## **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 Groupwide behaviour and risk decision making through a Group Policy Framework which helps everyone understand their responsibilities by clearly articulating and communicating rules, 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 2015 evolution of frameworks to address Senior Managers and Certification Regime (SM&CR) requirements and the recommendations from a third party review of the Three Lines of Defence.

For further information on Corporate Governance see pages 156 to 182.

120

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

## INVESTMENT PORTFOLIO, MATURITIES, DEPOSITS, SHORT-TERM BORROWINGS

**Trading securities and other financial assets at fair value through profit or loss; available-for-sale financial assets; held-to-maturity investments; and debt securities classified as loans and receivables**

The following table sets out the book values and valuations of the Group's debt securities, treasury and other bills and equity shares at 31 December for each of the three years indicated.

|   | <b>2015<br/>Book<br/>value<br/>£m</b> | <b>2015<br/>Valuation<br/>£m</b> | 2014<br>Book<br>value<br>£m | 2014<br>Valuation<br>£m | 2013<br>Book<br>value<br>£m | 2013<br>Valuation<br>£m |
|---|---------------------------------------|----------------------------------|-----------------------------|-------------------------|-----------------------------|-------------------------|
| Trading securities and other financial assets<br>at fair value through profit or loss |                                       |                                  |                             |                         |                             |                         |
| US treasury and US government agencies  | 663                                   | 663                              | 658                         | 658                     | 922                         | 922                     |
| Other government securities   | 21,454                                | 21,454                           | 24,815                      | 24,815                  | 19,767                      | 19,767                  |
| Other public sector securities  | 2,039                                 | 2,039                            | 2,170                       | 2,170                   | 2,197                       | 2,197                   |
| Bank and building society certificates of<br>deposit                                  | 135                                   | 135                              | 554                         | 554                     | 1,491                       | 1,491                   |
| Mortgage-backed securities  | 1,358                                 | 1,358                            | 1,034                       | 1,034                   | 798                         | 798                     |
| Other asset-backed securities   | 847                                   | 847                              | 850                         | 850                     | 927                         | 927                     |
| Corporate and other debt securities   | 20,316                                | 20,316                           | 22,090                      | 22,090                  | 20,620                      | 20,620                  |
| Treasury bills and other bills  | 74                                    | 74                               | 1,459                       | 1,459                   | 115                         | 115                     |
| Equity shares   | 60,476                                | 60,476                           | 61,576                      | 61,576                  | 66,403                      | 66,403                  |
|   | 107,362                               | 107,362                          | 115,206                     | 115,206                 | 113,240                     | 113,240                 |
| Available-for-sale financial assets   |                                       |                                  |                             |                         |                             |                         |
| US treasury and US government agencies  | 6,349                                 | 6,349                            | 7,226                       | 7,226                   | 6,594                       | 6,594                   |
| Other government securities   | 18,980                                | 18,980                           | 40,176                      | 40,176                  | 31,696                      | 31,696                  |
| Bank and building society certificates of<br>deposit                                  | 186                                   | 186                              | 298                         | 298                     | 208                         | 208                     |
| Mortgage-backed securities  | 197                                   | 197                              | 674                         | 674                     | 1,263                       | 1,263                   |
| Other asset-backed securities   | 319                                   | 319                              | 685                         | 685                     | 915                         | 915                     |
| Corporate and other debt securities   | 5,808                                 | 5,808                            | 5,529                       | 5,529                   | 1,855                       | 1,855                   |
| Treasury bills and other bills  | –                                     | –                                | 863                         | 863                     | 875                         | 875                     |
| Equity shares   | 1,193                                 | 1,193                            | 1,042                       | 1,042                   | 570                         | 570                     |
|   | 33,032                                | 33,032                           | 56,493                      | 56,493                  | 43,976                      | 43,976                  |
| Held-to-maturity investments  |                                       |                                  |                             |                         |                             |                         |
| UK government   | 19,808                                | 19,851                           | –                           | –                       | –                           | –                       |
| Debt securities classified as loans and<br>receivables                                |                                       |                                  |                             |                         |                             |                         |
| Mortgage-backed securities  | 2,528                                 | 2,493                            | 190                         | 155                     | 333                         | 285                     |

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|                                     |       |       |       |       |       |       |
|-------------------------------------|-------|-------|-------|-------|-------|-------|
| Other asset-backed securities       | 1,234 | 1,173 | 985   | 900   | 740   | 668   |
| Corporate and other debt securities | 526   | 441   | 164   | 45    | 407   | 298   |
|                                     | 4,288 | 4,107 | 1,339 | 1,100 | 1,480 | 1,251 |
| Allowance for impairment losses     | (97   | ) –   | (126  | ) –   | (125  | ) –   |
|                                     | 4,191 | 4,107 | 1,213 | 1,100 | 1,355 | 1,251 |

121

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MATURITIES AND WEIGHTED AVERAGE YIELDS OF INTEREST-BEARING SECURITIES**

The weighted average yield for each range of maturities is calculated by dividing the annualised interest income prevailing at 31 December 2015 by the book value of securities held at that date.

|   | <b>Maturing within one year</b> |                    | <b>Maturing after one but within five years</b> |                    | <b>Maturing after five but within ten years</b> |                    | <b>Maturing after ten years</b> |                    |
|---|---------------------------------|--------------------|---|--------------------|---|--------------------|---------------------------------|--------------------|
|   | <b>Amount<br/>£m</b>            | <b>Yield<br/>%</b> | <b>Amount<br/>£m</b>                            | <b>Yield<br/>%</b> | <b>Amount<br/>£m</b>                            | <b>Yield<br/>%</b> | <b>Amount<br/>£m</b>            | <b>Yield<br/>%</b> |
| <b>Trading securities and other financial assets at fair value through profit or loss</b> |                                 |                    |   |                    |   |                    |                                 |                    |
| US treasury and US government agencies  | 12                              | 1.3                | 417   | 1.0                | 107   | 1.7                | 127                             | 3.0                |
| Other government securities   | 655                             | 4.5                | 3,456   | 2.3                | 2,856   | 2.5                | 14,487                          | 2.7                |
| Other public sector securities  | 34                              | 3.7                | 18  | 5.6                | 48  | 4.4                | 1,939                           | 1.7                |
| Bank and building society certificates of deposit   | 135                             | 0.3                | –   | –                  | –   | –                  | –                               | –                  |
| Mortgage-backed securities  | –                               | –                  | 11  | 1.5                | 136   | 2.1                | 1,211                           | 1.7                |
| Other asset-backed securities   | –                               | –                  | 107   | 3.5                | 393   | 3.2                | 347                             | 2.4                |
| Corporate and other debt securities   | 14,703                          | 3.2                | 3,897   | 5.4                | 602   | 4.7                | 1,114                           | 4.7                |
| Treasury bills and other bills  | 74                              | 0.2                | –   | –                  | –   | –                  | –                               | –                  |
|   | <b>15,613</b>                   |                    | <b>7,906</b>                                    |                    | <b>4,142</b>                                    |                    | <b>19,225</b>                   |                    |
| <b>Available-for-sale financial assets</b>  |                                 |                    |   |                    |   |                    |                                 |                    |
| US treasury and US government agencies  | –                               | –                  | 3,077   | 2.3                | 1,676   | 4.9                | 1,596                           | 5.9                |
| Other government securities   | 335                             | 7.5                | 1,509   | 4.2                | 1,771   | 2.0                | 15,365                          | 4.0                |
| Bank and building society certificates of deposit   | 186                             | –                  | –   | –                  | –   | –                  | –                               | –                  |
| Mortgage-backed securities  | 60                              | 1.8                | 23  | 1.4                | –   | –                  | 114                             | 1.6                |
| Other asset-backed securities   | –                               | –                  | –   | –                  | 37  | 0.5                | 282                             | 0.9                |
| Corporate and other debt securities   | 508                             | 2.3                | 3,569   | 0.9                | 1,731   | 1.3                | –                               | –                  |
|   | <b>1,089</b>                    |                    | <b>8,178</b>                                    |                    | <b>5,215</b>                                    |                    | <b>17,357</b>                   |                    |
| <b>Held-to-maturity investments</b>   |                                 |                    |   |                    |   |                    |                                 |                    |
| Other government securities   | –                               | –                  | 3,654   | 3.0                | 16,154  | 3.7                | –                               | –                  |
| <b>Debt securities classified as loans and receivables</b>                                |                                 |                    |   |                    |   |                    |                                 |                    |
| Mortgage-backed securities  | –                               | –                  | –   | –                  | 30  | 2.0                | 2,498                           | 1.1                |
| Other asset-backed securities   | 75                              | 0.9                | 223   | 0.4                | 739   | 1.2                | 197                             | 2.1                |
| Corporate and other debt securities   | 33                              | –                  | 13  | –                  | 410   | 5.4                | 70                              | 0.4                |
|   | <b>108</b>                      |                    | <b>236</b>                                      |                    | <b>1,179</b>                                    |                    | <b>2,765</b>                    |                    |

The Group's investment holdings at 31 December 2015 include £57,599 million due from the UK government and its agencies and £7,011 million due from the US government and its agencies.

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**MATURITY ANALYSIS AND INTEREST RATE SENSITIVITY OF LOANS AND ADVANCES TO CUSTOMERS AND BANKS AT 31 DECEMBER 2015**

The following table analyses the maturity profile and interest rate sensitivity of loans by type on a contractual repayment basis at 31 December 2015. Following the reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

All amounts are before deduction of impairment allowances. Demand loans are included in the 'maturing in one year or less' category.

|  | <b>Maturing in one<br/>year or less<br/>£m</b> | <b>Maturing after<br/>one but within<br/>five years<br/>£m</b> | <b>Maturing after<br/>five years<br/>£m</b> | <b>Total<br/>£m</b> |
|--|--|--|---|---------------------|
| Loans and advances to banks            | 20,645   | 3,860  | 612   | 25,117              |
| Loans and advances to customers:       |  |  |   |                     |
| Mortgages                              | 11,357   | 47,944   | 253,576                                     | 312,877             |
| Other personal lending                 | 6,072  | 4,562  | 9,945                                       | 20,579              |
| Property companies                     | 4,835  | 10,567   | 16,826                                      | 32,228              |
| Financial, business and other services | 16,893   | 17,122   | 9,057                                       | 43,072              |
| Transport, distribution and hotels     | 6,088  | 4,762  | 2,676                                       | 13,526              |
| Manufacturing                          | 3,122  | 2,069  | 762   | 5,953               |
| Other                                  | 9,744  | 11,993   | 8,236                                       | 29,973              |
| Total loans                            | 78,756   | 102,879  | 301,690                                     | 483,325             |
| Of which:                              |  |  |   |                     |
| Fixed interest rate                    | 23,673   | 46,054   | 113,697                                     | 183,424             |
| Variable interest rate                 | 55,083   | 56,825   | 187,993                                     | 299,901             |
|  | 78,756   | 102,879  | 301,690                                     | 483,325             |

**DEPOSITS**

The following tables show the details of the Group's average customer deposits in each of the past three years.

| <b>2015<br/>Average<br/>balance</b> | <b>2015<br/>Average<br/>rate</b> | 2014<br>Average<br>balance | 2014<br>Average<br>rate | 2013<br>Average<br>balance | 2013<br>Average<br>rate |
|-------------------------------------|----------------------------------|----------------------------|-------------------------|----------------------------|-------------------------|
|-------------------------------------|----------------------------------|----------------------------|-------------------------|----------------------------|-------------------------|

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|                                      | £m             | %           | £m             | %           | £m             | %           |
|--------------------------------------|----------------|-------------|----------------|-------------|----------------|-------------|
| Non-interest bearing demand deposits | 45,294         | –           | 42,049         | –           | 35,994         | –           |
| Interest-bearing demand deposits     | 83,756         | 0.47        | 82,545         | 0.80        | 75,704         | 0.55        |
| Savings deposits                     | 174,239        | 1.00        | 201,046        | 1.18        | 266,122        | 1.93        |
| Time deposits                        | 122,142        | 0.99        | 133,060        | 1.32        | 56,055         | 1.02        |
| <b>Total average deposits</b>        | <b>425,431</b> | <b>0.79</b> | <b>458,700</b> | <b>1.04</b> | <b>433,875</b> | <b>1.41</b> |

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

### CERTIFICATES OF DEPOSIT AND OTHER TIME DEPOSITS

The following table gives details of the Group's certificates of deposit issued and other time deposits at 31 December 2015 individually in excess of US \$100,000 (or equivalent in another currency) by time remaining to maturity. Following the continuing reduction in the Group's non-UK activities, an analysis between domestic and foreign operations is not provided.

|                         | <b>3 months<br/>or less<br/>£m</b> | <b>Over 3 months<br/>but within<br/>6 months<br/>£m</b> | <b>Over 6 months<br/>but within<br/>12 months<br/>£m</b> | <b>Over<br/>12<br/>months<br/>£m</b> | <b>Total<br/>£m</b> |
|-------------------------|------------------------------------|---|--|--------------------------------------|---------------------|
| Certificates of deposit | <b>5,827</b>                       | <b>1,781</b>  | <b>3,452</b>   | <b>37</b>                            | <b>11,097</b>       |
| Time deposits           | <b>28,879</b>                      | <b>8,074</b>  | <b>7,023</b>   | <b>5,148</b>                         | <b>49,124</b>       |
| <b>Total</b>            | <b>34,706</b>                      | <b>9,855</b>  | <b>10,475</b>  | <b>5,185</b>                         | <b>60,221</b>       |

123

## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

**SHORT-TERM BORROWINGS**

Short-term borrowings are included within the balance sheet captions 'Deposits by banks', 'Customer accounts' and 'Debt securities in issue' and are not identified separately on the balance sheet. The short-term borrowings of the Group consist of overdrafts from banks, securities sold under agreements to repurchase, notes issued as part of lending securitisations, certificates of deposit issued, commercial paper and promissory notes issued and other marketable paper. Securities sold under agreements to repurchase, certificates of deposit issued, commercial paper, securitisation notes and covered bonds are the only significant short-term borrowings of the Group.

The following tables give details of these significant short-term borrowings of the Group for each of the past three years.

|  | <b>2015</b>   | 2014   | 2013   |
|--|---------------|--------|--------|
|  | <b>£m</b>     | £m     | £m     |
| <b>Liabilities in respect of securities sold under repurchase agreements</b> |               |        |        |
| Balance at the year end  | <b>7,061</b>  | 1,075  | 4,852  |
| Average balance for the year   | <b>5,960</b>  | 2,104  | 6,515  |
| Maximum balance during the year  | <b>9,467</b>  | 9,971  | 27,801 |
| Average interest rate during the year  | <b>0.6%</b>   | 1.1%   | 1.2%   |
| Interest rate at the year end  | <b>0.6%</b>   | 1.2%   | 0.6%   |
| <b>Certificates of deposit issued</b>  |               |        |        |
| Balance at the year end  | <b>11,101</b> | 7,033  | 8,866  |
| Average balance for the year   | <b>11,708</b> | 9,912  | 13,145 |
| Maximum balance during the year  | <b>13,925</b> | 11,376 | 14,343 |
| Average interest rate during the year  | <b>0.4%</b>   | 0.4%   | 0.9%   |
| Interest rate at the year end  | <b>0.2%</b>   | 0.3%   | 0.6%   |
| <b>Commercial paper</b>  |               |        |        |
| Balance at the year end  | <b>6,663</b>  | 7,373  | 5,035  |
| Average balance for the year   | <b>5,286</b>  | 8,432  | 10,878 |
| Maximum balance during the year  | <b>12,700</b> | 14,768 | 18,313 |
| Average interest rate during the year  | <b>0.6%</b>   | 0.3%   | 0.5%   |
| Interest rate at the year end  | <b>0.0%</b>   | 0.1%   | 0.5%   |
| <b>Securitisation notes</b>  |               |        |        |
| Balance at the year end  | <b>7,763</b>  | 11,908 | 18,613 |
| Average balance for the year   | <b>10,362</b> | 13,836 | 22,246 |
| Maximum balance during the year  | <b>12,155</b> | 15,787 | 28,059 |
| Average interest rate during the year  | <b>2.4%</b>   | 2.1%   | 2.4%   |
| Interest rate at the year end  | <b>2.7%</b>   | 2.0%   | 2.0%   |
| <b>Covered bonds</b>   |               |        |        |
| Balance at the year end  | <b>27,200</b> | 27,191 | 30,667 |
| Average balance for the year   | <b>26,503</b> | 29,754 | 37,138 |



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|                                       |               |        |        |
|---------------------------------------|---------------|--------|--------|
| Maximum balance during the year       | <b>27,200</b> | 31,684 | 40,673 |
| Average interest rate during the year | <b>4.2%</b>   | 4.5%   | 3.7%   |
| Interest rate at the year end         | <b>3.7%</b>   | 4.3%   | 4.2%   |

124

## MANAGEMENT AND EMPLOYEES

### **DIRECTORS AND SENIOR MANAGEMENT**

The Group is led by the Board comprising a Chairman (who was independent on appointment), independent Non-Executive Directors and Executive Directors with a wide range of experience. The appointment of directors is considered by the Nomination & Governance Committee and approved by the Board. Following the provisions in the articles of association, directors must stand for election by the shareholders at the first annual general meeting following their appointment. In line with UK Corporate Governance best practice, all Directors are subject to annual re-election by shareholders at each annual general meeting thereafter. Independent Non-Executive Directors are appointed for an initial term of three years after which their appointment may continue subject to an annual review. Their appointment may be terminated, in accordance with statute and the articles of association, at any time with immediate effect and without compensation.

The Board meets regularly. In 2015, a total of 10 Board meetings were held, 8 of which were scheduled at the start of the year.

The roles of the Chairman, the Group Chief Executive and the Board and its governance arrangements, including the schedule of matters specifically reserved to the Board for decision, are reviewed annually. The matters reserved to the Board for decision include the approval of the annual report and accounts and any other financial statements; the payment of dividends; the long-term objectives of the Group; the strategies necessary to achieve these objectives; the Group's budgets and plans; significant capital expenditure items; significant investments and disposals; the basis of allocation of capital within the Group; the organisational structure of the Group; the arrangements for ensuring that the Group manages risks effectively; any significant change in accounting policies or practices; the appointment of the Company's main professional advisers and their fees; and the determination of Board and Committee structures, together with their size and composition.

According to the articles of association, the business and affairs of the Company are managed by the Directors, who have delegated to management the power to make decisions on operational matters, including those relating to credit, liquidity and market risk, within an agreed framework.

All Directors have access to the services of the Company Secretary, and independent professional advice is available to the Directors at the Group's expense, where they judge it necessary to discharge their duties as directors.

The Chairman has a private discussion at least once a year with each Director on a wide range of issues affecting the Group, including any matters which the Directors, individually, wish to raise.

There is an induction programme for all Directors, which is tailored to their specific requirements having regard to their specific role on the Board and their skills and experience to date. Major shareholders are also offered the opportunity to meet new Non-Executive Directors.

The Directors and senior management of Lloyds Banking Group plc are:

## **NON-EXECUTIVE DIRECTORS**

### **LORD BLACKWELL**

*Chairman*

*Age: 63*

Chairman of the Nomination & Governance Committee, Member of the Risk Committee, the Remuneration Committee and the Responsible Business Committee.

Appointed: June 2012 (Board), April 2014 (Chairman)

Skills and experience: Lord Blackwell has deep financial services knowledge as well as extensive insurance, banking, 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. He was previously the Chairman of Scottish Widows Group and Interserve plc, a former Senior Independent Director of Standard Life and also chaired their UK Life and Pensions Board. His other former Non-Executive Directorships have included Halma plc, Dixons Group and SEGRO. He was also a member of the Board of the Centre for Policy Studies, a Non-Executive Board Member of Ofcom and of the Office of Fair Trading, a Partner of McKinsey & Co. and a Director of Group Development at NatWest Group. He was Head of the Prime Minister's Policy Unit from 1995 to 1997 and was appointed a Life Peer in 1997.

External appointments: None.

### **ANITA FREW**

*Deputy Chairman and Independent Director*

*Age: 58*

Chairman of the Remuneration Committee, Member of the Audit Committee, the Risk Committee, the Nomination & Governance Committee and the Responsible Business Committee.

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 management, manufacturing and utilities. Her extensive board level experience makes her an effective Deputy Chairman. Anita was Chairman of Victrex plc, having previously been its Senior Independent Director. She was also the Senior Independent Director of Aberdeen Asset Management and IMI plc, an Executive Director of Abbott Mead Vickers, Director of Corporate Development at WPP Group and a Non-Executive Director of Northumbrian Water. She has held various investment and marketing roles at Scottish Provident and the Royal Bank of Scotland.

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

125

MANAGEMENT AND EMPLOYEES

**ALAN DICKINSON**

*Independent Director*

*Age: 65*

Chairman of the Risk Committee, Member of the Audit Committee, the Remuneration Committee and the Nomination & Governance Committee.

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. Alan's strategic focus and core banking experience complements the balance of skills on the Board. More recently he was Chairman of Brown, Shipley & Co. Limited, a Non-Executive Director of Nationwide Building Society and Chairman of its Risk Committee and a Non-Executive Director of Carpetright plc.

External appointments: Non-Executive Director of Willis Limited and Chairman of its Risk Committee, Senior Independent Director of Urban & Civic plc and a Governor of Motability.

**SIMON HENRY**

*Independent Director*

*Age: 54*

Member of the Audit Committee and the Risk Committee.

Appointed: June 2014

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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 the Board Risk and Audit Committees. He was previously Shell's Chief Financial Officer for Exploration & Production and prior to that Head of Group Investor Relations.

External appointments: Chief Financial Officer and an Executive Director of Royal Dutch Shell plc with responsibility for Shell's Finance, IT, Strat